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Practice Update

The State of Restrictive Covenants in Franchising: New York at the Crossroads

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As this column reported in July, restrictive covenants in franchising are becoming a new focal point for federal and state lawmakers. The Federal Trade Commission's 2024 nationwide non-compete rule never took effect after a federal district court set it aside in August 2024, and the FTC abandoned its appellate effort in 2025. That removed the immediate federal threat to ban/restrict non-competes in franchising, leaving the underlying debate on the value of such a ban in franchising to linger on.

Congress has continued to consider broad non-compete restrictions, state regulators have urged closer review of franchise covenants, and state legislatures and courts are drawing sharper lines between employment restraints and restraints arising from commercial relationships. That latter distinction matters. A post-term franchise covenant is not merely a restriction on earning a living. It is one part of the exchange that incentivizes a franchisor's disclosure of its proprietary, unique, and successful operating methods, customer strategies, trade secrets, site-development knowledge, recipes, software, and brand playbooks to an independent business owner. The lingering question is whether lawmakers and courts will continue to recognize that commercial setting and facilitate incentives that promote franchise growth and often help franchisees go on to operate

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successful businesses, or hamper and potentially strangle the franchise relationship by importing employer-employee legal relationship assumptions into it.

The rule of reason appears to be prevailing in the courts to recognize the commercial setting of franchise relationship agreements to allow for restrictive covenants. California voids most covenants not to compete by statute, and the California Supreme Court in *Edwards v. Arthur Andersen LLP* rejected a judicially created "narrow restraint" exception, holding that non-competes are invalid unless expressly authorized by statute. But more recently, in *Ixchel Pharma, LLC v. Biogen, Inc.*, while the California Supreme Court reaffirmed that Section 16600 of the California Business and Professions Code renders employee non-competes void as a matter of law, it also appears to clarify that a "rule of reason" standard — rather than the stricter per se rule — governs competitive restraints on business operations and commercial dealings. In *BrightStar Franchising, LLC v. Foreside Management Company*, an Illinois district court held that *Ixchel* extends to post-termination covenants in the commercial context, and the franchise agreements governed by California law at issue there, which contained post-termination covenants, were commercial contracts subject to the "rule of reason."

Despite those recent court decisions, Virginia decided to take the opposite policy path. Effective July 1, 2026, amendments to the Virginia Retail Franchising Act make it unlawful to offer or enter into a covered franchise agreement that restricts a franchisee from engaging in a retail business after termination or expiration. The amendments also require Virginia law to govern covered franchise contracts. The prohibition is prospective: agreements entered before July 1, 2026, are not impaired, although a later renewal, extension, or amendment requires careful analysis. The principal exception permits a covenant of up to two years when a franchisee voluntarily sells the franchise, at

a mutually agreed upon price, to a third party or back to the franchisor. Virginia's approach is notable because it targets the franchise relationship itself, not the employer-employee relationship. For national systems, the practical response is a Virginia addendum and greater reliance on carefully drafted confidentiality, trade-secret, de-identification, non-solicitation, and post-termination transition provisions.

For those seeking to avoid the restrictive covenant analysis altogether, there may be another option. Forfeiture-for-competition clauses are now seen as a viable approach to achieving a similar result as non-competes without the public policy concerns. Because an employee subject to a forfeiture-for-competition agreement can still work for competitors (and instead would simply forfeit additional post-employment consideration for which they would be eligible if they did not compete), courts see these agreements as less harmful to mobility or labor markets. Federal and state courts, including in Delaware and New York, generally distinguish between restricting work (non-competes) and conditioning benefits on non-competition (forfeiture clauses), and often apply ordinary contract law to forfeiture claw back provisions, rather than the traditional restrictive covenant analysis that assesses reasonableness and injunctive standards. For example, in the New York Appellate case of *Xu v. Castleton Commodities International LLC*, the court held that a former employee forfeited equity units he had received from his former employer by becoming CEO and president of a competitor four months after his termination, and held it was not violative of fundamental public policy to enforce the forfeiture-for-competition agreement. (1st Dept March 2024). Although many franchisees are classified as independent contractors rather than employees, the forfeiture-for-competition arrangement may still be worth exploring in the franchisee/franchisor context. Practically, forfeiture-for-competition means that companies, including those in the

franchisor/franchisee relationship, can potentially structure deferred compensation (such as installment purchase price payments for a franchisee's book of business, royalty streams and future royalty fees owed to a franchisor, and goodwill payments owed to a franchisee upon termination or non-renewal of a franchise agreement) and other kinds of post-termination compensation to the franchisee with claw back provisions that face minimal judicial scrutiny as opposed to restrictive covenants.

Where does New York stand? New York still has no applicable statutory ban on restrictive covenants. A recent New York court decision that could impact the franchise relationship, *Twitchell Technical Products, LLC v. Mechoshade Systems, LLC*, addressed a restrictive covenant in an ordinary commercial contract, and the state court adopted a "rule of reason" analysis that examines legitimate business interests, reasonable geographic and temporal scope, and hardship to the restrained party. It also held that courts may sever and partially enforce an overbroad commercial covenant in appropriate circumstances. That framework naturally fits with franchise agreements. A franchisor seeking enforcement of a non-compete should identify the system-specific interests the covenant protects: confidential methods, brand goodwill, customer continuity, market development, and the prevention of immediate conversion of a branded unit into a copycat business. It should also explain why the selected radius tracks the actual market and why the duration corresponds to the time needed to install and stabilize a replacement operator. *Twitchell* permits narrowing, but it does not reward maximalist drafting; partial enforcement remains equitable and fact dependent.

More recently, in *Bonchon Franchise LLC v. Zhou*, a New York federal district court entered an unopposed preliminary injunction against a former franchisee who allegedly closed a Bonchon restaurant and immediately opened a competing

Korean restaurant at the same location. The agreement imposed a two-year, 10-mile restriction and contained confidentiality protection and an acknowledgment of irreparable harm. The court enjoined continued operation. Although the ruling arose on an unopposed record and involved a Connecticut outlet, it is a concrete example of a New York federal court treating a franchise agreement restrictive covenant as enforceable commercial protection where the alleged competitive conversion was direct and immediate.

By contrast, other recent New York state court employment relationship decisions caution against assuming that any restraint will survive. In *Arencibia v. SilverLining Interiors, Inc.*, the court held an unenforceable three-year covenant barring a former employee from transacting business with any construction firm in the New York metropolitan area. But in a later related case involving the same parties, the same court vacated a later injunction founded on that same covenant. Six months of severance did not rescue a three-year restraint. For franchise agreement drafting, the lesson is not that employment doctrine controls, but that duration, market definition, and the fit between restraint and protectable interest will receive close scrutiny. Reasonableness and rational basis for the restrictions should be the guiding principles for any such covenants.

Be aware, however, that in New York the legislative risk of invaliding non-competes nevertheless remains and does not seem to be going anywhere. After Governor Kathy Hochul vetoed a broad 2023 bill, narrower proposals followed. The latest vehicle, S.9759/A.10023, passed the Senate on June 3, 2026, and remained in the Assembly Labor Committee when the 2026 session ended. If passed, it would add Labor Law § 191-d and generally prohibit employers from obtaining non-competes from "covered individuals," while excluding highly compensated individuals earning at least $500,000 in average annual cash compensation and

preserving specified sale-of-business arrangements. Tracking New York's expansive employee protections, the bill is framed around employment and economic dependence, not expressly around franchise agreements.

That wording makes classification critical. A conventional franchisee purchasing a business opportunity, employing its own workforce, and bearing entrepreneurial risk supports arguments that it is not performing services in economic dependence on the franchisor. But statutes can migrate through expansive interpretation, particularly where a system exercises unusually detailed operational control or where the franchisee is effectively a single-person service provider. It remains to be seen whether the any future bill in New York will expressly distinguish franchise restraints from employer-employee non-competes rather than leave the issue to litigation.

Nationwide franchisors should try to avoid one-size-fits-all restrictive covenants; tie territory to the unit's trade area; select the shortest defensible non-compete duration; narrowly define competitive businesses by actual system offerings; and separately protect confidential information, trademarks, telephone numbers, digital assets, and customer transition. For now in New York, reasonable and rational restraints on competition will be enforced, but time will tell where the New York legislature decides to go with non-competes in the franchise world and otherwise. In the meantime, companies may have forfeiture-for-competition agreements at their disposal to avoid restrictive covenants entirely.

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