Recent Developments in Litigation and Regulation Related to No-Hire and Employee Non-Compete Agreements: Implications for Franchise Systems

by Aaron M. Fix, Jee-Yeon K. Lehmann, and Michael J. Schreck; Analysis Group, Inc.

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Aaron M. Fix


Jee-Yeon K. Lehmann


Michael J. Schreck

No-hire or non-solicitation agreements, hereafter collectively referred to as "no-hire agreements,"[1] are agreements between employers that place certain restrictions on their ability to recruit or to hire one another's employees. Employee non-compete agreements, often referred to as "covenants not to compete," are agreements between an employer and an employee that restrict the employee, upon leaving the employer, from taking a job at a competing firm for a defined period of time.[2]

Both types of agreements are drawing increased scrutiny from legislators and regulators due to concerns over their potential impact on competition in labor markets. The use of each type of agreement in the context of franchise systems has also been challenged in federal and state courts.

In this article, we discuss recent legal and regulatory challenges to these agreements, including relevant legal precedents, important economic issues that they raise, and their significance for franchise systems.

No-Hire Agreements between Employers

Agreements between firms not to compete with one another, either for the sale of products or for the purchase of inputs into production, are heavily scrutinized by courts and agencies under U.S. antitrust law. "Naked" agreements not to compete, meaning agreements that are separate from or not reasonably necessary to a larger legitimate collaboration or joint venture, are considered *per se* illegal restraints of trade. The Department of Justice (DOJ) and Federal Trade Commission (FTC) recently issued the *Antitrust Guidance for Human Resource Professionals* (hereafter "DOJ and FTC Guidance"), clarifying that the *per se* doctrine applies to horizontal agreements not to compete in labor markets, just as it does in other markets.[3]

No-hire clauses are common in franchise agreements. In fact, the majority of large franchisors' contracts with franchisees include clauses explicitly stating that the franchisee will not recruit or hire workers that are either currently or recently employed by another franchisee within the same franchise system.[4] These clauses have attracted attention from both litigants and policymakers. Two antitrust class actions filed in the past year allege that no-hire agreements between and among franchisors and franchisees in the fast food industry constitute *per se* violations of the Sherman Act.[5] Another class action, filed in California, alleges that similar agreements violate California's state antitrust laws.[6] On the policy front, a November 2017 letter from Senators Elizabeth Warren (D-Mass.) and Cory Booker (D-N.J.) to Attorney General Jeff Sessions specifically asks whether the DOJ and FTC Guidance "applies to 'no-poach agreements' among franchisees within a single corporate entity."[7] The letter describes these agreements as "deeply concerning" and asserts that they "undoubtedly restrict competition in the labor market ...."[8]

Relevant case law and economic reasoning provide a basis for determining whether franchise no-hire agreements constitute an antitrust violation. Key considerations are whether a franchise system is a single economic entity (and therefore incapable of conspiring within itself), and, if not, whether a no-hire agreement in this context constitutes a "reasonable" restraint that facilitates the more efficient operation of the franchise system.

Can Franchisor and Franchisees Conspire in Violation of §1?

The Supreme Court's 1984 decision in *Copperweld v. Independence Tube* held that a parent corporation and its wholly owned subsidiary were incapable of violating §1 of the Sherman Act, owing to the "complete unity of interest" between the parties and the fact that one "corporate consciousness" guides their actions.[9] That decision did not specifically consider the franchise system of distribution. However, the Court's reasoning that separate legal entities can constitute a "single economic enterprise" – and thereby be exempt from §1 scrutiny – has subsequently been employed as a legal defense by franchises accused of §1 violations. The general argument is that the franchisor and franchisees have unity of interest in the success of the franchise, and that the franchisor exerts a significant degree of control over the franchisees. The areas of control may include defining and communicating operating standards for each location, marketing activities, product development, employee training, and negotiating purchases of inputs.

While franchises' use of the "single economic enterprise" defense has met with mixed success,[10] it did prevail in a Ninth Circuit case specifically related to no-hire provisions in franchise agreements. In *Williams v. I. B. Fischer Nevada*, a manager of a Jack-in-the-Box restaurant owned by one of the defendants filed an antitrust claim after he was prevented from working at another Jack-in-the-Box restaurant due to a "no-switching" clause in the franchise agreement.[11] The District Court's finding that defendants were "a single enterprise incapable of competing for purposes of *Section 1* of the Sherman Act"[12] was affirmed on appeal by the Circuit Court. In reaching its decision, the District Court emphasized the "economic unity of interest"[13] between Jack-in-the-Box and its franchisees as well as the "almost complete control"[14] that Jack-in-the-Box exercised over franchisees' operations, including doing "everything in its power to minimize competition and promote uniformity [among the] franchises."[15] In affirming the District Court's decision, the Circuit Court noted that "whether corporate entities are sufficiently independent requires an examination of the particular facts of each case."[16]

The Supreme Court considered the facts of *American Needle, Inc. v. National Football League* in 2010.[17] In considering whether the teams that comprise the National Football League constituted a single economic enterprise, the Court noted that while "NFL teams have common interests such as promoting the NFL brand," the teams constitute separate potential competitors as suppliers of valuable trademark rights to apparel companies.[18] Consequently, the Court found that the NFL teams' decisions were subject to §1, "at least with regards to [the] marketing of property owned by the separate teams."[19] In the context of a no-hire agreement, then, a key question is whether franchises in the same system constitute independent competitors in the labor market even if they share common interests in other dimensions. Indeed, recent breach-of-contract litigations in Ohio and Texas have pitted franchisees against other franchisees of the same franchise system that allegedly violated the "no-hire" clauses in the franchise agreement.[20]

Plaintiffs in recent antitrust class actions related to franchise no-hire agreements seek to establish that franchisees constitute independent decision-makers that should and do compete with each other in some areas of their business. In *Leilani Deslandes v. McDonald's USA*, the plaintiff, a former manager at a McDonald's store in Florida, argues that McDonald's' franchise model is designed to encourage competition among franchises by, for example, refusing to grant franchisees exclusive territories and advising franchisees that they may face competition from other franchisees or outlets owned by McDonald's itself.[21] Another §1 class action brought by a managerial employee in the fast food industry, *Kristen Ion v. Pizza Hut, LLC*, asserts that Pizza Hut's franchise agreements "provide that the franchisees are independent of Pizza Hut and are responsible for all employment practices ...."[22] A similar claim in *Luis Bautista, et al., v. Carl Karcher Enterprises LLC, et al.* alleges that Carl's Jr. franchisees compete with one another on many dimensions of their business.[23]

In all three matters, plaintiffs' emphasis on the independence of franchisees suggests an intent to establish that franchisees are separate competitors in the labor market even if they share common interests in other areas. Per the Supreme Court's ruling in *American Needle*, analysis of the extent of the franchisees' separate interests is probative for whether the no-hire clause may be subject to §1 scrutiny.

As the Supreme Court explained in *American Needle*, if the parties to an agreement are deemed capable of conspiring under §1, the court "must decide whether the restraint of trade is an unreasonable and therefore illegal one."[24] A variety of institutional and economic factors may be relevant to this inquiry.

The primary economic question is whether the no-hire agreement is reasonably necessary to the larger operations of the franchise system. Plaintiffs will likely seek to establish that the no-hire clause serves no purpose other than to restrict employee mobility. Such a restriction on employee mobility may result in decreased wages and supracompetitive profits that can be shared within the franchise system. Defendants will likely argue that the agreement facilitates improved operation of the franchise system by encouraging franchisees to invest in training their employees. Specifically, defendants may argue that without the protection of a no-hire clause, a franchisee may invest less in its own employees due to the risk that those employees will be subsequently recruited by another franchisee of the same system.

If a no-hire agreement can be shown to be reasonably necessary to the operation of the franchise system, evaluation of its legality requires weighing its potential benefits against its potential anticompetitive impact, including suppression of wages. A key consideration is whether market forces in the labor market are able to discipline the potential effects of the no-hire agreement on wages. In the recent class actions mentioned above, managerial employees allege that the training they received was specific to their own franchise system. As such, they claimed that their skills were not readily transferrable to managerial positions at other types of restaurants or franchise systems, meaning that employment opportunities outside the at-issue franchise system did not place competitive pressures on the wages offered to experienced employees who were subject to the no-hire agreement.

Covenants Not to Compete between Employer and Employee

Unlike no-hire agreements, employee non-compete agreements include the employee as an explicit party to the agreement. Non-competes have traditionally been used by employers as a means of protecting their own investments in employees' "human capital."[25] These investments may take the form of sharing confidential business information, giving access to customer lists, or providing training. Employers may be less likely to make these investments without contractual provisions restricting appropriation of such investments by the employee and competing firms upon the employee's departure.

Without these investments, employees are likely to be less productive on the job. As a result, non-competes that preserve employers' incentives to invest in their employees can increase the demand for labor and lead to higher wages.[26] However, non-compete agreements can also reduce employee mobility by limiting their ability to seek a job at a competing firm. Restrictions on employee mobility can reduce employees' bargaining power in negotiations with employers and lead to lower wages. Non-compete

agreements may also be used by firms to foreclose competitors from accessing talent, an important input into their production.

In principle, the no-hire agreements discussed in the first section of this article can have many of the same effects as the non-compete agreements described in this section. An obvious difference is that the employee may not be aware of the no-hire agreement between the franchisor and the franchisee. From an economic perspective, employee awareness of the agreement is not necessary to generate either pro- or anti-competitive effects, although the employee's ability to benefit from the agreement by receiving consideration or sharing in the surplus created by training are negatively affected if that employee is unaware of the existence of the agreement.

Because non-competes can have both pro- and anti-competitive effects, most state laws permit them, while providing the courts wide latitude to decline to enforce or to limit any agreement that is deemed "unreasonable" or harms competition.[27] For example, where an employee is exposed to only a limited amount of trade secrets or confidential information, where training costs are negligible, or where a job requires low-skill levels so that the employees are more easily replaceable, procompetitive justifications for the use of non-competes are unlikely to outweigh the potential for anticompetitive harm. Agreements with an overly broad scope, that go beyond the specific type of work performed by the employee or outside the boundaries of firm's economic activity, are also more likely to be challenged or deemed unenforceable by courts.

Recent Scrutiny of Employee Non-Compete Agreements

Recently, non-compete agreements have faced the scrutiny of regulators and legislators at both the state and federal level, with a special focus on their use among low-wage workers. In June 2015, U.S. Senators Al Franken (D-Minn.) and Chris Murphy (D-Conn.) introduced a bill to ban non-compete agreements for workers making less than $15 per hour. [28] In March 2016, the White House and the U.S. Treasury Office of Economic Policy issued reports focusing on the potential negative effects of non-compete agreements on job mobility and wages.[29] In October 2016, the White House issued a "State Call to Action" urging state legislators to ban non-competes for certain categories of workers, including those below a certain wage threshold and those who are unlikely to be exposed to trade secrets, and limit their terms or enforceability in other cases. Several state legislatures have since considered restrictions on the enforceability of non-compete agreements for workers below a certain income level. Beginning in 2017, the *Illinois Freedom to Work Act* made it illegal for employers to enter into non-competes with employees earning less than $13 per hour.[30]

The legality and enforceability of non-compete agreements have also been challenged in the courts by State Attorneys General as well as private plaintiffs. Most notably, Jimmy John's' use of non-compete covenants prohibiting sandwich makers and delivery drivers from working for a competitor was first challenged in a federal class action lawsuit in 2014 in the Northern District of Illinois.[31] Those claims were dismissed due to sworn testimony by Jimmy John's that it had no intention of ever enforcing the agreements, but not before a group of U.S. Representatives led by Joseph Crowley (D-N.Y.) and Linda Sanchez (D.-Calif.) publicly called for the FTC to investigate

the practice, calling it "anti-competitive and intimidating to workers."[32] Jimmy John's has since entered into settlements with the State Attorneys General of New York and Illinois, discontinuing the use of non-compete agreements between franchisees and employees in those states.[33] The two State Attorneys General have since continued their enforcement activities with respect to non-competes, targeting companies in a variety of industries in settlements and lawsuits.[34]

Implications for Franchises

These recent developments are particularly relevant for franchise systems. First, many franchises employ relatively low-skilled, low-wage workers – exactly the type of workers that legislators and regulators seek to protect. Second, low-level workers in franchise systems may not be exposed to trade secrets or confidential business information that would warrant the use of non-compete agreements. These workers may not have long-term customer relationships and often their work is performed in public. Third, non-compete agreements, including the specific contractual language signed by the employee, may be derived from the franchisor-franchisee agreement. Thus, while vertical contracts signed between employers and employees have traditionally been treated under state competition and labor laws, franchisors that institute non-compete agreements throughout their franchise systems across different states risk a challenge under federal antitrust laws, which govern interstate commerce.[35]

Summary and Outlook

No-hire agreements between employers have recently come under increased scrutiny from regulators and legislators. They have also been challenged by private plaintiffs under both federal and state antitrust laws. Non-compete agreements, while previously within the purview of state laws, have also attracted national attention, and could be subject to similar challenges under federal antitrust law.

In light of the prevalence of no-hire and non-compete clauses in franchise agreements, these developments have significant implications for franchise systems. To the degree that employees have low wages, their skillsets are easily replaceable by other members of the workforce, or they are not exposed to confidential business information, franchise systems may find that these clauses in franchise agreements invite unwelcome attention from regulators and plaintiffs.

Editor's Note: *Subsequent to the authors' submission of this article, on January 24, 2018, an antitrust class action was filed in Illinois federal court against Jimmy John's. The plaintiffs in that case allege that recruiting restrictions in Jimmy John's franchise contracts, and widespread non-compete agreements between franchises and employees, facilitated a no-hire conspiracy among franchisees and constituted a per se violation of the Sherman Act. The case is Sylas Butler v. Jimmy John's Franchise, LLC, et al., No. 3:18-cv-00133 (S.D. Ill. January 24, 2018).*

Endnotes

1 No-hire or non-solicitation agreements have also been referred to as "no-poaching" or "no-switching agreements," depending on the specifics of the agreement. For the remainder of this article, we refer to the class of agreements that place restrictions on hiring between employers as "no-hire" agreements.

2 Employee non-compete agreements, which are the subject of this article, should not be confused with another common "non-compete" agreement in the franchise context: that between a franchisor and its franchisees. When contracting with a new franchisee, the franchisor often requires a post-termination non-competition clause in order to prevent the franchisee from eventually withdrawing from the franchise system to operate independently as a competitor using the knowledge gained from its experience with the franchisor.

3 *See* Dep't of Justice, Antitrust Division, & Fed, Trade Comm'n, Antitrust Guidance for Human Resource Professionals, (Oct. 2016), *available* at https://www.justice.gov/atr/file/903511/download ("Guidance").

4 *See* Alan B. Krueger & Orley Ashenfelter, *Theory and Evidence on Employer Collusion in the Franchise Sector*, (Princeton University Industrial Relations Section Working Paper No, 614, 2017). Krueger and Ashenfelter's findings were reported in the *New York Times* in September 2017. *See* Rachel Abrams, *Why Aren't Paychecks Growing? A Burger-Joint Clause Offers a Clue*, N.Y. Times, Sept. 27, 2017, https://www.nytimes.com/2017/09/27/business/pay-growth-fast-food-hiring.html.

5 *Leilani Deslandes v. McDonald's USA, LLC, et al.*, No. 1:17-cv-04857 (N.D. Ill. June 28, 2017). *Kristen Ion v. Pizza Hut, LLC*, No. 4:17-cv-00788 (E.D. Tex. Nov. 3, 2017).

6 *Luis Bautista and Margarita Guerrero v. Carl Karcher Enterprises, LLC, et al.*, No. BC649777 (Cal. 2017).

7 *See* Letter from Senators Elizabeth Warren and Cory A. Booker to Attorney General Jeff Sessions, (Nov. 21, 2017), *available* at https://www.warren.senate.gov/files/documents/2017_11_21_No_Poach.pdf.

8 *Id.*

9 *Copperweld v. Indep. Tube Corp.*, 467 U.S. 752 (1984).

10 *See, e.g., Motive Parts Warehouse v. Facet Enterprises*, 774 F.2d 380, 387-88 (10th Cir. 1985) (finding that where franchisees have "an independent personal stake" in an agreement with a franchisor to restrain trade, that agreement can violate §1); *Hall v. Burger King Corp.*, 912 F. Supp. 1509 (S.D. Fla. 1995) (finding no evidence of conspiracy, but noting that the conspiracy claim was doomed because franchisors and franchisees "are incapable of conspiring with each other").

11 *Williams v. Nevada*, 794 F. Supp. 1026 (D. Nev. 1992), *aff'd sub nom. Williams v. I.V. Fischer Nevada*, 999 F.2d 445 (9th Cir. 1993).

12 *Id.* at 1032.

13 *Id.* at 1031.

14 *Id.* at 1031.

15 *Id.* at 1032.

16 *Williams*, 999 F.2d at 447.

17 *Am, Needle, Inc. v. Nat'l Football League*, 560 U.S. 183, 130 S. Ct. 2201, 176 L. Ed. 2d 947 (2010).

18 *Id.* at 2213.

19 *Id.* at 2215.

20 *Herbert L. Washington v. Sam Covelli, et al.*, 35 NE 3d 578 (Ohio 2015); *Gator Apple, LLC, v. Apple Texas Restaurants, Inc.*, 442 S.W.3d 521 (Tex. App. 2014).

21 Complaint, *Leilani Deslandes v. McDonald's USA, LLC*, No. 1:17-cv-04857 (N.D. Ill. June 28, 2017).

22 Complaint, *Kristen Ion v. Pizza Hut, LLC*, No. 4:17-cv-00788 (E.D. Tex. Nov. 3, 2017).

23 *Luis Bautista and Margarita Guerrero v. Carl Karcher Enterprises, LLC, et al.*, No. BC649777 (Cal. 2017).

24 *Id.* at 2212.

25 Economists use the term "human capital" to refer to productive knowledge or training that increases a person's earnings potential. *See*, e.g., Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, Vol. 50(5), Part 2 *J. of Pol. Econ.*, 1962, 9-49.

26 *See*, e.g., Paul H. Rubin & Pater Shedd, *Human Capital and Covenants Not to Compete*, Vol. 10(1) *J. of Legal Stud.*, 1981, , 93-110.

27 *See*, e.g., "Employee Noncompetes: A State by State Survey," maintained by Beck Reed Riden LLP, *available* at https://www.faircompetitionlaw.com/wp-content/uploads/2017/07/Noncompetes-50-State-Survey-Chart-20170711.pdf.

28 Claire Zillman, Senators: Jimmy John's Workers Should Not Have to Sign Non-Competes, Fortune, June 3, 2015, available at http://fortune.com/leadership/non-compete-ban-bill-jimmy-johns/. See also Butler v. Jimmy John's Franchise, LLC, No. 3:18-cv-00133 (U.S.D.C. S.D.Ill. Jan. 24, 2018).

29 U.S. Dept. of Treasury, Office of Economic Policy Report, Non-compete Contracts: Economic Effects and Policy Implications (2016), *available* at https://www.treasury.gov/resource-center/economic-policy/Documents/UST%20Non-competes%20Report.pdf;The White House, Non-Compete Agreements: Analysis of the Usage, Potential: Issues, and State Responses, (May 2016).

30 820 ILCS 90, *available* at http://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=3737&ChapterID=68.

31 *Brunner v. Jimmy John's Enterprises, Inc. et al*, No. 14 C 5509, 2015 WL 5086388 (N.D. Ill. Aug. 19, 2015).

32 Claire Zillman, *Senators: Jimmy John's Workers Should Not Have to Sign Non-Competes*, Fortune, June 3, 2015, *available* at http://fortune.com/leadership/non-compete-ban-bill-jimmy-johns/.

33 *People v. Jimmy John's Franchise, LLC*, 2016 CH 07746, Ill. Cir. Ct. (June 8, 2016), Final Order and Consent Decree; Letter from Eric T. Schneiderman, New York Attorney General, to Gerald Maatman of Seyfarth Shaw LLP, Jun 16, 2016.

34 During the summer of 2016 the New York Attorney General reached settlements with Examination Management Services Inc., a medical information services company, and Law360, a legal news website. In October 2017 the Illinois Attorney General sued Check into Cash Illinois LLC, a payday lender, alleging that non-compete agreements with employees are illegal because, among other reasons, many of those employees make less than $13 per hour.

35 As we discussed above, federal regulators have recently made clear that an agreement between employers that limits competition for employees can be considered a *per se* violation of the Sherman Act.