

Distribution

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David Evans, James Nichols, and Dan Graulich
Editors

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Message from the Co-Chairs

Welcome to our first edition of *Distribution* for the 2018-19 ABA year! Thanks once again to our editors David Evans, James Nichols, and Dan Graulich for soliciting and editing the articles.

This edition covers four very topical issues in distribution law:

- **Michael Dady** and **Rachel Stych** analyze means of challenging post-termination non-compete provisions in franchise agreements and also discuss the decline of non-solicitation (no poach) provisions.
- **Thomas Griffith** discusses the antitrust treatment of two-sided platforms in four different industries since the Supreme Court's decision in *Ohio v. American Express*.
- **Chris Young** reviews recent developments concerning no poach provisions in franchise agreements, ranging from legislative initiatives and regulatory investigations to private class actions.
- **Nick Brod** and **Dan Graulich** review the Ninth Circuit's decision in *Arandell Corp. v. CenterPoint Energy Services*, which used the *Copperweld* doctrine offensively to hold a wholly owned subsidiary liable for its parent's antitrust violations even if it did not know or act purposefully to carry out those violations.

We hope you find these articles informative and useful. We are always looking for additional topics and authors! If you would like to submit or have an idea for an article for a **future issue** of *Distribution*, or are interested in summarizing

one of our Committee or Spring Meeting programs for a future publication, please contact David Evans (devans@kelleydrye.com), James Nichols (nichols.james@dorsey.com), or Dan Graulich (daniel.graulich@hoganlovells.com).

We also hope you are attending our **Committee programs** covering different aspects of distribution and franchise law either at the time or afterwards through the Committee audio page on Connect. Our most recent program on algorithmic price fixing was held on December 14, 2018, and we are planning a program on exclusive dealing and related issues for January. Please also attend our **Spring Meeting program** on March 27, 2018 on the intersection between competition and comparative advertising. If you have ideas for additional programs or would like to help organize or speak at one, please reach out to David Evans (devans@kelleydrye.com) or Deena Schneider (dschneider@schnader.com) so we can put you in touch with one of our Vice Chairs Chris Casamassima, Greg Fortsch, James Nichols, and Frank Qi.

We thank all members of our Committee's leadership, including our Young Lawyer Representatives Anna Aryankalayil and Dan Graulich, for their contributions to our efforts to bring our members worthwhile programs and publications on distribution and franchise law. Thanks also to our Committee members, program attendees, and publications readers. If you aren't already a member of our Committee, please join us and bring a colleague. We'll make it worth your while!

Best regards,

David H. Evans
Deena Jo Schneider

Co-Chairs, Distribution & Franchising Committee

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Legal Challenges to No-Poach Provisions in Franchise Agreements

By: A. Chris Young¹

Over the last 18 months, no-poach provisions in franchise agreements have drawn considerable attention from academics, state attorneys general, politicians, and the class action plaintiffs' bar. Senators Cory Booker and Elizabeth Warren highlighted the dangers of no-poach agreements between franchisors and franchisees and introduced S. 2480, a bill that would prohibit agreements — including agreements among franchisors and franchisees — that “restrict[] one employer from soliciting or hiring another employer’s employees or former employees.” This political action seems to be a response to a Princeton University economic study showing that 58 percent of franchisors with more than 500 franchise units in the United States have no-poach provisions in the franchise agreements.²

On July 9, 2018, the attorneys general of 10 states and the District of Columbia announced they are investigating no-hire provisions in franchise agreements of fast-food franchisors. Three days later, on July 12, 2018, seven national fast-food chains agreed not to enforce no-poach/no-hire provisions in their franchise agreements and to remove the employment restrictions from any future

franchise agreements in a deal negotiated with the Washington state attorney general to fend off an enforcement action.

On the civil front, private plaintiffs have filed multiple class action complaints targeting restrictive hiring and solicitation provisions in the franchise agreements of many fast food franchisors including Carl Karcher Enterprises (*i.e.*, Carl Jr.'s) (February 2017),³ McDonald's (June 2017),⁴ Pizza Hut (November 2017),⁵ Jimmy John's (January 2018),⁶ Arby's (August 2018),⁷ Cinnabon (August 2018),⁸ Little Caesars (September 2018),⁹ Burger King (October 2018),¹⁰ and Dunkin Donuts (October 2018).¹¹

The legal challenges to no-poach provisions in franchise systems raise interesting questions about application of antitrust laws to buy side labor markets, the appropriate standard of review, and the legal treatment of restraints in largely vertical intrabrand distribution systems. The scope and duration of individual no-poach provisions, and how they are

³ Class Action Complaint, *Bautista v. Carl Karcher Enters.*, No. BC 649777 (Sup. Ct. Cal. Feb. 8, 2017).

⁴ Class Action Complaint, *Deslandes v. McDonald's USA, LLC*, No. 17-cv-04857 (N.D. Ill. June 25, 2017).

⁵ Class Action Complaint, *Ion v. Pizza Hut, LLC*, No. 4:17-cv-00788 (E.D. Tex. Nov. 3, 2017), *voluntarily dismissed without prejudice* on July 6, 2018.

⁶ Class Action Complaint, *Butler v. Jimmy John's Franchise, LLC, et al.*, No. 18-133 (S.D. Ill. July 31, 2018).

⁷ Class Action Complaint, *Richmond v. Bergey Pullman, Inc., et al.*, No. 2:18-cv-00246 (E.D. Wa. August 3, 2018).

⁸ Class Action Complaint, *Yi v. SK Bakeries, LLC, et al.*, No. 18-5627 RJB (W.D. Wa. August 3, 2018).

⁹ Class Action Complaint, *Ogden v. Little Caesars Enterprises, Inc., et al.*, No. 2:18-cv-12792 (E.D. Mi. Sept. 7, 2018).

¹⁰ Class Action Complaint, *Michel v. Restaurant Brands Int'l Inc., et al.*, No. 1:18-cv-24304 (S.D. Fl. October 18, 2018).

¹¹ Class Action Complaint, *Avery v. Albany Shaker Donuts LLC, et al.*, No. 1:18-cv-09885 (S.D. N.Y. October 25, 2018).

¹ A. Christopher Young is a partner in the Philadelphia office of Pepper Hamilton LLP and chairman of the Franchise, Distribution and Marketing Section of the Trial and Dispute Resolution Practice Group.

² Jeffrey Stein, *Booker, Warren Take Aim at Chains that Use 'Non-Poaching' Deals To Keep Workers Stuck at One Store*, Washington Post, March 1, 2018.

enforced, present individual questions that may strongly influence their legality under the antitrust laws. And, if a court should decide to review a no-poach provision under the rule of reason, a relevant geographic market determination will present evidentiary and substantive legal challenges to a private plaintiffs' claim. Many of these issues are only now being litigated in state and federal courts. But federal courts have issued preliminary decisions that give a glimpse of how these issues may ultimately be resolved. This article will examine the issues presented by these legal challenges and analyze the recent federal decisions.

No-poach agreements between two or more employers are horizontal where the employers compete in the same labor markets — regardless of whether they are competitors in downstream product markets for the sale of goods or services. When horizontal no-poach agreements impose a naked restraint on competition, the antitrust enforcers may view the restraint as illegal *per se* and subject to criminal prosecution as hardcore cartel conduct.

As a general matter, agreements between franchisors and franchisees are typically subject to the rule of reason because they can be viewed as vertical restraints that may produce procompetitive benefits. For example, restrictions in franchise agreements on the items franchisees can sell, where they can sell it, and how they can advertise ensure that franchisees are selling a uniform product and enhancing a unified brand, which encourages interbrand competition. Because franchise no-poach agreements raise questions about competition for labor — rather than competition for consumers — the proper way to characterize the nature of labor-market restraints within a franchise business are relatively uncharted territories of antitrust law.

Lawsuits targeting no-poach provisions in franchise agreements initially posed heightened obstacles for plaintiffs because it was unclear whether such agreements should be evaluated under the *per se* rule, the rule of reason, or the quick-look approach. But as one court recently explained, such cases may become “hornbook examples” of the quick-look rule.

I. Appropriate Standard of Review

Not surprisingly, the parties' legal positions in the three most recent putative class action cases involving franchise businesses — McDonald's, Pizza Hut (which was recently voluntarily dismissed without prejudice), and Jimmy John's and Cinnabon — include similar arguments as to the appropriate evaluation of the agreements. In the three cases, plaintiffs allege that the no-poach provisions at issue are unlawful *per se* or under the quick-look test because of horizontal competition for employees with franchisor owned stores or because the anticompetitive effects of the restraints are so plain.

Defendants counter in their motions to dismiss the class action complaints that there is no case in which a court *actually declared* a no-hire agreement to be unlawful, and that many courts, in evaluating the proper standard, have determined that the rule of reason should apply.¹² Defendants also argue that, regardless of whether the agreements at issue are properly deemed horizontal, application of the *per se* rule is inappropriate because that standard is applied only to agreements that judicial experience has shown are so pernicious that they could never be justified. They explain that no-poach

¹² See, e.g., *Eichorn v. AT&T Corp.*, 248 F.3d 131, 144 (3d Cir. 2001); *Bogan v. Hodgkins*, 166 F.3d 509, 515 (2d Cir. 1999); *Nichols v. Spencer Int'l Press, Inc.*, 371 F.2d 332, 337 (7th Cir. 1967).

agreements in the franchise space can plausibly serve procompetitive purposes, like discouraging employee raiding, which promotes investment in employees and fosters interbrand competition.

Moreover, defendants argue that parallel adherence to a vertical restriction in a franchise agreement cannot imply a horizontal restraint of trade because, if it did, any dual-distribution system that imposed restraints, such as resale price maintenance, would be illegal.

Finally, defendants argue that, under any theory, plaintiffs would need to adequately allege collusion or agreement between franchisees, and that such allegations would be implausible because the alleged conspiracy would include thousands of co-conspirators. Defendants also note that plaintiffs have not alleged communications between franchisees about hiring or salaries, any ultimatums by franchisees that they would join the no-poach agreements only if others did, or that the franchisor adopted a no-poach clause at the urging of franchisees.

Plaintiffs, in turn, point to the franchise agreements themselves as evidence of collusion. Plaintiffs argue that their claims are the rare conspiracy allegations that rest on an actual written agreement and that the franchise agreements emphasize the independence of franchisees from the franchisors and from each other.¹³ Plaintiffs also note that some franchisors, like McDonald's, operate company-owned stores that directly compete with franchisees, making the no-poach provisions horizontal restraints. Finally, plaintiffs emphasize that

¹³ These provisions were likely inserted to prevent a ruling that the franchisor is a joint employer with the franchisee and therefore accountable for compliance with labor laws.

the alleged conspiracies should be viewed as hub-and-spoke conspiracies among horizontal franchisees (the "spokes"), orchestrated or facilitated by the franchisor (the "hub").¹⁴ They note that franchise agreements have standard terms, so that all franchisees know what other franchisees have agreed to, and that the agreements often include enforcement mechanisms, such as liquidated damages provisions and loss of franchise licenses, for violating the no-poach provisions.

A. "Quick Look" Prevails: The *McDonald's* and *Cinnabon* Decisions:

On June 25, 2018, Judge Alonso held that plaintiffs in the *McDonald's* case had stated a claim under the quick-look test, finding that "[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."¹⁵ The court agreed with plaintiffs that "an employee working for a below-market wage would be extremely valuable to [his or her] employer."¹⁶ Noting that the case was not about competition for the sale of hamburgers to consumers, but about competition for employees, the court found that the "McDonald's franchisees and McOpCos within a locale are direct, horizontal competitors."¹⁷ As competing brands, "[d]ividing the market does not promote intrabrand competition for employees, it stifles interbrand competition."¹⁸

¹⁴ Cf. *United States v. Apple, Inc.*, 791 F.3d 290, 323-25 (2d Cir. 2015), *cert. denied*, 133 S.Ct. 1376 (2016); *Toys 'R' Us, Inc. v. FTC*, 221 F.3d 928, 935-36, 940 (7th Cir. 2000).

¹⁵ *Deslandes v. McDonald's USA, LLC*, No. 17-cv-04857, 2018 U.S. Dist. LEXIS 105260, at *20 (N.D. Ill. June 25, 2018).

¹⁶ *Id.* at 21.

¹⁷ *Id.* at 22.

¹⁸ *Id.*

Although the *McDonald's* court deemed the no-poach provision a horizontal restraint and that a naked no-poach provision was indistinguishable from a naked agreement to divide markets, it found that *per se* treatment was inappropriate. The no-poach provision was ancillary to McDonald's franchise agreements, which themselves are procompetitive because they increase output of burgers and other McDonald's products. Thus, the court held that the quick-look test, under which the court would evaluate proffered procompetitive benefits in the market for employees, was appropriate.¹⁹

On November 13, 2018, Judge Bryan of the Western District of Washington found that the plaintiff had plausibly alleged facts showing no-poach provision in Cinnabon's franchise agreements should be evaluated under the quick look test relying largely on Judge Alonzo's decision in *McDonald's*. In doing so he agreed with Cinnabon that *per se* treatment of the no-poach provision was inappropriate because the defendants had made plausible arguments that the practice is efficiency enhancing and makes markets more competitive.²⁰ The defendants' pro-competitive justifications of the no-poach provision was irrelevant at the 12(b)(6) stage of the proceedings.

¹⁹ The court warned that procompetitive benefits in the market for downstream goods and services are not relevant because the case was about a restraint in the market for employees. It also appeared skeptical that the no-poach terms were narrowly tailored to encourage franchisees to train employees for management positions because the terms applied to all employees, not just managers, and were not limited to a reasonable period after employees received management training.

²⁰ Judge Bryan also rejected Cinnabon's legal argument that it and its franchisees were a single entity incapable of conspiring under the Sherman Act as a matter of law. Judge Bryan found plaintiff alleged enough facts to show at the early stage of litigation the defendants were "independent centers of decision-making" competing to hire employees.

B. Standard of Review Punt: The *Jimmy John's* Decision

On July 31, 2018, grappling with whether the no-poach agreements were vertical, horizontal, or a combination of the two, the *Jimmy John's* court found that plaintiffs properly alleged a "hub-and-spoke" conspiracy, where the "hub" enters a collection of vertical agreements with other firms — the "spokes" — and those spokes then enter into a collection of horizontal agreements that make up the "wheel."²¹ The facts alleged against Jimmy John's were materially different than the facts alleged against McDonald's and Cinnabon. The Jimmy John's no-poach provision allegedly made all current and future franchisees third party beneficiaries of each other's no-poach provision with the right to enforce it against other franchisees. In addition, Jimmy John's allegedly designed non-competes for its franchisees to enter into with their employees to protect them against enforcement claims from other franchisees. The court found a two-fold effect of the alleged Jimmy John's no-poach scheme: "(1) a horizontal boycott of certain employees; and (2) a horizontal price-fixing scheme to suppress the price of labor for said employees."²² Given this alleged effect of the no-poach scheme coupled with the alleged "high levels of independence" enjoyed by Jimmy John's franchisees, the court held that plaintiffs had stated a plausible claim for relief under Section 1 of the Sherman Act but declined to decide which standard would ultimately apply:

This case could prove to be a hornbook example of [the quick-look] rule: Although the franchisees are

²¹ *Butler v. Jimmy John's Franchise, LLC*, No. 18-cv-0133-MJR-RJD, 2018 U.S. Dist. LEXIS 128149, at *17 (S.D. Ill. July 31, 2018).

²² *Id.* at **19-20.

dealing in the same brand, they are still competitors, and anyone with a rudimentary understanding of economics would understand that the no-hire agreements have an anticompetitive effect on the labor market targeted by those firms.²³

The ultimate rule to be applied will rise or fall on the evidence of franchisee independence.²⁴

C. Other Hurdles

Additional tests lie ahead for plaintiffs challenging franchise no-poach agreements who survive motions to dismiss. First, some courts, like the Southern District of Illinois in *Jimmy John's*, may choose to delay deciding the appropriate standard until after discovery, in which case the parties will likely engage in an intense and complicated effort to discover the levels of franchisee independence, potential justifications for the agreements at issue, and their effects on competition. During this stage, the particular language of the franchise agreements will become of prime importance. For example, the alleged no-poach term in the Pizza Hut franchise agreement applies only to management-level employees. Therefore, if the claims against Pizza Hut are refiled, Pizza Hut may be able to show that the no-poach provisions in its franchise agreements are justified by a desire to promote investment in employee training, as opposed to franchisors whose no-poach terms apply to entry-level employees and managers alike.

In addition, the parties may find themselves in protracted relevant market discovery. And without clarity on which standard will apply, market power in a properly defined market

would be particularly challenging for plaintiffs because the inquiry would be factually complex. Evaluating the relevant product market could potentially involve discovering all employers that provide reasonable substitutes for jobs, as well as the existence of any specialized or nontransferable training. As the court in *McDonald's* acknowledged, employees and potential employees of fast-food companies are likely to seek work in a limited geographic area, so the analysis could potentially produce thousands of relevant geographic markets. Lastly, well-established precedent disfavors single-brand markets.²⁵

Finally, plaintiffs in the franchise cases will also need to obtain class certification. In all three federal cases, class members include at least all current or former employees (or managers in the case of Pizza Hut) at all franchisee-operated restaurants of the franchisor.²⁶ As noted by the *McDonald's* court, allegations of a large number of geographically small relevant markets might cut against class certification of a nationwide class. Class certification proceedings in past no-poach cases have produced mixed results and often hinged on plaintiffs' ability to show that common issues related to antitrust injury and damages predominated over individualized issues. For example, in *Weisfeld v. Sun Chemical Corp.*, the Third Circuit affirmed a court's refusal to certify a class of employees of ink-printing companies who allegedly entered no-hire agreements.²⁷ The court held that showing class members had lower salaries and were deprived of job

²³ *Id.* at *22 (internal citations omitted).

²⁴ *Id.* at *22-23.

²⁵ See, e.g., *Tanaka v. Univ. of S. Cal.*, 252 F. 3d 1059, 1063-64 (9th Cir. 2001); *Hack v. President & Fellows of Yale Coll.*, 237 F. 3d 81, 86-87 (2d. Cir. 2000); *Queen City Pizza, Inc. v. Domino's Pizza Inc.*, 124 F. 3d 430, 438 (3d. Cir. 1997).

²⁶ The *McDonald's* Amended Complaint also includes employees at restaurants operated by McDonald's.

²⁷ *Weisfeld v. Sun Chemical Corp.*, 84 Fed. Appx. 257 (3d Cir. 2004).

opportunities would require analysis of numerous individualized factors, including “whether a covenant not to compete was included in a particular employee's contract; the employee's salary history, educational and other qualifications; the employer's place of business; the employee's willingness to relocate to a distant competitor; and [employees'] ability to seek employment in other industries in which their skills could be utilized”²⁸ By contrast, in *Nitsch v. Dreamworks Animation SKG Inc.*, the Northern District of California certified a class of animation and visual-effects employees of companies, which allegedly entered a series of bilateral agreements limiting employee mobility and compensation, and rejected defendants’ arguments that, among other things, individual issues related to antitrust injury and damages predominated.²⁹ The Court found that the defendants’ no-hire agreements and collusive communications suppressed compensation levels that affected all class members and that the claimed damages were the result of class-wide injury.³⁰

II. Conclusion

There is much that is yet to be determined how these cases will proceed, and the federal district courts will be on the frontline in bringing clarity to the ultimate treatment of no-poach provisions.

²⁸ *Id.* at 263-64 (internal citations omitted).

²⁹ *Nitsch v. Dreamworks Animation SKG Inc.*, 315 F.R.D. 270 (N.D. Cal. 2016).

³⁰ *Id.* at 303-4.

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Submission of Materials: Distribution welcomes submissions of articles, commentary, and case summaries involving significant or interesting decisions, trials, or developments in antitrust law affecting all types of distribution arrangements.

Committee Leadership

Co-Chairs

Deena Jo Schneider
Schnader Harrison Segal & Lewis LLP
dschneider@schnader.com

David Evans
Kelley Drye & Warren LLP
devans@kelleydrye.com

Council Representative
John Roberti Allen & Overy
john.roberti@allenoverly.com

Vice-Chairs

Christopher Casamassima
Wilmer Cutler
Chris.Casamassima@Wilmerhale.com

Gregory Fortsch
The Nature's Bounty Co.
gfortsch@nbty.com

James Nichols
Dorsey & Whitney LLP
nichols.james@dorsey.com

Frank Qi
Qualcomm
frank.y.qi@gmail.com

Young Lawyer Representatives

Anna Aryankalayil
Dechert LLP
anna.aryankalayil@dechert.com

Daniel Graulich
Hogan Lovells US LLP
daniel.graulich@hoganlovells.com