Requiring Franchisees to Have Their Employees Execute Non-Competes and Confidentiality Agreements—Good or Bad Idea?

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Franchisors routinely require franchisees to agree to confidentiality agreements and post-termination non-competition agreements. The purpose of non-compete and confidentiality agreements is to protect the franchisor's marks and system from misappropriation. For similar reasons, some franchisors require franchisees to have their employees sign confidentiality and post-employment non-compete agreements as a condition of employment. When used appropriately, these agreements may help franchisors ensure that the knowledge obtained by franchise employees is not misappropriated. In theory, this practice benefits both franchisors and franchisees. The franchisor maintains control over its system and marks, while the franchisees benefit from the franchisor's support, information, and training. But, is this practice a good or bad idea? Analysis of this question is colored by the tensions between trademark law, which requires a franchisor to exercise adequate control over its marks, the views of worker advocates, and the shifting tide of joint employment jurisprudence.

Under trademark law, brand owners are required to monitor and enforce their trademark rights to retain the protections afforded by federal trademark registrations. "The critical question in determining whether a licensing program is controlled sufficiently by the licensor to protect his mark is whether the licensees' operations are policed adequately to guarantee the quality of the products sold under the mark." *General Motors Corp. v. Gibson Chem & Oil Corp.*, 786 F.2d 105, 100 (2d Cir. 1986).

Non-compete and confidentiality agreements are two types of restrictive covenants by which the franchisor may police its marks and protect its legitimate business interests. Depending on state law, legitimate business interests may include business principles, formulas associated with the brand, training received by those in the franchise system, customer lists, and the preservation of the integrity of the franchise system. Non-compete agreements protect the franchisor and the franchise system from unfair competition, while confidentiality agreements prevent the dissemination of trade secrets and other proprietary information.

Over the last several years, restrictive covenants applied to low-wage earners have been strictly scrutinized. To protect the legitimate business interests of the franchise and prevent unfair competition, franchisees may impose non-compete and confidentiality obligations on employees, like management, who have access to trade secrets and other confidential information. On the other hand, low-wage earners, such as cashiers and food preparation workers, typically do not have access to trade secrets or confidential information. Those employees are at low risk of poaching by competitors. Accordingly, many worker advocates view the use of restrictive covenants with low-wage workers as unnecessary and unfair.

The Jimmy John's chain is one well known example of a franchise system scrutinized for its mandate that franchisees impose non-compete obligations on employees. Last year, the New York Attorney General launched an investigation into Jimmy John's mandate that its franchisees use non-compete agreements with low-wage employees, and the Illinois Attorney General initiated litigation over the same clause. The Jimmy John's standard non-compete agreement prohibited Jimmy John's employees, including sandwich makers, from working at any other company that earned more than 10% of its revenue from sandwiches within two miles of any Jimmy John's store, during employment and for two

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years post-termination. *See* Memorandum Opinion at 4, *Brunner v. Jimmy John's Enterprises, Inc.*, No. 1:14-cv-05509 (N.D. Il. Apr. 8, 2015), ECF No. 109. Both New York and Illinois raised concerns over the breadth of the provision and questioned the legitimacy of requiring low-wage earners to sign such agreements. Ultimately, Jimmy John's settled with both states and promised, moving forward, not to enforce the agreements or include them in employment contracts.

In Illinois, the Jimmy John's litigation was a catalyst for new legislation. On, August 19, 2016, Governor Bruce Rauner signed the Illinois Freedom to Work Act (the "Act"). The Act, effective January 1, 2017, renders any covenant not to compete entered between a private sector employer and low-wage earner "illegal and void." 820 Ill. Comp. Stat. Ann. 90/1. Under the Act, an employer includes "…any person or group of persons acting directly or indirectly in the interest of an employer in relation to an employee, for which one or more persons are gainfully employed on some day within a calendar year." 820 Ill. Comp. Stat. Ann. 105/3. The Act defines "low-wage employee" as "an employee who earns the greater of (1) the hourly rate equal to the minimum wage required by the applicable federal, State, or local minimum wage law or (2) $13.00 per hour." 820 Ill. Comp. Stat. Ann. 90/5. The Act prohibits non-compete clauses that restrict a low-wage employee from performing work for another employer during a specified time, in a specified geographical area, or for another employer in a similar industry. *See* 820 Ill. Comp. Stat. Ann. 90/5. Interestingly, the Act does not prohibit agreements that seek to protect an employer's confidential information and trade secrets.

The new Illinois law and definition of employer coincides with the National Labor Relation Board's ("the Board's") broadening of joint employment jurisprudence. In 2015, the Board's *Browning-Ferris* decision changed the landscape on joint employment and expanded the potential that franchisors may be considered joint employers and liable for labor violations. Considering this decision, and other recent decisions which appear to expand the scope of potential joint employment liability, a franchisor should think twice about requiring franchisees to have employees execute non-compete and confidentiality agreements.

In *Browning-Ferris*, the Board rejected prior self-imposed limitations on the joint employer standard and restated the standard as a two-part test that considers: (1) whether a common-law employment relationship exists, and (2) whether the potential joint employer "possesses sufficient control over employees' essential terms and conditions of employment to permit meaningful bargaining." *Browning-Ferris Indus. of California, Inc.*, 362 NLRB No. 186, at 2 (Aug. 27, 2015). Essential terms and conditions of employment may include, *inter alia*, wages and hours as well as hiring, firing, discipline, supervision and direction. *Id.* at 19.

The *Browning-Ferris* analysis of the joint employer standard focuses on a company's possession or reserved right to control, rather than the mere exercise of control. In its discussion of the relevance of a reserved right to control, the Board states: "Where a user employer reserves a contractual right … to set a specific term or condition of employment for a supplier employer's workers, it retains the ultimate authority to ensure that the term in question is administered in accordance with its preferences." *Id.* at 17. In line with its reasoning that a company may be a joint employer where it has reserved the right to control essential terms and conditions of employment, the Board also found that control exercised indirectly, such as through an intermediary, may establish joint employer status, even if the control is not exercised directly or immediately. *Id.* at 2.

In a possible attempt to limit its decision, the Board states that "a joint employer will be required to bargain only with respect to such terms and conditions which it possesses the authority to control," but later states that "all of the incidents of the relationship must be assessed" when evaluating whether a joint employer situation exists. *Id.* at 16. This language leaves the standard open ended and suggests that whether a franchisor will be considered a joint employer depends on the totality of the circumstances.

In his amicus brief, Board General Counsel, Richard Griffin, states that "[t]he Board should

continue to exempt franchisors from joint employer status to the extent that their indirect control over employee working conditions is related to their legitimate interest in protecting the quality of their product or brand…" *Browning-Ferris* at 45, citing, Amicus Br. at 15-16 fn. 32. Nevertheless, if a franchisor requires its franchisees to have all employees including low-wage earners sign non-complete and confidentiality agreements, this situation is bound to be strictly scrutinized, especially where the effect of the agreement is to prohibit employees from taking similar jobs at higher paying wages. In these situations, restrictive covenants become a form of wage control, and the ability to control wages is considered an essential term of employment. *See Browning-Ferris* at 19.

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Whether the *Browning-Ferris* decision poses a true risk to a franchisor's ability to adequately supervise and control the operations of its franchisees and their employees is yet to be determined. The *Browning-Ferris* decision is on appeal. Oral argument was heard in March, but the D.C. Court of Appeals has yet to render a decision. President Trump has appointed Republican, Marvin Kaplan, to sit on the Board. This appointment follows the selection of another Republican, Phillip A. Miscimarra, to head the Board. The full effect of Board changes on the joint employer standard remains uncertain. What is clear, however, is that under *Browning-Ferris*, the Board no longer requires a company to have direct and immediate control over terms and conditions of employment, or to exercise that authority, to be considered a joint employer. Rather, indirect and unexercised control over essential employment terms and conditions may provoke joint employer status.

In the wake of shifting joint employment jurisprudence, mandating franchisees to require that employees sign non-compete and confidentiality agreements may have unintended consequences. By requiring or encouraging franchisees to require such covenants, a franchisor risks being found to have exercised enough control over the franchisees' employment decisions to be deemed a joint employer. If the Board focuses on a franchisor's right to indirectly control franchisee employees through non-completes and confidentiality agreements, even if never actually enforced, franchisors could be deemed joint employers. Once designated a joint employer, a franchisor may be found liable for labor violations and forced to pull up a seat at the collective bargaining table.

Therefore, for franchisors seeking to avoid joint employment liability, requiring franchisees to have all employees execute non-compete and confidentiality agreements is a bad idea. If deemed necessary, such agreements should be sought from only those high-level franchisee employees who have access to trade secrets and confidential information, and, in many cases, a stand-alone confidentiality agreement may be more appropriate. Unlike non-compete agreements, which directly restrain an employee's ability to take another job, confidentiality agreements only prohibit the dissemination of propriety information and are more likely to be viewed as a legitimate tool through which the franchisor may protect its marks. Thus, the key to maintaining the franchise model without rocking the joint employer boat will be the franchisor's ability to protect brand integrity without overreaching.■