How Do Firms Protect Competitively Sensitive Information? The Case of Franchising

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Abstract:

This paper explores the types of contract clauses that franchisors rely on to protect competitively sensitive information. Based on a sample of contracts obtained from franchise disclosure documents (FDDs) for a set of 298 franchisors whose FDDs are available circa both 2010 and 2020, we show that franchisors use several different covenants to protect sensitive information about their business. These include confidentiality clauses, non-competition covenants, non-recruitment clauses, and covenants requiring that the franchisee participate in the operation of the business. Moreover, the contracts impose requirements not only on the franchisee, but also on other individuals, notably the franchisee's business partners as well as family members, and employees. In fact, a number of franchisors require that such individuals sign additional, separate covenants. We find that the extent to which franchisors use various covenants has not changed much between 2010 and 2020, with the exception of non-recruitment clauses. However, the reliance on these covenants varies across industries. Our results on the extent and application of the restrictions allow us to contribute to the current policy debate regarding many of these types of covenants in both commercial and employment contracts, much of which has focused on their negative effect on labor mobility rather than their potentially important role in protecting valuable information from competitors.

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1. INTRODUCTION

Firms have a strong interest in protecting their intellectual property and competitively sensitive information, such as inventions, trade secrets and confidential information (Besen and Raskind, 1991). The legal system provides different means of achieving this goal. Patents are known for embodying strong intellectual property (IP) rights, but trade secrets and other laws complement the IP regime beyond the patent system. The choice as to how best to protect competitively sensitive information depends on several factors beyond the fact that patents do not always represent a feasible path (Friedman, Landes and Posner, 1991; Posner, 2005). In fact, evidence suggests that firms rely more on informal rather than formal IP protection mechanisms (Hall, Helmers, Rogers and Sena, 2014), especially when the aim is to protect process information rather than the invention of new products (Levin, Klevorick, Nelson, Winter, Gilbert and Griliches, 1987).

In this paper, we explore how firms use specific clauses in their contracts to exercise control over the dissemination of and protect competitively sensitive information.[1] We do this in the context of franchising, which has (at least) two important advantages for our purposes. First, the Federal Trade Commission (FTC) requires that franchisors provide specific documentation to potential franchisees in the form of a Franchise Disclosure Document, or FDD, and some states further require that these documents be filed with a state agency. Recent efforts by various organizations to make these documents available more broadly on the internet have meant that it is now possible to access large numbers of FDDs, each of which includes the franchise agreement and other relevant contracts.[2] Second, franchising offers opportunities to investigate commercial as well as employment relationships because, depending on the specific clause considered, the covered individuals in the contracts may be a franchisee (or business partner) or an employee.

The protection of competitively sensitive information is a central issue for business-format franchisors, such as Jimmy John's and the UPS Store, because their main business is to develop a business model, along with associated trademarks and supply or other relationships,

[1] Following Hall, Helmers, Rogers and Sena (2014), firms can choose between "formal" intellectual property (IP) protection mechanisms, which include patents, trademarks, registered designs, and copyright, and "informal" appropriation mechanisms, such as secrecy, confidentiality agreements, lead time, or complexity. Similarly, Gallié and Legros (2012) distinguish between statutory protection mechanisms (referred to here as formal IP mechanisms) and non-statutory protection mechanisms (informal IP mechanisms).

[2] Obtaining access to these documents used to be time consuming and/or expensive, while now they are relatively cheaper and accessible from multiple sources.

that they then make available to franchisees in exchange for compensation.[3] In other words, they derive their revenues from proprietary methods and know-how, and so preventing the dissemination or appropriation of these by copycats and competitors is a central concern for these firms.

Trade secrets, know-how, and other competitively sensitive information, however, are embedded in both workers and firms (Kitch, 1980; Becker, 2009), and three main channels usually favor the dissemination of such information: competitive intelligence, business transactions, and departing employees (Lemley, 2008). A statistical analysis of trade secrets litigation in federal courts reveals that in over 85% of cases, the alleged channel is an employee or a business partner (Almeling, Snyder and Sapoznikow, 2009).[4]

From the trade literature and the set of franchise contracts we examine in detail, garnered from 298 franchised companies that we observe in both 2010 and 2020, we identified the following covenants as principal means that franchisors use as informal IP mechanisms to protect competitively sensitive information from dissemination by commercial partners (i.e. franchisees, franchisees' business owners and partners, and directors and officers) and by workers (i.e. franchisees' managers and employees): confidentiality, non-competition, and non-recruitment covenants, as well as covenants that require that the franchisee be directly involved in the operation of the business.[5] We discuss both the use, scope and structure of these clauses, while also noting how they can affect the business and employment relationships in franchised chains.

2. PREVIOUS LITERATURE

In this section we briefly discuss the literature on the use of non-compete covenants and other covenants in employment contracts, and the related literature on franchising that has considered the role and effect of such clauses.

A series of studies have shown that the use of non-compete covenants in employment contracts is quite widespread in the U.S., that such covenants cover not only highly

[3] Traditional, or product and tradename franchising is characterized by a franchisor that makes a product available for resale by the franchisee. While the franchisor in this context will also typically have a set of rules as to how the retail business should operate, much of the intellectual property is embedded in the product itself, and as such, protecting the intangible intellectual property associated with the retail activities is less of an issue in this type of organization.

[4] Of course, case law represents a selected set of matters that may not be representative. For more on this issue, see Priest and Klein (1984).

[5] These covenants are either a clause in the franchise contract or embedded in a separate contractual agreement that the covered individual signs.

compensated workers but also a good number of low-wage and low-skilled workers, and that these covenants have anticompetitive effects in the form of lower wages for at least some of these workers.[6] In particular, an individual employee-level survey conducted in 2014 found that 18 percent of private sector and public sector healthcare workers were covered by non-compete covenants, while 38 percent indicated they had signed one in the past, at least once (Prescott, Bishara and Starr, 2016; Starr, Prescott, and Bishara, 2021). An establishment-level survey conducted in 2017 further showed that 49 percent of establishments have at least some employees covered by a non-compete covenants, with nearly a third indicated that they rely on such covenants with all employees (Colvin and Shierholz, 2019). Similar findings emerge from studies focused on specific occupations, such as executives (Schwab and Thomas, 2006; Garmaise, 2011), engineers (Marx, Magne, Nahid-Mobarakeh, Pierfederici and Davat, 2011), physicians (Lavetti, Simon and White, 2020), and hairstylists (Johnson and Lipsitz, 2022).

Non-compete covenants, however, are not the only tool used by firms to restrict what former employees can do. An analysis of a sample of CEO employment contracts shows that, in addition to non-compete covenants, 75.6 percent of CEOs are banned from soliciting the firms' employees upon the CEO's departure, 50.8 percent ban the solicitation of customers or clients, and 87.1% prohibit the disclosure of confidential information (Bishara, Martin and Thomas, 2015). Leveraging two large-scale surveys (at the firm and worker level), Balasubramanian, Starr and Yamaguchi (2021) find that firms use bundles of covenants – namely, non-disclosure (covering 57 percent of workers), non-solicitation (covering 28 percent of workers), non-recruitment (covering 24 percent of workers), and non-compete (covering 22 percent of workers) – to restrict what former employees can do.

In the context of franchising, researchers have examined the extent and effects of a specific clause commonly known as a no-poaching clause found in a number of franchise contracts (Krueger and Ashenfelter; 2022; Callaci, Gibson, Pinto, Steinbum and Walsh, 2023; Lafontaine, Saattvic and Slade, 2023). Such clauses limit the franchisees' ability to hire each other employees within the same chain, so they limit intra-brand labor mobility. These clauses apply to employees within the chain, and so they cannot serve the purpose of protecting competitively sensitive information from outsiders. As a result, we do not consider these here.

[6] See the recent FTC proposal to ban non-compete agreements for a survey of this literature: FTC, January 5th, 2023, https://www.ftc.gov/news-events/news/press-releases/2023/01/ftc-proposes- rule-ban-noncompete-clauses-which-hurt-workers-harm-competition

More closely related to our research, Callaci (2021) and Callaci, Pinto, Steinbum and Walsh (2022) study the incidence of certain vertical restraints, including covenants not to compete and personal obligations to operate the franchised business, in a sample of 530 digitized franchised contracts. Callaci (2021) finds that covenants not to compete are ubiquitous in franchise agreements, with an average duration of 19 months. He also finds that 35 percent of contracts include a personal obligation to operate the business. For his part, Norlander (2023) exploits a set of 17,785 FDDs from an undisclosed number of franchisors and machine learning tools and finds that 25 percent of these include "suspected" "no-hire" statement (defined by the author as a statement barring franchisees from hiring workers), and 26 percent include language supportive of, or requiring that, franchisees use noncompete clauses in their relationships with employees. He also notes that this latter tendency has grown over time (from below 20 percent in 2017 to nearly 50 percent in 2022).[7]

The above studies mostly focus on the clauses that restrict labor mobility in franchise contracts. From a public policy perspective, we believe it is important to also understand the information protection role of the clauses and examine the extent to which these firms can or do rely on other covenants for the purposes of protecting competitively sensitive information from their competitors. In particular, as Norlander mentions, and as we will also see below, the imposition of non-competes on employees in franchised businesses may mostly arise at the request of a third-party to the employment relationship, namely the franchisor. And indeed, in these organizations, the franchisor owns the IP and know-how and as such, would be the party that would be most concerned with the potential leakage of such information.

3. THE INSTITUTIONAL SETTING

In this section we briefly discuss the type of IP that franchisors want to protect and some evidence that they have strong incentives to protect it. We then describe the legal standards governing some of the covenants in franchise contracts that franchise lawyers and practitioners identify as informal IP protection mechanisms, i.e., covenants used to protect the franchisor's competitively sensitive information, namely non-compete covenants,

[7] Blair and Lafontaine (2005) discuss multiple sources of estimates of the number of franchisors in the U.S. and suggest that somewhere around 2,500 is a reasonable estimate for the population of franchisors at a point in time. They also document that many firms start franchising, and many exit franchising or go out of business each year. The FDDs analyzed by Norlander (2023) are indeed distributed across a time frame of 11 years, namely from January 2011 to August 2022. The overall sample thus contains multiple contracts from the same franchisors.

confidentiality covenants, and non-recruitment covenants.[8] Finally, we summarize the current policy debate regarding some of these clauses.

3.1. The value of IP in business format franchising

As mentioned earlier, business-format franchising involves the creation of a business model and associated training, products and trademarks, and business relationships so that franchisees can replicate the business and provide a uniform experience to customers in various locations.[9] The franchisor collects an upfront franchise fee and ongoing royalties which are typically calculated as a percentage of the franchised business' sales in exchange for the right to use the trademark and the business model. To retain its value for consumers and thus franchisees, the franchisor in turn must continue to invest in the brand, and in developing new products along with improved processes given an ever-evolving market and technological opportunities. For example, a recent WSJ article describes how McDonald's has spent the last seven years on a quest to improve its products:

> "McDonald's […] decided it's had enough with dry patties and squishy buns. For the past seven years, the chain that made its name on burgers has been on a quest to improve its signature offering.
>
> […]
>
> The more than 50 tweaks on its burgers add up to the Chicago-based company's biggest upgrades in decades to its core menu. With increased competition in the burger market—especially from higher-end, fast-casual burger chains such as Five Guys—executives decided to revamp some of the industrial-scale techniques that have produced cheap, uniform burgers. In some cases, McDonald's is reviving practices it scrapped long ago in a push for efficiency." (Haddon, 2023)

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[8] See two International Franchise Associations (IFA) guides: Christopher Kelly, Vincent Frantz (2019), Basics Track: Franchisor's Intellectual Property and How to Protect It (available at: https://www.franchise.org/sites/default/files/2019-05/BasicsTrack_Franchisor%27sIP.pdf); Stephanie J. Blumstein, Maisa Frank (2021), Basics Track: Franchise Litigation (available at: https://www.franchise.org/sites/default/files/2022-06/Basics%20Track%20-%20Franchise%20Litigation%20-%20Paper.pdf).

[9] The other form of franchising according to the Department of Commerce is called traditional, or product and tradename franchising. It is characterized by a franchisor that makes a product available for resale by the franchisee, often under an exclusive dealing arrangement whereby the franchisee can identify their business with the franchisor's tradename. Examples include gasoline stations and car dealerships. In this type of franchising, the franchisor typically has a set of rules as to how the retail business should operate, but much of the intellectual property of the franchisor is embedded in the product itself, and as such, protecting the intangible intellectual property associated with the retail activities is less of an issue.

Franchisees typically pay between 4 and 8 percent of their sales revenue (top line) to their franchisors.[10] At Jimmy John's, for example, this fee is 6 percent of the restaurant's gross sales. It would be a clear overstatement to argue that the full amount of royalties should be attributed to the value of the business format and the ongoing activities performed by franchisors, given that franchisees also value the brand and trademarks under which they are allowed to operate. But it is also noteworthy that franchisees typically pay a separate per dollar of sales revenue fee – most often between 1 and 3 percent (4.5 percent at Jimmy John's according to their 2021 FDD) as an advertising fee. The moneys generated by this fee is meant to be spent on advertising at the national or regional level and thus support the value of the brand as well. One might thus conclude that at least a sizable proportion of the royalty payments are paid for the ongoing value of the business model and associated products. Moreover, ultimately, the value of the brand depends on the ongoing investments that the franchisor makes in product and process development as well as in advertising the brand itself.

As should be clear from the above, the type of IP and know-how that franchisors want to protect beyond their trademarks does not lend itself to formal protection via patents for example. As a result, protecting competitively sensitive information and know-how embedded in franchisee training (training that is often extended to franchisee store managers by the franchisor), in the operations manuals provided to franchisees and in the various proprietary processes and methods made available to franchisees and their employees in various contexts is of the utmost importance for franchisors.[11]

3.2. Tools to protect competitively sensitive information

The legal system accords property rights in information in three main ways, namely through patent law, copyright law, and trade secret and associated law; in addition, trademark law grants property rights in labels, such as logos and brand names (Shavell, 2004). In the context of franchising, patents play a limited role. On the other hand, trademarks and know-how are ubiquitous components of the business-format franchising model (Blair and Lafontaine, 2005). Therefore, a franchisor aiming to protect their competitively sensitive information must rely on trade secret and contract law approaches and remedies, which have been referred to as informal IP mechanisms.[12]

[10] See e.g. Blair and Lafontaine (2005), chapter 3, for more on franchise fees.
[11] See Kelly and Frantz (2019) for more on this issue.
[12] See e.g. Hall, Helmers, Rogers and Sena (2014),

From a legal and economic perspective, it is important to distinguish between the protection granted by trade secret law and contract law. To secure the actionability of trade secret law remedies, three essential requirements must be met: type of knowledge or information (not commonly known in a trade or industry); reasonable precautions (i.e. reasonable diligence in protecting the information); and misappropriation (Lemley, 2008). When the parties involved are employees and/or business partners, reasonable precautions usually take the form of a written covenant, of which confidentiality agreements are most typical. Thus, certain covenants reinforce the actionability of trade secret claims.

As information leakage often occurs through individuals moving across organizations, many covenants aim to limit this mobility or limit what individuals can do once they move. Covenants such as non-competes and non-recruitment draw a clear line where the sole act of accepting employment or starting a new competing business is prohibited under the former whereas employing someone who worked at the prior firm is prohibited under the latter. With these, firms do not need to demonstrate that a trade secret or confidential information was misappropriated or disclosed.[13] When mobility is not restricted, the burden of proof – i.e., showing that the franchisee, employee, or business partner misappropriated and disclosed or used the information – is a harder burden to meet.[14]

3.3. The current legal framework for post-termination covenants

In this section we summarize the basic legal rules governing non-competition covenants, confidentiality covenants, and non-recruitment covenants as they apply after the contractual relationship ends. As a general legal matter, in the U.S., the legitimacy of these types of covenants is assessed under a reasonableness test when they are ancillary to either business or employment contracts.[15]

Non-competition covenants prevent departing individuals (franchisees, business partners, employees) from competing with their former franchisor or employer – not working

[13] See two American Bar Association (ABA) guides: Joanna Kim, Jeffrey K Riffer, Gregory Bombard, and Emily J Friedman (2020), Guide to Protecting and Litigating Trade Secrets (available at: https://www.americanbar.org/products/inv/book/400924012/); Scott Graham C. (2021), Protecting Trade Secrets: Before, During and After Trial (available at: https://www.americanbar.org/products/inv/book/413411613/).

[14] A defendant accused of misappropriation has multiple potential defenses, including independent development, reverse engineering, and – quite relevant to our research – demonstrating that the plaintiff did not make reasonable efforts to keep the information secret. See: https://www.justia.com/intellectual-property/trade-secrets/infringement/

[15] In other words, these covenants do not independently violate the antitrust laws. However, they might be assessed to determine if they are reasonable. See FTC September 30th, 2019 https://www.ftc.gov/enforcement/competition-matters/2019/09/just-because-its-ancillary-doesnt-make-it-legal

for a competitor or starting a new competing business. Non-compete covenants in employment contracts are governed by state laws. They are usually assessed under a reasonableness test and enforced accordingly. In some states, like California, they are not enforceable. In recent years several other states have restricted or banned their use. Likewise, non-compete covenants in franchise agreements are regulated at the state level and assessed under a reasonableness test.[16] States usually have different rules for employment and commercial relationship – in California, for example, the same rule applies and therefore non-compete covenants in franchising relationships are void.

Unlike non-competition covenants, **confidentiality covenants** (often referred to as non-disclosure) do not restrict mobility: the covered individual can work for a competitor or start a new competing business. Obligations typically imposed include: restrictions against disclosure of the information to third parties; restrictions on use of the information, generally limiting use to the business purpose stated in the original commercial or employment agreement or to fulfilling contractual obligations; restrictions on access to and use of the information within the recipient's business and among its employees.[17] Traditionally courts enforce them if the restriction is reasonable in scope and tailored to protect legitimate business interests (Bishara, Martin and Thomas, 2015). In recent years, case law suggests that courts have started not enforcing confidentiality agreements that go too far beyond the protection of trade secret information – e.g., when they cover public information or workers' general knowledge (Hrdy and Seaman, 2023).

Non-recruitment covenants limit the ability of those who sign them to hire employees of the previous firm or the current contracting party in other businesses upon departure. Non-recruitment agreements limiting a former employee from soliciting former colleagues to join in competition against the former employer are usually enforced by courts when they are reasonably limited. Some states, such as Georgia, assimilate them to other restrictive covenants in employment contracts, thus requiring the same limitations as to time, territory, and scope of activities.[18] In the context of franchising, when the franchisee or a business partner/owner are

[16] Source: Westlaw, American law report, Validity and construction of restrictive covenant not to compete ancillary to franchise agreement (accessed October 19, 2023)

[17] Source: Westlaw, Practical Law Commercial Transactions, Confidentiality and Nondisclosure Agreements (accessed October 19, 2023)

[18] Source: Westlaw (accessed on: October 19, 2023)

covered, the covenant forbids the recruitment of former employees, while they can be framed as non-recruitment of former co-workers when an employee is the subject of the agreement.

3.4. The current policy debate

In January 2023, the Federal Trade Commission (FTC) issued a notice of proposed rulemaking (NPRM) aimed at banning the use of non-compete covenants in employment contracts.[19] In this NPRM, the FTC provides a detailed analysis of the literature and issues with non-compete covenants in employment contracts, and it describes covenants that it suggests could potentially achieve similar goals without hampering labor mobility, including notably confidentiality covenants.

The proposed non-compete rule explicitly excludes non-compete covenants between franchisors and franchisees.[20] However, the FTC notes that "non-compete clauses [between a franchisor and franchisee] may present concerns under Section 5 similar to the concerns presented by non-compete clauses between employers and workers."[21] The FTC therefore sought comments on (1) whether the Rule should cover franchisor/franchisee non-compete covenants and why; (2) if the Rule were to cover franchisor/franchisee non-compete covenants, should they be categorically banned or subject to a rebuttable presumption of unlawfulness; and (3) if the rule should apply uniformly to all such non-compete covenants or whether certain

[19] FTC, January 5th, 2023, see https://www.ftc.gov/news-events/news/press-releases/2023/01/ftc- proposes-rule-ban-noncompete-clauses-which-hurt-workers-harm-competition. As mentioned in the previous paragraphs, beside the FTC's actions in this regard, several states have enacted new rules regarding non-competition covenants. These range from the outright ban of non-compete covenants (e.g. Minnesota, which thus follows the example of California and North Dakota) to rules that forbid their use for workers whose wages are below certain thresholds (e.g. Colorado, Washington, and Illinois).

[20] The proposed rule applies to contractual terms between an employer and a worker, where worker "means a natural person who works, whether paid or unpaid, for an employer. The term includes, without limitation, an employee, 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. Non-compete clauses between franchisors and franchisees would remain subject to Federal antitrust law as well as all other applicable law." The FTC further states that "The Commission has surveyed the available evidence relating to non-compete clauses and is not aware of research on the effects of applying additional legal restrictions to non-compete clauses between franchisors and franchisees."

[21] "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 on competitive conditions similar to non-compete clauses between employers and workers. Franchisor/franchisee non-compete clauses could also potentially be exploitative and coercive in some cases, such as where there is an imbalance of bargaining power between the parties. While the relationship between franchisors and franchisees may, in some cases, be more analogous to a business-to-business relationship, many franchisees lack bargaining power in the context of their relationship with franchisors and may be susceptible to exploitation and coercion through the use of non-compete clauses"

categories of franchisor/franchisee non-compete covenants should be exempted or subject to different standards.[22]

In a separate initiative, the FTC sought comments and evidence on how franchisors may exert control over and restrict the mobility of both franchisees and their employees.[23]

In clarifying the use of various covenants in franchise contracts, our work relates to these FTC initiatives directly. In particular, the FTC argues in the NPRM that firms have alternative means to protect valuable investments, such as (among others) nondisclosure agreements and remedies offered by trade secret laws, stating that "these alternatives restrict a considerably smaller scope of beneficial competitive activity than non-compete clauses because—while they may restrict an employee's ability to use or disclose certain information—they generally do not prevent workers from working for a competitor or starting their own business altogether." More specifically, the FTC indicates that (1) intellectual property law provides employers with viable means of protecting their investments in trade secrets, and (2) appropriately tailored nondisclosure agreements may prevent workers from disclosing or using certain information, without limiting their freedom to work. As we have noted above, however, enforcement and legal costs are very different for covenants such as non-competes, which establish a clean line for enforcement, compared to covenants that are enforced based on trade secret laws, for example, where the plaintiff must demonstrate that the three requirements mentioned earlier are met.

4. METHODOLOGY

We procured access to a database of Franchise Disclosure Documents (FDDs) through *Franchimp*.[24] Because we wanted to examine not only the current use of various covenants, but also how franchisors may have changed their contract over time, we extracted from this database the FDDs for a set of franchised chains where we could find contracts 10 years apart, specifically for the years 2010 and 2020, for each company. In Appendix (1) we provide more details about how we arrived at our final sample, which consists of 596 FDDs, from 298 different franchised chains.

[22] For example, the FTC disclosure rule exempts fractional franchises and franchising to large franchisees.

[23] FTC, March 10th, 2023, see https://www.ftc.gov/news-events/news/press-releases/2023/03/ftc-seeks-public-comment-franchisors-exerting-control-over-franchisees-workers

[24] https://www.franchimp.com/

We considered different ways to extract information from these FDDs. Machine Learning (ML) techniques are increasingly being deployed for research on contracts and other documents, and even specifically for studying covenants in franchise contracts (Norlander, 2023). However, ML techniques require a large amount of training data, and our sample of contracts is relatively small. Furthermore, ML algorithms are agile tools to identify patterns and locate specific information. However, they are less effective for the purpose of analyzing the detailed content of certain covenants, which is what we ultimately want to study.

We therefore proceed "more traditionally", reading the full franchise agreements to identify, and hand-code detailed information related to the covenants we focus on, including information such as type of covenant, content, scope (e.g. geographic, type of business), and individual(s) covered. In Appendix (2) we describe the hand-coding methodology. We also used *Python* to automate some parts of the process, and to extract franchised chains' characteristics from the FDDs that can help explain variation in the use and scope of the covenants.[25]

5. THE EXTENT OF USE AND APPLICATION OF COVENANTS

In this section, we first document how much franchisors use covenants to protect their competitively sensitive information in the franchise relationship.[26] We then focus on both commercial and employment relationships to show which other individuals are covered by these covenants and, also, describe the contractual mechanism that franchisors use with franchisees to entice them to have their commercial partners and employees sign additional covenants. Finally, we provide additional evidence on the use of non-compete and non-recruitment covenants, and on the relevance of industry differences.

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[25] We mainly used the package *Pandas* (see: https://pandas.pydata.org/pandas-docs/stable/getting_started/overview.html). Unlike most of the covenants we focus on (which are not located in pre-defined location in FDDs or franchise agreements), some information is listed in tables or specific ITEMS in the FDD. For example, the covenant that imposes the "obligation to participate in the actual operation of the franchised business" is listed in ITEM 15 in each FDD. For this covenant, then, we were able to extract the information automatically for roughly 2/3 of the franchisors in our sample (in the remaining cases, we had to extract that information via inspection). The same applies to other pieces of information (such as, number of outlets) that do not require further action if extracted correctly. The performance of the automation process also heavily relies on the quality of the documents, and unfortunately, those related to the year 2010 were often non machine readable.

[26] Throughout this section, we provide examples of provisions by quoting clauses from the franchise agreements and FDDs that we gained access to. We remove references to the firms or chains that they refer to because this information is confidential.

5.1. Use of different covenants in the franchise relationships

We first focus on covenants that are used in the franchise contracts to define how information will be protected in the franchisor-franchisee relationship specifically. Table 1 reports the incidence of different covenants, namely confidentiality, non-compete, non-recruitment, and covenants that impose the requirement that the franchisee be involved full-time in the operation of the business. We differentiate based on whether the restriction applies during the franchise relationship or to the period afterwards, namely after the franchise relationship is terminated.[27]

Table 1: Use of different covenants in franchise contracts

	confidentiality	non-compete	obligation to operate the business	confidentiality	non-compete	non-recruitment
Year		*During*			*After*	
2010	100.0	90.3	44.3	100.0	86.2	37.9
2020	100.0	89.9	40.9	100.0	85.6	21.5

Incidence is calculated based on 298 chains in our sample in each of 2010 and 2020.

Virtually every franchise agreement and FDD contain references to confidential information and to the measures that franchisees must take to make sure that this information is not disclosed. During the franchise relationship, contracts refer to what franchisees gained access to by signing the franchise agreement, which is what they need to also maintain confidential.[28] The "after" version is either mentioned in a specific provision (e.g., related to the operating manual) or reported in the list of franchisees' obligations upon termination or non-renewal.[29]

[27] As mentioned in Section 2, non-recruitment covenants during the franchise relationship limit intra-brand labor mobility. These are not relevant to our study given our focus on the protection of sensitive information dissemination.

[28] An example of such a clause is: "*Franchisee acknowledges that during the term of this Agreement Franchisee will have access to and become acquainted with various trade secrets, inventions, innovations, processes, information, records, and specifications owned or licensed by (...) and/or used by Franchisor in connection with the operation of its business, including, without limitation. Franchisor's business and product processes, designs, methods, supplier and product lists, and procedures. Without this information, Franchisee could not effectively and efficiently operate said business. Franchisee agrees that Franchisee will not disclose any of the aforesaid, directly, or indirectly, or use any of them in any manner, either during the term of this Agreement or at any time thereafter, except as required in the course of operating the Franchised Business*." (emphasis added).

[29] An example of clause that imposes the return of the manual, confidential information and copyright is: "*Franchisee will immediately turn over to Franchisor the Manual(s), Confidential Information, and all information for which Franchisor claims a copyright, instructions, software and accompanying documentation, all other materials provided by Franchisor related to operation of the Franchised Business, and all copies thereof (all of which are acknowledged to be Franchisor's property). Franchisee will retain no copy or record of any of the foregoing, excepting only Franchisee's copy of this Agreement and any correspondence between the parties, and any other documents which Franchisee reasonably needs for compliance with any provision of law*."

In line with results in Callaci (2021), Table 1 shows that non-compete covenants are also quite ubiquitous: around 90 percent of contracts include a clause restricting the franchisee's opportunity to operate a competing business during the franchise relationship, with a slightly lower percentage (85-86) restricting them after the relationship ends. Notably, these clauses limit what franchisees can do in their capacity to operate or being involved in a different business, but we also find that more than half of the non-compete clauses in our sample also limit franchisees in their capacity as potential employees: Franchisees cannot be employed in a competing business during the franchise relationship in 64 (66) percent of contracts in 2010 (2020). Likewise, in 66 percent of contracts in both 2010 and 2020. franchisees cannot be employed in a competing business after the franchise relationship ends.[30]

Covenants that impose the full-time participation of the franchisee in the operation of the business are also relevant in our framework, as they restrict what franchisees can do during the franchise relationship in a way that protects the competitively important information of the franchisor (since by definition the franchisee cannot simultaneously be involved in a competitive business). We find that these clauses are fairly frequently used, as they are included in 44 (41) percent of the contracts in our sample in 2010 (2020).[31]

Turning to the use of "inter-brand" non-recruitment clauses, which are clauses that prevent a former franchisee from hiring individuals employed by the franchisor or any of the other franchisees once the franchise relationship is terminated, their incidence is notable, but interestingly, it has decreased from approximately 38 percent in 2010 to roughly 22 percent in 2020.[32]

Overall, the use of non-compete covenants and the use of covenants that impose the full-time participation of the franchisee in the operation of the business in franchise agreements have remained rather stable over time, while the use of non-recruitment clauses has decreased from 2010 to 2020. This reduction may result from the fact that these clauses are often written

[30] For example: "*During the Term, without our prior written consent, neither you nor any of your Covenanting Personnel, nor any person or entity controlling, controlled by, or under common control with you or them, will individually or jointly with others, directly or indirectly, by, through, on behalf of, or in conjunction with, any person or entity: (i) own, manage, engage in, be employed by, advise, make loans to, participate in, consult for, or have any other interest in* (…) [a competing business]". (Emphasis added.)

[31] Examples of such a clause are "*if you are an individual, you must either serve as a Manager or designate a Manager*" (not requiring the franchisee to operate) or "*You must personally participate in the day-to-day operation of your Restaurant or Restaurants*" (imposing an obligation to participate in the operation of the business). We classified as a "yes" only the clauses that impose the full-time involvement in the operation of the business – otherwise one could operate the business but still be involved in other businesses.

[32] Non-recruitment restrictions are often written in a combined clause that restricts the hiring of employees of other franchisees both during and after the franchise relationship ends.

in a combined clause that restricts the hiring of employees of other franchisees both during and after the franchise relationship ends. With the issues raised about no-poaching clauses in franchise contracts, and the Washington State Attorney General's initiative to eliminate these clauses, many franchisors have signed agreements with the AG to forgo no-poaching clauses in their contracts nationally. Given the combined clauses, the decrease in the use of non-recruitment clauses "after" the contract may be explained by the reduction in no-poaching clauses.[33] On the other hand, given the low cost of separating the covenants to keep the constraint on non-recruitment after the relationship terminates, the fact that a number of franchisors choose to forgo this clause potentially along with the no-poaching clause would suggest that these franchisors do not find the non-recruitment clause particularly valuable.

5.2. Use of different covenants in the commercial relationships

Having examined the franchise contracts in our sample carefully, we find that clauses that control the franchisee's behavior during or after the contract are not the only tools that franchisors use to protect their competitively sensitive information. Table 2 shows that franchisees are not the only party covered by the covenants included in the franchise contract. Some family members, usually a spouse, (20-30 percent, approximately) and business partners or owners (50-60 percent, approximately) often are covered by the same covenants as the franchisee, and the tendency to include them in the contract has gone up between 2010 and 2020.[34] A much smaller number of franchise contracts extend their covenants to directors and officers (16-19 percent, approximately), who are usually involved in the franchise agreement when the franchisee is organized as a corporation, rather than operated by an individual.

Table 2: Individuals covered by the same covenants as the franchisee*

Year	business partners	franchisee family members	Directors/ officers
		During	
2010	58.4	24.5	17.1
2020	62.1	32.6	18.1
		After	
2010	53.7	19.5	16.8
2020	59.1	27.5	18.8

Incidence out of the 298 chains in our sample each year.
*Obligation to operate not included

[33] See Callaci, Gibson, Pinto, Steinbum and Walsh (2023) and Lafontaine, Saattvic and Slade (2023) for analyses of the effect of no-poaching clauses on employee compensation.

[34] In the example reported in the previous footnote, the franchise agreement clarifies that "*for the purposes of this Agreement, "Covenanting Personnel" means you, your Owners, and your directors and officers, as added to, deleted from, or replaced from time to time*."

In addition, when they are covered by the franchise contract, these individuals are often required to separately sign additional covenants, as Table 3 shows. Business partners (mainly, other owners) are those who are most often required to do so, followed by directors and officers, and family members.[35] The clauses often make clear that it is access to confidential information that determines whether an individual is required to sign such covenants.

Table 3: Individuals required to sign additional covenants, by type of covenant

Year	business partners	franchisee family members	Directors/ officers
Confidentiality			
2010	46.6	10.1	37.6
2020	49.0	11.7	38.9
Non-compete			
2010	29.2	7.7	21.1
2020	29.5	9.1	20.1
Non-recruitment			
2010	13.8	2.7	9.1
2020	9.7	2.3	6.7

Incidence out of the 298 chains in our sample each year

5.3. Use of different covenants in the employment relationships

While the coverage of commercial partners and family members is perhaps not surprising – especially considering that they often are guarantors or formally part of the franchise relationship – Table 4 shows the extension of coverage of covenants in franchise contracts towards managers (10-12 percent of contracts, approximatively) and employees (7-8 percent, approximately).[36]

[35] As discussed in the next section, these provisions are included in the franchise agreements. An example is: "*You agree to obtain similar covenants from the personnel we specify, including officers, directors, key-holding employees, and other employees attending our training program or having access to Confidential Information. We have the right to regulate the forms of agreements you use and to be a third-party beneficiary of those agreements with independent enforcement rights. You must keep copies of those agreements and send them to us upon request*." (Emphasis added.)

[36] For example: "*during the term of this Agreement, neither Franchisee nor any holder of a legal or beneficial interest in Franchisee (or any member of their immediate families and households). nor any officer, director, executive, manager or member of the professional staff of Franchisee, either directly or indirectly, for themselves, or through, on behalf of or in conjunction with any person, partnership, corporation, limited liability company or other business entity, shall* (…)". (Emphasis added.)

Table 4: Employees covered by the same covenants as the franchisee*

Year	managers	employees
During		
2010	11.7	7.9
2020	11.1	7.9
After		
2010	11.1	8.4
2020	10.1	7.0

Incidence out of the 298 chains in our sample
*Obligation to operate not included

Unlike the individuals in the previous section, managers and employees are not part of the franchise relationship, and therefore their inclusion via clauses in the franchise agreement would raise legal concerns about the enforceability of these obligations against them. However, as it is for the case of commercial partners and family members, employees and managers are also often required to sign separate covenants (Table 5).[37] Differently from results in Table 4, we can distinguish in this case between different formulations that franchisors use, which allows us to differentiate between requirements that cover only certain types of workers. "Employees" is a residual category mutually exclusive from the other cases in which a specific type(s) of worker is listed.[38] This is an important aspect, as it means that to obtain an overall percentage of contracts that require workers to sign, for example, a confidentiality agreement, we need to sum the percent of "other" employees covered (approximately 22 percent) plus the percent of any of the specific types of workers called out (which for the confidentiality agreements are 9.1 or 11.1 or 13.1 percent respectively), for a total of nearly 31 to 35 percent. On the other hand, documenting that franchisors often specify what type of franchisees' employees should sign additional covenants again provides some hints on the reasons behind this practice.

[37] For example: "*Franchisee agrees to require any personnel having access to any confidential information of (...) or information about Clients or potential clients to execute covenants that they will maintain the confidentiality of information they receive in connection with their employment by or association with Franchisee in the* (…) *Business. Such covenants shall be in a form satisfactory to* (…)*, including specific identification of* (…) *as a third-party beneficiary of such covenants with the independent right to enforce them*." (Emphasis added.)

[38] In other words, these additional covenants either specify some type of workers (columns 1 to 4) or generally refer to employees (column 5).

Table 5: Employees required to sign additional covenants, by type of covenant

Year	managers	key employees	trained employees	employees with access to confidential information	other employees
Confidentiality					
2010	32.2	9.1	11.1	13.1	21.8
2020	37.6	14.1	11.1	13.8	22.1
Non-compete					
2010	23.2	5.0	6.7	6.0	12.8
2020	25.2	9.7	6.4	6.4	9.7
Non-recruitment					
2010	12.4	4.4	3.0	3.4	5.7
2020	7.7	4.0	2.7	2.7	4.7

Incidence out of the 298 chains in our sample each year

From an economic perspective, the requirement that individuals sign additional agreements can be seen as preferable to including clauses that restrict what workers can do during or after the employment relationship in the franchise agreement because workers are not a party to that contract, and so they may not be informed about the constraints in such cases. On the other hand, workers might have limited awareness or wrong beliefs regardless, especially concerning the actual enforceability of covenants (Starr, Prescott and Bishara, 2020; Prescott and Starr, 2022; Boeri, Garnero and Luisetto, 2023).

The literature on non-competes in general has treated the relationship between the employer and employee as the locus of the decision to impose non-competes and other post-contractual covenants. Our results demonstrate that in contexts such as franchising, but also potentially in joint ventures, alliances, etc., other business entities, that are related to the employer by virtue of a commercial contract, may have an interest in whether the employer constrain their employees. In the case of franchising, the franchisor owns the IP that is protected via such clauses, so they can be the reason why an employer imposes, or is constrained by contract to impose, certain contractual restrictions on their employees.

5.4. How do franchisors require franchisees' commercial partners and employees to sign additional covenants?

As the previous sections show (5.2. and 5.3.), franchisors often mandate that franchisees require business partners, directors and officers, franchisee's family members, and employees to separately sign additional covenants, namely confidentiality agreements, non-compete agreements, non-recruitment clauses.

Table 6 provides more details about this “contractual mechanism.” In 40-43 percent of cases, franchisees are required to ask these further individuals to sign, while in 35-37 percent of cases the requirement is upon request of the franchisor (columns 1 and 3, respectively).[39] Moreover, templates for such covenants are often mentioned in the franchise agreement and included as Exhibits in the FDDs.[40] At least one template is provided in 30-33 percent of contracts when franchisors mandate franchisees to meet this burden, and in 21-22 percent of cases when the requirement is upon request of the franchisor – overall, at least one template is provided in 50-54 percent of the contracts in our sample.[41] If we were to interpret the presence of a template as a signal of an increased likelihood that a franchisor would actually require the franchisees to meet this burden, the fact that these percentages are similar for the “mandatory” and the “upon request” version of the covenant suggests that there might be little practical difference between the two versions.

Table 6: Different requirements of covenants to be signed by individuals other than the franchisee

Year	mandatory	template provided	upon request	template provided
2010	40.3	29.9	37.0	20.8
2020	43.0	32.6	35.2	22.1

Incidence out of the 298 chains in our sample each year.

[39] We differentiate mandatory requests to ask for the signature of additional agreements from requirements that are upon request of the franchisor because they provide different degrees of certainty. An example of the first scenario was reported in footnote 37. An example of a “not mandatory” requirement is: “*At Company's request, Franchisee must require and obtain covenants similar to those set forth in this Section 31 (Including covenants applicable upon the termination of a person's relationship with Franchisee) from any or all of the following persons; (1) all managers of Franchisee and any other personnel employed by Franchisee who have received or will receive training from Company; (2) all officers, directors, and holders of a beneficial interest of five percent (5%) or more of the securities of Franchisee, and of any corporation directly or indirectly controlling Franchisee, if Franchisee is a corporation; and (3) the general partners and any limited partners (Including ,any corporation, and the officers, directors and holders of a beneficial interest of five percent (5%) or more of the securities of any corporation which controls, directly or indirectly any general or limited partner), If Franchisee is a partnership. Every covenant required by this Section 31 must be in a form satisfactory lo Company and must specifically identify Company as a third-party beneficiary of such covenants with the independent right to enforce them. The current form of agreement is attached as Exhibit E*.” (Emphasis added.)

[40] See the final sentence of the example reported in the previous footnote.

[41] We use “at least” because some franchisors use multiple templates, for instance because they want to have some individuals sign only a confidentiality covenant and others a confidentiality covenant plus other covenants.

5.5. The characteristics of non-compete clauses

Beyond establishing the reliance on non-compete clauses and additional covenants in franchise contracts, we think it is important also to describe the duration, geographical scope, and sector or industry scope of the prohibition in the franchise relationship.

We find that almost all non-compete clauses include a time limit for the application of the clause: no time limit is specified in only 1 (2) percent of clauses in 2010 (2020). The average duration of non-compete covenants after the franchise relationship ends is 23 months in both 2010 and 2020.[42] This mean duration is not exactly representative of actual durations: instead, it reflects the fact that, as shown in Figure 1 in Appendix (3), the more common choices are 12 months (approximately 18 percent in 2010 and 17 percent in 2020) and 24 months (approximately 73 percent in 2010 and 71 percent in 2020). Figure 1 in Appendix (3) also shows little change between 2010 and 2020 in the distribution of duration for these clauses.

One might think that the geographical scope of the non-compete covenant might be relevant for both the "during" and the "after" version of the covenant. However, we find that the restriction on competition during the franchise agreement is limited to a defined geographic area in only 2 (1) percent of clauses in 2010 (2020). By contrast, the geographical area for the restriction on competition after the franchise relationship is terminated is specified in 96 percent of clauses (in both 2010 and 2020), of which: 9 percent of clauses limit the restriction to a designated area such as a county (in both 2010 and 2020); 2 percent of clauses stipulate that the restriction covers the entire Unites States (in both 2010 and 2020); 0.4 percent limit the restriction to the relevant metropolitan area (in both 2010 and 2020). In all the remaining cases (85 percent), the geographical scope is stated in terms of a distance in miles, averaging 26 (24) miles in 2010 (2020). Figure 2 in Appendix (3) shows little change again in the distribution of the geographical coverage in 2010 and 2020.

Finally, the scope of the restriction in terms of type of business (i.e. sector or industry) is always specified, whether the restriction applies during the franchise relationship or after it

[42] For non-competition clauses during the contract, duration is by definition set by the duration of the franchise relationship.

ends, although in different ways that range from a generic reference to competitive business[43] to a specific definition of the sector where the franchisor operates.[44]

Regarding non-compete clauses that individuals such as business partners and family members are required to sign, we find that approximately 4 percent of clauses in 2010 and 5 percent in 2020 do not specify a duration of the restriction after the relationship ends, and the average duration is 22 months in both 2010 and 2020. On the other hand, in approximately 23 percent of clauses in 2010 and 19 percent of clauses in 2020 there is no geographical limitation (again, for the restriction after the relationship ends), and the average geographical scope is 28 miles in both 2010 and 2020.

5.6. Duration of non-recruitment clauses after the relationship ends

"Inter-brand" non-recruitment clauses limit the ability to hire the employees of a formally affiliated business or franchisee after the (franchise, commercial or employment) relationship ends. We find that in 28 percent of clauses in 2010 and 24 percent in 2020 the covenant specifies that the former employee can be hired after a period of time has passed since the termination of their employment.[45] When such a duration is set, it lasts about 7 months in 2010, and 4 months in 2020, on average.

Likewise, we find that non-recruitment clauses that individuals are required to sign as a requirement of franchisees set a duration of this limit in 19 percent of clauses in 2010 and 17 percent in 2020. On average, when the duration is set, the restriction lasts for 8 months in 2010 and 6 months in 2020.

[43] For example: "*During the term you shall not* (…)*: Own, maintain, advise, consult for, make loans to, operate, engage in or have an ownership interest (including any right to share in revenues or profits) in any Competitive Business which is, or is intended to be located within* (…)".

[44] For example: "*directly or indirectly, irrespective of whether compensation is provided, enter into the employ of, render any service to or act in concert with any person, partnership, limited liability company, corporation or other entity that owns, operates, manages, franchises or licenses any business that (A) sells pizza or other non-pizza products (excluding soft drinks) that are the same as those sold by* (…) *restaurants on a delivery or carry-out basis, including, without limitation, business formats such as* (…)*, or (B) derives 20% or more of its gross revenues, at the retail level, from the sale of pre-cooked, ready-to-eat food products on a delivery basis (a "Competitive Business")*".

[45] For example: "(b) *For two years after the expiration or termination of this* [franchise] *Agreement or an approved Transfer to a new franchisee, you and your Owners may not, without our prior written consent, (…) (ii) solicit for employment any person who at <u>any time within the immediate past 12 months has been employed by us, or our affiliates, or by any of our franchisees</u>.*" (Emphasis added.)

5.7. The use of bundles of covenants

The previous literature has shown that the covenants we focus on often come in different bundles (Balasubramanian, Starr and Yamaguchi, 2021; Boeri, Garnero and Luisetto, 2023). As should be clear from Table 1 above, franchisees are subjected to sets of covenants as well: basically all of them have a confidentiality clause and almost all of them have a non-compete clause as part of the franchise agreement. Whatever other covenant they are subjected to, they ultimately are covered by a combination of constraints.

We also find that franchisors use multiple combinations of these clauses (Table 7) with other individuals: in 22 percent of cases in 2010, and 14 percent of cases in 2020, the franchisors require the use of all three covenants. In another 22.5 (32.2) percent of cases in 2010 (2020), they require them to sign a confidentiality clause plus a non-compete clause, and in 31 (37) percent of cases in 2010 (2020) they require only a confidentiality agreement. It is very rare that they require only a non-compete covenant.

Table 7: Different bundles of covenants

Year	only confidentiality + non-compete	only confidentiality + non-recruitment	confidentiality + non-compete + non-recruitment	confidentiality (only)	non-compete (only)
2010	22.5	1.0	21.8	31.2	2.7
2020	32.2	1.0	14.4	37.2	2.0

Incidence out of the 298 chains in our sample in each year.

6. FACTORS AFFECTING THE USE OF COVENANTS

In this section we focus on variables that may help explain variation in the use and scope of the covenants, starting with industry differences. We then turn to measures that are meant to capture the value of the confidential information shared by the franchisor.

[Section 6 is to be completed]

6.1. Cross-industry reliance on covenants

In this section we focus on the relevance of industry differences in explaining the incidence of different covenants across franchised chains.[46]

[46] We follow the classification used in *Franchimp*, and then correct a handful of franchised chains that were classified in the wrong category.

Table 8, which replicates the table on the use of different covenants applied to franchisees (Table 1), shows that the covenants are not used at all in the lodging and leisure industry. Second, there is a reduction in the use of covenants that impose the full-time participation of the franchisee in the operation of the business in two industries, namely the Auto & Travel and the Professional Services Industries. Third, there is an increase in the use of non-recruitment covenants over time in all industries, except for the Auto & Travel Industry. Recall from Table 1 that the use of this covenant has gone down overall, however.

Table 8: Use of covenants in franchise contracts, by industry

Industry		confidentiality clause	non-competition clause	obligation to operate the business	confidentiality clause	non-competition clause	non-recruitment clause
		During			*After*		
Auto & Travel							
	2010	100.0	100.0	47.6	100.0	100.0	28.6
	2020	100.0	95.2	42.9	100.0	95.2	14.3
Food & Beverage							
	2010	100.0	93.8	35.8	100.0	95.1	16.0
	2020	100.0	96.3	35.8	100.0	97.5	18.5
Health & Fitness							
	2010	100.0	94.1	41.2	100.0	92.2	17.6
	2020	100.0	88.2	41.2	100.0	86.3	23.5
Lodging & Leisure							
	2010	100.0	0.0	0.0	100.0	0.0	0.0
	2020	100.0	0.0	0.0	100.0	0.0	0.0
Professional Services							
	2010	100.0	98.3	58.3	100.0	97.4	26.1
	2020	100.0	90.4	50.4	100.0	88.7	27.0
Retail							
	2010	100.0	84.6	38.5	100.0	84.6	15.4
	2020	100.0	76.9	38.5	100.0	76.9	23.1

Incidence out of the 298 chains in our sample in each year, which is divided by industry as follows: 80 food & beverages; 21 auto & travel; 51 health & fitness; 18 lodging & leisure; 115 professional services; 13 retail.

We now turn our attention to the use of additional covenants that certain individuals related to franchisees are required to sign (Table 9). We find that the practice of requiring individuals to sign additional covenants has mostly remained stable over time within sectors, with some variation in the type of request – for example, in the food & beverage industry there is an increase in the mandatory requests (from 45.7 to 51.9 percent) and a slight decrease in the requests that are deferred to franchisors' will (from 27.5 to 25.9 percent). Second, we see an increase in the use of confidentiality covenants in Food and Beverage (from 58.0 to 63.0 percent), and in Professional Services (from 68.7 to 73.0 percent). Finally, the reliance on non-recruitment clauses has decreased in most industries, while the use of non-compete covenants has remained steady.

Table 9: Types of (additional) covenants to be signed by some individuals, by industry

Industry		mandatory	upon request	confidentiality agreement	non-compete agreement	non-recruitment agreement
Auto & Travel						
	2010	33.3	28.6	61.9	33.3	9.5
	2020	33.3	33.3	61.9	38.1	9.5
Food & Beverage						
	2010	45.7	27.5	58.0	42.0	19.8
	2020	51.9	25.9	63.0	37.0	8.6
Health & Fitness						
	2010	56.9	21.6	68.6	54.9	27.5
	2020	56.9	17.6	68.6	51.0	19.6
Lodging & Leisure						
	2010	0.0	41.2	35.3	0.0	0.0
	2020	0.0	35.3	35.3	0.0	0.0
Professional Services						
	2010	39.1	47.0	68.7	47.8	28.7
	2020	40.9	46.1	73.0	53.9	22.6
Retail						
	2010	15.4	76.9	46.2	38.5	23.1
	2020	23.1	69.2	46.2	30.8	7.7

Incidence out of the 298 chains in our sample, which is divided by industry as follows: 80 food & beverages; 21 auto & travel; 51 health & fitness; 18 lodging & leisure; 115 professional services; 13 retail.

[To be completed]

7. CONCLUSION

In the U.S. the current academic and policy debate has placed a great deal of emphasis on employment non-compete covenants, and more recently also on other clauses that restrict what workers can do after their employment relationship ends. Several states have enacted new regulations ranging from banning employment non-compete covenants to more tailored approaches (e.g. forbidding their use for low-wage workers). Relatedly, the FTC has launched multiple initiatives in this area, including the proposal of a new rule aimed at banning non-compete covenants in employment relationships. Overall, the discussion has been centered on the labor consequences of these types of covenants, with only a few studies focused on employers' interests and strategies in relying on such clauses with employees (see recently: Hirawa, Lipsitz and Starr, 2023; Ganco, Jingnan, Haifeng, Yamaguchi, 2022).

We explore the use of these covenants as a means to protect competitively sensitive information in the context of franchising. Using an in-depth analysis of 596 franchise disclosure documents, 10 years apart for 298 franchised chains, we shed light on how covenants in the franchise agreements constrain the dissemination of information by the franchisee, but also extend beyond the franchisee to cover commercial partners (e.g., owners and officers and directors) and family members, as well as workers, especially those with access to training and other sensitive information. Moreover, franchisors often mandate that franchisees require such individuals to separately sign additional covenants, including confidentiality covenants, non-compete covenants, and non-recruitment covenants. Finally, franchisors use a combination of covenants, including confidentiality agreements and non-recruitment clauses along with non-competes in their contracts.

These findings are important for several reasons. First, they show how, in the context of franchising, the use of these covenants is related to both commercial and employment relationships; in turn, this divide (commercial vs. employment) often overlaps, for example when franchisees and other commercial partners are limited in their job opportunities, ultimately confirming the interplay between product and labor markets dynamics.

Second, given the importance of franchising in the U.S. economy, including in terms of employment, the contractual mechanism of requiring further individuals (among them some groups of workers) to sign these covenants helps explain the spread of these covenants to low-wage employees for example in the U.S. labor market.

Third, in its NRPM, the FTC proposes that firms use alternative covenants and remedies, such as confidentiality and trade secret litigation, because they are less restrictive in terms of labor mobility. However, our analysis shows that firms already use such mechanisms to protect competitively sensitive information, and that different enforcement and legal costs are involved with the various covenants. In fact, as we mentioned early on, it is a requirement for trade secret litigation to have a chance to succeed for the franchisor to demonstrate that they exerted effort to protect the information, a requirement that is fulfilled often via the use of confidentiality (or non-disclosure) requirements, suggesting that the different clauses may be complements rather than substitutes in protecting firms' know-how and trade secrets, especially in light of the fact that dissemination often occurs via worker or business partner mobility.

Finally, the literature on employment covenants restricting worker mobility has treated those almost exclusively as though they are the domain of the employer/employee relationship only. However, our results demonstrate that in contexts such as franchising, but also potentially in other contexts such as joint ventures, alliances, etc., other business entities, that are related to the employer by virtue of a commercial contract, may have an interest in whether the employer constrain how their employees might use or disseminate sensitive information. In the case of franchising, the franchisor owns the IP that is protected via such the types of covenants we have focused on, so it makes sense that they would want to have a franchisee employer impose certain contractual restrictions on their employees.

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Appendix 1. Sample construction

Franchimp has a database that consists of 4,466 chains in total (https://www.franchimp.com/). From the original database, we selected a sample where we have franchised firms with 10 years of variation (2010-2020ish) – rule: 2021-2019 and 2011-2009 are good substitutes of 2010, with preference given to 2021 and 2011, and then recoded as either 2010 or 2020.

We obtained a sample of 372 franchised chains.

With this sample we first attempted to implement a strategy directed at appending the information regarding non-compete covenants (as reported in ITEM 17) automatically extracted with Python. However, we realized that the information contained in ITEM 17 (the relevant boxes related to non-compete covenants) is not a precise description of what the franchise agreement contains. Likewise, we realized that franchise agreements contain further covenants as well as references to additional covenants to be signed by some individuals. Furthermore, we realized that FDDs contain templates, thus suggesting that proceeding manually was best.

We then identified the industry within which each franchisor operates, using *Franchimp*'s classification, which divides the full sample into 6 groups: food & beverages; auto & travel; health & fitness; lodging & leisure; professional services; retail.

We then had to remove some chains mainly for reasons related to the matching operation that *Franchimp* performed. In fact, in several cases what appears to be the same chain does not correspond (i.e., the FDD related to a chain in 2020 is not the same as the one in 2010). In some cases, we re-coded the industry manually while in other cases, we changed the year manually, for example because the specific year was not available, but the close one was (e.g., FDD of 2011 instead of 2010). If no close year was available, we removed the chain from the sample.

Our final sample consists of 298 franchised chains (for a total number of 596 FDDs), in the following industries: 80 food & beverages; 21 auto & travel; 51 health & fitness; 18 lodging & leisure; 115 professional services; 13 retail.

Appendix 2. Data processing methodology

Locating the covenants in the franchise agreement

We use several keywords for locating manually the covenants of interest, such as "non-compete" "confidential", "confidentiality", "nondisclosure". For identifying the covenants of interests and the requirement to sign additional covenants separately, in this analysis we consider only information in the franchise agreement, not from ITEMS (apart from ITEM 15, which contains information on the obligation to participate in the actual operation of the business). [In a subsequent robustness analysis, we plan to extend it to other items. For example, the FDD 106232_2010 does not mention a confidentiality covenant in the franchise contract, but ITEM 15 provides that "*your employees who have access to confidential information and trade secrets must sign confidentiality agreements*". Since it is the only place where it is mentioned, we coded it as a 0 at this stage]. Therefore, we can say that our estimation is a lower bound estimation. To conduct this robustness analysis, we plan to either extract info related to ITEMs 14 and 15 of the chains for which we do not already know that they have these additional covenants or use a ML technique.

Other individuals covered by the same covenants as the franchisee

Non-compete covenants in the franchise agreement always mention that the franchisee is restricting from competing "*directly or indirectly*". Indirect means of competition might be running a competing business through a family member. In our hand-coding strategy we do not take this reference into account, and hand-code the other individuals as covered only if they are mentioned explicitly.

Obligation to participate in the actual operation of the business

There are different possible grades of requirements to participate in the actual operation of the business (e.g., full-time, or part-time). In a 0-1(no-yes) framework, we hand-code as a 0/no every time there is a way to not being involved, even if it is recommended and there is minimum training or monitoring duties. We hand-code 1 if it is said that the franchisee needs to operate themselves if they are an individual. For example: "*We require at least one individual who signs the Franchise Agreement to participate personally in the direct operation of (…)*" is a hand-coded as a 1. A fuzzy division is as follows: "*You may, with our written consent, designate another individual as your District Manager*" (hand-coded as a 0); conversely clauses such as "*You must personally supervise the operation of your Restaurant unless we othenwise permit in writing*" (hand-coded as a 1). In addition, we hand-code as a 0 also the cases in with the full-time involvement is required for a certain number of months/years (for example: "*Franchisees are required to devote their full time, energy, effort, and resources to the management and operation of the Franchised Business for at least the first six (6) months of operation"*. The reason is that the duration of franchise contracts usually is 10-20 years.

Requirement to sign additional covenants

We hand-code differently depending on a formulation that imposes it as mandatory or upon request. Therefore, we split this variable into 2 columns, and put together all the cases in which the formulation is something like "*you shall require and obtain*", "*you agree that you will require*", "*you agree to require and obtain*", "*you agree to obtain similar covenants*", "*you must sign*" "*you must implement all reasonable procedures we prescribe from time to time to prevent unauthorized use or disclosure of the Confidential Information, including the use of nondisclosure agreements (in form and substance satisfactory to us) with your officers, directors, managers and assistant managers and the delivery of such agreements to us*". This is to differentiate from cases such as "*at franchisor's request*", "*Franchisor may request that*

Franchisee require" or "*franchisor may require*", "*including, restrictions on disclosure to your employees and the use of nondisclosure and noncompetition agreements we may prescribe for employees or others who have access to the Confidential Information*", "*We reserve the right to require each of your owners to execute and bind themselves to the confidentiality and non-competition covenants*", "*The Franchisor reserves the right to require*" or "*if requested by Company, using confidentiality and non-competition agreements with those having access to Confidential Information*".

<u>Template attached</u>

If there is a template attached, but not a specific mention in the franchise agreement, we adopt a conservative approach and hand-code it as it is at franchisor's request.

Appendix 3. Distribution of the duration and geographical scope of non-compete covenants in franchise agreements after the franchise relationship ends

Figure 1: Distribution of the duration of non-compete clauses *after* the franchise relationship ends

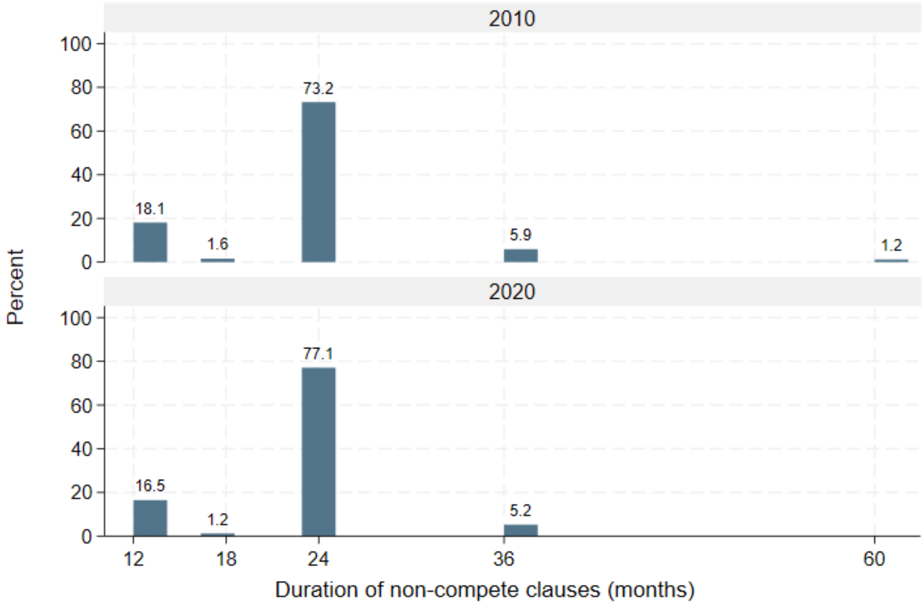

Figure 2: Distribution of the geographical scope of non-compete clauses *after* the franchise relationship ends (all cases where it is stipulated in terms of miles around the existing business)