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New Challenges for International Franchising
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VERTICAL? HORIZONTAL? DIAGONAL? – U.S. STATE AND FEDERAL ENFORCERS DIVERGE ON APPLICATION OF ANTITRUST PRINCIPLES TO NO POACH AGREEMENTS IN FRANCHISE SYSTEMS

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During the summer of 2018, fast-food franchisors faced increased claims that so-called "no poach" agreements were anticompetitive. Over the last few months, antitrust enforcement agencies have advanced competing legal theories on a key question about the application of competition principles to franchise systems. While these legal theories are being considered by the courts, fifty franchisors in a variety of industries have entered into consent agreements to remove no poach provisions from their franchise agreements.

Background

In July of 2018, eleven state attorneys general, led by Massachusetts Attorney General Maura Healey, sent a letter to several national franchisors seeking information and documents about provisions in franchise agreements that restrict franchisees in the same chain from soliciting or hiring workers away from each other. These types of clauses are generally known as "no poach," "non-solicitation," or "no hire" agreements. According to the July 9 letter, state enforcers were concerned that such agreements in franchisor contracts with their franchisees may negatively impact fast-food industry employees in their respective states; notably, most of those investigations were generally staffed with Fair Labor division units, rather than antitrust units, of those AG Offices, which may suggest that that they view this issue as more a matter of worker protection than anti-competition.

Three days later, on July 12, Washington State Attorney General Bob Ferguson announced that the State of Washington had reached agreements with seven national franchisors ending restrictions on the movement of workers. According to Ferguson, such restrictions violated Washington State antitrust laws, but these settlements went beyond Washington State and extended nationwide to over 25,000 restaurants. Specifically, these franchisors agreed to no longer enforce language in their franchise agreements that stop workers from moving to other positions and to remove such language from current and future contracts. Dozens of other franchisors have subsequently agreed with the State of Washington to end their no poach practices. In addition to fast-food franchisors, consent agreements have been signed with franchisors in the health club, automotive supplier, tax preparation, cleaning service, and other personal services business industries.

[1] Thanks to Steve Feirman and Ronaldo Rauseo-Ricupero of Nixon Peabody LLP for their insights in drafting this article.

All of this state activity comes against the backdrop of several active investigations conducted by the United States Department of Justice ("DOJ") into whether no poach agreements among employers violate federal antitrust laws.

There has also been increased action on the Congressional level. In the summer of 2018, Senators Cory Booker and Elizabeth Warren sent letters to the CEOs of 90 franchisors requesting information on the franchisors' no poaching clauses and requesting that they remove from their franchise agreements "any language that imposes limits on worker mobility." Citing a 2017 Princeton University study by economists Alan Krueger and Orley Ashenfelter, "Theory and Evidence on Employer Collusion in the Franchise Sector," that described the pervasiveness of no poaching clauses in the franchise industry, Senators Booker and Warren expressed concern that no poaching provisions were contributing to wage stagnation. This was in the context of various federal legislative proposals that would prohibit no poach provisions and similar restrictive employment practices, including the End Employer Collusion Act, the Workforce Mobility Act, and the Economic Freedom and Financial Security for Working People Act.

Case Law Developments

Many of these issues came to a head last month in the rare occurrence of U.S. federal and state attorneys general advocating opposite legal interpretations within a single proceeding, when Washington State Attorney General Ferguson submitted an amicus brief in *Stigar v. Dough Dough Inc. et al.*, E.D. Wash. No. 18-cv-244. Ferguson argued against the position advanced less than a week earlier by the US DOJ's Antitrust Division's Statement of Interest in the same case.

The Practical Context

The dispute centers around how much scrutiny must be given to a no poach provision. The federal Antitrust Division's position is that such agreements can be analyzed under the 'rule of reason' analysis[2] because those agreements between a franchisor and its franchisees are essentially vertical restraints of trade,[3] whereas

[2] The rule of reason analysis is a judicial doctrine of antitrust law which provides that a trade practice violates the antitrust laws only if the practice is proven to unreasonably restrain trade, based on economic factors.

[3] Vertical restraints are competition restrictions in agreements between firms or individuals at different levels of the production and distribution process.

(Footnote continued on next page)

Attorney General Ferguson argues they should be examined under the stricter *per se* rule[4] because their constraints are essentially horizontal restraints.[5]

Stigar v. Dough Dough Inc. et al. was filed as a class action in August of 2018 on behalf of employees of franchisees of the Auntie Anne's brand. The plaintiff, a former employee of an Auntie Anne's franchise, sought damages in excess of $5,000,000 based on allegations that Auntie Anne's and many of its Washington-based franchisees violated state and federal antitrust laws and artificially suppressed fast-food worker wages. Specifically, the plaintiff alleged that the employees had been harmed by an agreement to "not employ or seek to employ an employee of [Auntie Anne's] or another franchisee, or attempt to induce such an employee to cease his/her employment without the prior written consent of such employee's employer." According to the plaintiff, the agreement constituted a *per se* violation of the antitrust law because it "artificially suppresses fast food worker wages."

Stigar was a follow-on complaint to one of the consent agreements reached by Washington State Attorney General Ferguson. To date, it appears that only one franchise system, Jersey Mike's sandwich shops, declined to settle, and Ferguson's office is pursuing a civil enforcement action against the system in state court. *State of Washington v. Jersey Mike's Franchise Systems, Inc., et al.*, No. 18-2-25822-7-SEA.

The Theoretical Dispute

Against this backdrop of state attorneys general aggressively seeking enforcement, the DOJ's Statement of Interest in the *Stigar* case took a much more skeptical view of whether such agreements were actually anti-competitive in the franchise context: "The franchise relationship is in many respects a vertical one because the franchisor and the franchisee normally conduct business at different levels of the market structure. Restraints imposed by agreement between the two are usually vertical and thus assessed under the rule of reason." Statement of Interest at 11. DOJ's Statement in *Stigar* noted how such agreements in the franchise context can be helpful for the marketplace because they promote inter-brand competition, rather than intra-brand competition. Id. at 12.

Notably, this skepticism of the anticompetitive nature of no poach agreements in the franchise context represents an aberration from the DOJ's approach to no poach agreements generally, as the DOJ has gone so far as to as threaten criminal enforcement: it published guidance in 2016 that put businesses on notice that it would be focused on reviewing such agreements among competitors and, in appropriate cases, would consider

[4] In U.S. law, the term illegal *per se* means that the act is inherently illegal and does not require proof that it has an unreasonable effect on competition.

[5] A horizontal restraint of trade involves an agreement among competitors at the same distribution level.

proceeding with criminal prosecutions in addition to civil enforcement actions. In several recent speeches, key DOJ leaders from the DOJ's Antitrust Division, have reinforced DOJ's interest, and specifically identified no poach agreements as an area of focus and one ripe for criminal enforcement, and announced that they would be targeting health care companies.

AG Ferguson's competing Amicus Brief began with a discussion of how state antitrust law need not mirror federal antitrust law. *Id.* at 1-6. But when it came time for the brief to confront the DOJ's claim that such constraints were primarily vertical in nature, rather than addressing that argument head-on, the AG's Brief appeared to cabin its theory of *per se* analysis to those situations involving franchisees competing with franchisor-operated stores: "to the extent a franchise agreement restricts solicitation and hiring among franchisees and a corporate-owned store—which is indisputably a horizontal competitor of a franchisee for labor—the agreement must properly be analyzed as a *per se* restraint." Ferguson Brief at 6-7.

Rather than engage the antitrust theories at issue, it simply argued that because no poach agreements are not "common or uniform provisions" in franchise agreements, "franchisors should have a heavy burden to show that a no poach provision in a franchise agreement can be justified as a restraint that is 'reasonably necessary' to a separate, legitimate business transaction or collaboration." *Id.* at 9.

Ferguson's Brief was quick to claim that his *per se* theory had been upheld by the Washington state court as a matter of state law interpretation. *Id* .at 5. ("a state court has already rendered a decision relevant to the present matter"). But this claim that "a state court judge has already ruled that these claims can be subject to *per se* liability under the [Washington State Consumer Protection Act]" is a very broad interpretation of a two-paragraph order that simply states, in operative part, "Because the State of Washington has alleged two causes of action, that if proven entitle the plaintiff to relief, the Defendants' motion is hereby DENIED." *See State of Washington v. Jersey Mike's Franchise Systems, Inc., et al.*, No. 18-2-25822-7-SEA (King Cty. Sup. Ct.), Order Den. Def.'s Mot. to Dismiss (Jan. 28, 2019). However, we will never know whether that thin reed of a ruling would be deemed a sufficiently compelling state court interpretation to influence an outcome that could have affected franchise across the U.S. – shortly after the submission, and on the eve of the motion to dismiss hearing, the parties settled the dispute.

On the Horizon

While the case may have settled, the debate rages on. For example, the DOJ Statement of Interest has already been cited in an April 2019 motion to dismiss a no poach action that is currently pending against the Papa John's franchise system currently pending in the Western District of Kentucky. *See* Deft's Mtn to Dismiss, Dkt. 59,

In Re: Papa John's Employee and Franchisee Antitrust Litigation, Case No.: 3:18-CV-00825-JHM-RSE (April 5, 2019) see also Defts' Mtn to Dismiss, Dkt. 42, *Arrington v Burger King Worldwide, Inc*., S.D. Fla. 18-CV-241248-JEM (April 19, 2019). That is another follow-on from a September 2018 settlement entered into with the Washington Attorney General's Office.

Notably, on the day that AG Ferguson submitted his brief in the *Stigar* case, the multi-state working group announced its resolution with other top franchisors, which required the franchisors to agree to not include no poach provisions in franchise agreements, not to enforce existing no-poach agreements, to encourage franchisees to agree to amendments eliminating them from current agreements, and to notify workers directly that they are not prohibited from seeking employment with other locations within the franchise system.

While Ferguson and other attorneys general are free to ask franchisors to enter into settlements, the allegations and legal theories have been staked out, and the threat of follow-on actions remains.

In light of these developments, franchisors from a wide range of franchisee system types explicitly identified by the Washington Attorneys General as future targets – from home health care to insurance adjustors – would be well advised to undertake an antitrust-focused review of their franchise agreements and policies.