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Anti-Poaching Provisions in Franchise Agreements Are Drawing Increased Scrutiny

By Jess A. Dance

Franchise agreements often contain provisions prohibiting the franchisee from soliciting or hiring workers employed by the franchisor or other franchisees. Such "anti-poaching" agreements have recently come under increased scrutiny from regulators, legislators, and class action plaintiffs.

The Department of Justice ("DOJ") and the Federal Trade Commission ("FTC") have stated that they view naked anti-poaching agreements (that is, agreements that are separate from or not reasonably necessary to a larger legitimate collaboration between the employers) as *per se* antitrust violations under the Sherman Act that could result in criminal prosecution. Pending federal legislation would outlaw anti-poaching provisions in franchise agreements. Meanwhile, private plaintiffs have sued franchisors in at least four class actions, contending that anti-poaching provisions in franchise agreements violate federal and state antitrust laws. A federal court in Illinois recently allowed a federal antitrust class action to move forward against McDonald's.

In light of this increased scrutiny, as well as potential antitrust and joint-employment liability, franchisors should carefully review any anti-poaching provisions in their franchise agreements.

What Are Anti-Poaching Agreements?

"No-hire" (sometimes called "no-switching") agreements are contracts between or among employers not to hire each other's employees. Similarly, a "non-solicitation" agreement prevents an employer from soliciting another employer's employees, but does not prevent their hire as long as there was no solicitation. (We collectively refer herein to no-hire and non-solicitation agreements as "anti-poaching" agreements.)

A recent survey by Princeton economists found that 58 percent of the largest franchise systems—those with more than 500 franchise outlets in the US—have anti-poaching provisions in their franchise agreements that restrict the recruitment and hiring of workers currently (and sometimes formerly) employed at another outlet in the franchise system. The percentage is even higher among quick-service restaurant, full-service restaurant, tax preparation, and automotive

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franchise systems. The survey did not distinguish between anti-poaching provisions that apply to all employees and those that are limited to management-level employees, but noted that "[m]ost no-poaching agreements [in the survey] apply to all workers while a minority are limited to managerial workers."

When used in franchise agreements, anti-poaching provisions prevent intra-brand freeriding; that is, they bar franchisees from raiding each other's employees after another franchisee has already incurred substantial time and expense to train the employee regarding the specialized skills and methods necessary to deliver the franchise system's products or services to customers. This is particularly important regarding management-level employees who necessarily require a greater level of investment by the franchisee. By helping franchisees protect their significant investment in training (especially regarding managers), anti-poaching provisions strengthen the overall franchise system and foster inter-brand competition.

Governmental Scrutiny

In October 2016, the DOJ's Antitrust Division and the FTC jointly issued "Antitrust Guidance for Human Resource Professionals" ("Joint Guidance") to alert companies that federal antitrust laws apply to competition among companies to hire and retain employees, regardless of whether those companies compete in the same product or service market. Critically, the Guidance asserts that "naked" anti-poaching agreements constitute *per se* antitrust violations. In a significant policy shift, the DOJ announced its intent to criminally investigate and prosecute such alleged *per se* violations regarding anti-poaching agreements. The Joint Guidance further warned that anti-poaching agreements that do not result in criminal sanctions may still lead to civil liability under federal antitrust law.

In a January 2018 speech, the DOJ's Antitrust Chief announced that the agency expects to initiate multiple criminal proceedings targeting naked anti-poaching agreements in the coming months. No specific criminal cases have been announced yet.

Anti-poaching attention has turned to franchising in recent months. Citing the Princeton survey discussed above, Senators Elizabeth Warren and Cory Booker sent a letter to Attorney General Jeff Sessions in November 2017, regarding anti-poaching provisions in franchise agreements. Opining that anti-poaching agreements are "deeply concerning" and "undoubtedly restrict competition in the labor market," the Senators asked whether the Joint Guidance "applies to 'no-poach agreements' among franchisees within a single corporate entity," whether the DOJ is currently investigating the use of anti-poaching provisions in franchise agreements, and whether the DOJ is "currently pursuing legal action against any franchisors for their use of no-poach agreements."

On March 1, 2018, Senators Warren and Booker introduced S.2480—the End Employer Collusion Act—which, if passed, would expressly prohibit anti-poaching provisions in franchise agreements. Specifically, the bill would prohibit any entity from entering into, enforcing, or threatening to enforce a restrictive employment agreement. Under the proposed bill, a "restrictive employment agreement" is an agreement between two or more employers, "including through a franchise agreement," that "prohibits or restricts one employer from soliciting or hiring another employer's employees or former employees." A violator would be liable for the actual damages sustained by an injured worker, punitive damages, and attorneys' fees and costs. A companion bill (H.R.5632) was introduced in the House of Representatives on April 26, 2018.

In a letter to Congress dated June 20, 2018, the International Franchise Association ("IFA") pointed out that there are "legitimate and necessary applications" of anti-poaching provisions, but acknowledged "in some circumstances, can be used inappropriately." The IFA warned that the proposed legislation is "overly broad" and "could have negative and unintended consequences for the thousands of small businesses that make up the franchise small business network across America. The IFA offered to help develop a bipartisan solution that would both provide employees with sufficient protections and avoid harming brand value and the economy.

Finally, some states are getting in on the action as well. In February 2018, the Washington Attorney General issued civil investigative demands ("CIDs") to multiple franchisors, requesting information about franchise agreements signed in the past five years that contain anti-poaching provisions and the franchisors' reasons for having, changing, or eliminating those provisions.

Class Actions

In the past year, four class actions have been filed against franchisors (Carl's Jr., McDonald's, Pizza Hut, and Jimmy John's) based on anti-poaching provisions in their franchise agreements:

- *Bautista v. Carl Karcher Enterprises, LLC*, Case No. BC649777 (Cal. Super. Ct. County of Los Angeles filed Feb. 8, 2017)

- *Deslandes v. McDonald's USA, LLC*, Case No. 1:17-cv-04857 (N.D. Ill. filed June 28, 2017)
- *Ion v. Pizza Hut, LLC*, Case No. 4:17-cv-00788 (E.D. Tex. filed Nov. 3, 2017)
- *Butler v. Jimmy John's Franchise, LLC*, Case No. 3:18-cv-00133 (S.D. Ill. filed Jan. 24, 2018)

The class action plaintiffs contend that anti-poaching agreements between the franchisor and its franchisees suppress workers' wages and mobility, and constitute *per se* violations of federal and state antitrust laws. Such antitrust class actions carry the risk of huge potential class sizes, treble damages, and attorneys' fees. As discussed below, the federal antitrust claim against McDonald's recently survived dismissal and is moving forward. Motions to dismiss are pending in the other three cases.

The McDonald's case in particular has garnered national attention. The *Deslandes* complaint alleges that McDonald's franchise agreements prohibit franchisees from employing, or seeking to employ, any person employed by McDonald's, any of its subsidiaries, or any of its franchisees, and that McDonald's similarly precludes company-owned stores from hiring persons employed by franchisees. Plaintiff Leilani Deslandes worked as a department manager at a franchised McDonald's restaurant in the Orlando area. She was scheduled to attend McDonald's "Hamburger University" training in Illinois in connection with seeking a promotion to general manager, but the franchisee she worked for canceled her training after learning she was pregnant. Soon thereafter she applied for a manager opening at a nearby company-owned McDonald's restaurant. The second restaurant expressed a desire to hire Deslandes with more pay, better promotion opportunities, and a better shift; however, after learning that she worked for a McDonald's franchisee, the second restaurant said it could not interview (much less hire) her unless she was "released" by the franchisee she worked for. According to the complaint, the franchisee refused, preventing her from moving to a better job at a company-owned restaurant.

On June 25, 2018, the Northern District of Illinois denied McDonald's motion to dismiss, allowing Deslandes' federal antitrust claim to proceed. *Deslandes v. McDonald's USA, LLC*, 2018 WL 3105955 (N.D. Ill. June 25, 2018). After finding that McDonald's anti-poaching provision restrained competition for workers between horizontal competitors—franchisee-owned and company-owned restaurants—the court held that Deslandes sufficiently alleged a Sherman Act claim because "[e]ven a person with a rudimentary understanding of economics would understand that if competitors agree not to hire each other's employees, wages for employees will stagnate." *Id.* at *7. The court rejected McDonald's argument that the anti-poaching provision promotes inter-brand competition: "This case . . . is not about competition for the sale of hamburgers to consumers. It is about competition for employees, and, in the market for employees, the McDonald's franchisees and [company-owned restaurants] within a locale are direct, horizontal, competitors." *Id.* at *8. The court also rejected the argument that the provision promotes intra-brand competition by encouraging franchisees to train employees for management positions. The court noted the restraint "is not limited to management employees who had received expensive training at Hamburger University," but "applies even to entry-level employees with no management training." *Id.* Further, according to the court, "every employer fears losing the employees it has trained. That fear does not, however, justify [anti-poaching agreements]." *Id.*

Notwithstanding the recent *Deslandes* order, each case will turn on its own facts and circumstances. Franchisors have several potential legal defenses to antitrust challenges to their anti-poaching agreements. For example, it will be difficult for a plaintiff to establish standing or show that class certification is appropriate if the particular anti-poaching provision is rarely, if ever, enforced.

No court has held an anti-poaching agreement to be *per se* illegal. Moreover, franchising is generally viewed as a "vertical"—not "horizontal"—relationship for antitrust purposes. While naked horizontal agreements between competitors to restrict competition are *per se* illegal, alleged vertical restraints generally are analyzed under the more lenient "rule of reason," which only prohibits a practice if its anti-competitive effects outweigh its pro-competitive benefits in the relevant market. Courts have also applied the rule of reason analysis to non-naked horizontal restraints. (In *Deslandes*, the court held that McDonald's anti-poaching agreement was a horizontal restraint as it restrained competing franchisee-owned and company-owned restaurants from competing for workers, but was nevertheless subject to the rule of reason analysis as the restraint was "ancillary" to the franchise agreement, which has procompetitive effects.)

Under a rule of reason analysis, courts generally require proof that the defendant has "market power" in the relevant market. While the class action plaintiffs noted above are trying to argue that the relevant market is limited only to jobs within the particular franchise system, courts are resistant to single-brand market arguments. (The *Deslandes* court did not address this issue.) As a result, it is unlikely that the class action plaintiffs will be able to show that any single franchisor possesses sufficient market power under a rule of reason analysis.

Further, an antitrust violation requires, at a minimum, an agreement between two or more persons or entities. Some courts have in the past rejected antitrust claims against franchisors on the grounds that a franchisor and its franchisees constitute a "single enterprise" incapable of competing for purposes of the Sherman Act. *See, e.g., Williams v. I.B. Fischer Nevada*, 999 F.2d 445 (9th Cir. 1993) (rejecting antitrust challenge to anti-poaching provision in Jack-in-the-Box's franchise agreement on "single enterprise" grounds). However, it is unclear whether such precedents survive the U.S. Supreme Court's decision in *American Needle v. National Football League*, 560 U.S. 183 (2010), which held that the NFL and individual teams were not a "single enterprise" for antitrust purposes regarding certain licensing activities. McDonald's did not raise a single-enterprise argument in *Deslandes*.

An additional concern is that establishing a single-enterprise defense may open up a franchisor to arguments that it is a "joint employer" liable for its franchisees' labor and employment law violations. As it relates to franchise systems, the "single enterprise" argument is premised on the significant control the franchisor exerts over its franchisee's operations. Meanwhile, though the test for determining joint employment can vary from statute to statute and court and court, the general touchstone is control. While there is a compelling argument that the operational control relevant to the single-enterprise defense is not the type of employment-related control relevant to a joint-employer finding, establishing a single-enterprise defense could carry joint employment risks for franchisors.

In light of joint employment concerns, many franchisors now disclaim any involvement in franchisees' hiring decisions. By prohibiting franchisees from soliciting or hiring qualified workers who work (or worked) at another franchisee's outlet, anti-poaching provisions may undermine such disclaimers and increase the risk of joint-employer exposure. As a result, even if a "single enterprise" defense remains available after *American Needle*, franchisors should seriously consider whether they want to make the argument in light of potential joint employment exposure.

What's Next?

When reviewing anti-poaching provisions in their franchise agreements, franchisors should ask a series of questions: What is the purpose of the provision? It is necessary to protect the overall franchise system—for example, does it encourage franchisees to invest in providing thorough training? Is the provision overly restrictive or narrowly tailored? Does it apply to all outlets nationwide or just those within a close geographic proximity to a franchisee's outlet? Does it only restrict the soliciting or hiring of another franchisee's current workers or does it extend to former workers as well? Does it bar a franchisee from poaching the franchisor's corporate employees at headquarters or company-owned outlets—and if so, why? Agreements that are arguably "horizontal"—for example, where the franchisor and its franchisees both operate outlets and agree not to poach *each other's* employees—are more problematic than "vertical" agreements—for example, where the franchisor prohibits franchisees from poaching other *franchisees'* employee. Are there less restrictive options—for example, instead of a prohibition on hiring another franchisee's employee, would a requirement that the hiring franchisee reimburse the other franchisee's costs of training a replacement employee serve the same goal? Alternatively, could the provision be limited to the solicitation or hiring of only management-level employees? Finally, has the anti-poaching provision ever actually been enforced?

While there are strong arguments that narrowly tailored anti-poaching provisions can serve legitimate, pro-competitive purposes within a franchise system, franchisors should eliminate or modify overbroad, unnecessary, or unenforced anti-poaching provisions in their franchise agreements. Franchisors should also consider whether any involvement in their franchisees' hiring decisions is justified in light of potential joint-employment claims.

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