Are my Franchisees or their Employees Actually my Employees?!

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I. INTRODUCTION

It has been eight years since the Massachusetts Supreme Judicial Court’s landmark decision declaring a franchisee to be an “employee” eligible for unemployment insurance and four years since the District of Massachusetts’ determination that franchising is a “modified Ponzi scheme.” Since then there has been a renewed interest in and challenges to the independent contractor relationship between franchisors and franchisees. As discussed below, the consequences of how this issue is ultimately resolved may have profound implications for franchising’s viability as a going-forward business model.

II. WHO IS AN “EMPLOYEE?”

Traditionally, individuals who perform services in exchange for compensation have been classified into one of two categories: employees or independent contractors. Black’s defines the terms as follows:

Employee. A person who works in the service of another person (the employer) under an express or implied contract of hire, under which the employer has the right to control the details of work performance.

Independent Contractor. One who is entrusted to undertake a specific project but who is left free to do the assigned work and to choose the method for accomplishing it.

These definitions are based on the traditional common law distinction that focuses on control over how assigned work is performed. An “employer” has the “right to control” how an “employee” performs assigned tasks, while a “principal” has little to no control over how an “agent” performs a particular assignment.

Not content with the nebulous “right to control” standard, several states have adopted statutes defining more precisely when an employment relationship exists. Generally, these statutory definitions are more inclusive than the traditional common law standard and have as a stated goal the “protection” of individuals from being “misclassified” as independent contractors. This protection is necessary, states argue, because public policy requires that “employee” status be as broad as possible. This, in turn, ensures the greatest number of individuals receive

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1 Coverall N. Am., Inc. v. Comm’r of Unemployment Assistance, 447 Mass. 852 (2006) and Awuah v. Coverall N. Am., Inc., 707 F. Supp. 2d 80, 84 (D. Mass. 2010) (“Describing franchising as a business in itself, as Coverall seeks to do, sounds vaguely like a description for a modified Ponzi scheme - a company that does not earn money from the sale of goods and services, but from taking in more money from unwitting franchisees to make payments to previous franchisees.”).

2 Perhaps not surprisingly given recent Supreme Court decisions concerning the “personal” rights of incorporated entities, even companies can be classified as “individual” employees or independent contractors. See Amero v. Townsend Oil, Civil Action No. 07-1080, Slip Op. at 5 n.4 (Mass. Super. Ct. Dec. 3, 2008) (holding that plaintiff’s formation and use of a corporate entity did not preclude his wage claim as an ‘individual.’).


“employment’s” attendant benefits, including workers’ compensation protection, unemployment insurance, timely wage payment, overtime wages and others. Not surprisingly, “employee” status also benefits the federal government and state governments. The more “employees,” the more individuals who are subject to income tax withholdings and unemployment premiums.

Unfortunately, at both the federal and state level, multiple tests exist for determining whether an individual is an “employee” or “independent contractor.” These different tests, discussed below, often result in different classifications of individuals performing similar or identical tasks depending on the context in which they are applied.6

A. Federal Tests

The federal government’s interest in employment classification impacts several statutes, including the Fair Labor Standards Act, Americans with Disabilities Act, Family Medical Leave Act and National Labor Relations Act. Generally, these statutes rely upon the common law right to control test to determine employment status, however the federal government utilizes at least one other test to determine status.

1. Common Law Right to Control Test

The traditional test for determining an individual’s status under federal law is the common law “right to control” test.7 Although application of the test seems to vary from case to case, its common elements include: (1) whether the worker has the right to control work details and has control over the manner and means by which the job is performed, including the right to perform the work at a time and place of the worker’s choosing and the right to hire a substitute without the employing unit’s knowledge or consent; (2) the worker’s opportunity for profit or loss depending on his or her managerial skill; (3) the worker’s investment in equipment or materials, or employment of helpers; (4) whether the service rendered requires a special skill; (5) the permanence of the working relationship; (6) whether the service rendered is an integral part of the employer’s business; (7) whether the worker’s services are available to the general public on a continuing basis; (8) whether the worker is paid on a job basis and is responsible for all incidental expenses; and (9) how the parties view the relationship.8 When applying the test, no one factor is conclusive and the titles parties have adopted play a minimal role.9

One critical factor in applying the test is distinguishing between the “right” to control and the actual exercise of control. Generally, courts focus on whether a putative employer exercises

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actual control over an individual’s work.10 This distinction is important because it prohibits employers from hiding behind contractual terms disavowing control when those disavowals do not reflect the reality of a particular relationship.11 Some courts, however, have held the contractual right to control is sufficient to establish an employment relationship regardless of whether control is in fact exercised. In Ayala v. Antelope Valley Newspapers, Inc., the California Supreme Court rejected the argument that the independent contractor determination should depend on how much “actual control” the alleged employer exercises over individuals, and held that the relevant inquiry is the alleged employer’s “right of control” over the workers.12 The Ayala Court noted that “[p]erhaps the strongest evidence of the right to control is whether the hirer can discharge the worker without cause, because ‘[t]he power of the principal to terminate the services of the agent gives him the means of controlling the agent’s activities.”13

Likewise, in In re: Fed Ex Ground Package Sys., Inc., the court rejected defendant’s claim that the contractual right to control, if not in fact exercised, was insufficient to establish the “right to control” necessary to support an employment relationship.14 There the court certified a class of Kansas plaintiffs challenging their independent contractor classification by relying on the uniformity of provisions in the independent contractor agreements.15 “While courts should look to the actual employment relationship as opposed to an employer’s unilateral determination, the nature of the employment relationship is determined by the existence of the right to exercise control, not the actual control FedEx exercised over some employees.”16 Based on this uniformity, which would also exist in standardized franchise agreements, the court certified the plaintiff class.17

Other courts have applied the common law test differently. In FedEx Home Delivery v. NLRB, the court recognized the difficulty in determining what “control” truly means and the fact that “some controls were more equal than others.”18 To deal with this issue, the court focused

10 See, e.g., United Ins. Co. of America, 390 U.S. at 259 (upholding a finding of employee-status based on evidence of “the reality of the actual working relationship”).
11 See, e.g., Rutherford Food Corp. v. McComb, 331 U.S. 722, 729 (1947) (“Where the work done, in its essence, follows the usual path of an employee, putting on an ‘independent contractor’ label does not take the worker from the protection of the [FLSA]”; see Richard R. Carlson, Why the Law Still Can’t Tell an Employee When it Sees One and How it Ought to Stop Trying, 22 Berkeley J. Emp. & Lab. L. 295, 341-42 (2001) (“Unfortunately, a test of statutory coverage giving significant weight to a written contract between the parties raises the risk that employers will create the appearance of an independent contractor relationship on paper simply to avoid employment laws. A contractual disclaimer of control may be a sham, because the power to control can emanate from economic circumstances as much as from a contract.”).
13 Id. at 6.
15 Id. at *48-52.
16 Id. at *46-47.
17 The court in In re FedEx later granted summary judgment in favor of FedEx, finding that the agreement did not establish a sufficient right of control to make the drivers employees under the common law test. In re FedEx, 734 F.Supp.2d 557, 588-601 (N.D. Ind. Aug. 11, 2010). That decision, which was appealed to the Seventh Circuit, is currently pending at the Kansas Supreme Court, where the federal court certified the case for clarification of the standard to apply under Kansas law. Craig v. Fed Ex Ground Package Sys., Inc., 686 F.3d 423 (7th Cir. July 12, 2012).
18 563 F.3d 492, 497 (D.C. Cir. 2009).
instead on “whether the putative independent contractors have significant entrepreneurial opportunity for gain or loss.” Applying this test, the court determined that delivery drivers were not employees, but rather independent contractors not eligible to organize under the National Labor Relations Act. Regardless of how it is defined, “control” is the touchstone of the federal common law test and what the parties will try to define to their advantage.

2. IRS 20 Factor Test

Although the Internal Revenue Service has also adopted the “common law” test, it has developed its own benchmarks for applying it. Historically, the IRS used a 20 factor test to evaluate the “right to control.” The factors the IRS considered were: (1) level of instruction; (2) amount of training; (3) degree of business integration; (4) extent of personal services; (5) continuity of relationship; (6) flexibility of schedule; (7) demands for full-time work; (8) need for on-site services; (9) sequence of work; (10) requirements for reports; (11) method of payment; (12) payment of business or travel expenses; (13) provision of tools and materials; (14) investment in facilities; (15) realization of profit or loss; (16) work for multiple companies; (17) control of assistants; (18) availability to public; (19) control over discharge; and (20) right of termination. Today, the IRS focuses on three primary concepts: (1) behavioral – whether the company controls or has the right to control what the worker does and how the worker does his or her job; (2) financial -- whether the business aspects of the worker’s job are controlled by the payer (these include things like how the worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.); and (3) type of relationship – whether there are written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.); whether the relationship will continue and whether the work performed is a key aspect of the business. This evolving IRS standard and its changing focus on what precisely to examine in classifying individuals is further proof that the concept of “control” continues to beguile those forced to apply it.

B. State Tests

There are a variety of tests employed by courts and governmental agencies to determine whether an individual should be considered an employee or independent contractor. There are, however, two standards which are most commonly employed by state courts in determining status.

19    Id.

20    Id. at 504; but see In re FedEx Ground Package Sys., Inc., C.A. No. MDL-1700, 2007 U.S. Dist. LEXIS 76798, at *47-48 (N.D. Ind. Oct. 15, 2007) (applying Kansas “common law” test to individuals performing identical duties for same putative employer to determine that “right to control” means ability to control, regardless of whether right is exercised).


22    IRS Pub. 1779.

The standard used by 24 states and the District of Columbia is the “common law” test, which is based on whether the alleged employer has the “right to control” the worker’s actions.\textsuperscript{24} While each state’s test has its own nuances, they invariably include some of the following elements: (1) whether the worker has the right to control work details and has control over the manner and means by which the job is performed, including the right to perform the work at a time and place of the worker’s choosing and the right to hire a substitute without the employing unit’s knowledge or consent; (2) the worker’s opportunity for profit and or loss depending on his or her managerial skill; (3) the worker’s investment in equipment or materials, or employment of helpers; (4) whether the service rendered requires a special skill; (5) the permanence of the working relationship; (6) whether the service rendered is an integral part of the employer’s business; (7) whether the worker’s services are available to the general public on a continuing basis; (8) whether the worker is paid on a per job basis and is responsible for all incidental expenses; and (9) how the parties view the relationship.\textsuperscript{25}

1. **ABC Test**

The test utilized by the 26 states that do not use the right to control test is the “ABC” test. To avoid being deemed an individual’s employer under the “ABC” test, the putative employer must show that: (A) the individual has been and will continue to be free from control and direction in connection with the performance of services, both under the contract for the performance of service and in fact; (B) such service is performed either outside the usual course of the business for which the service is performed or is performed outside of all the places of business of the enterprise for which the service is performed, and (C) such individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.\textsuperscript{26} Although the “A” part of the ABC Test generally corresponds with the common law test, the ABC Test imposes the additional burdens of the “B” and “C” components, all of which the party seeking the independent

\textsuperscript{24} Id. The states are: Alabama, Arizona, California, Florida, Iowa, Kansas, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New York, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, Texas, Washington, Wisconsin and Wyoming.

\textsuperscript{25} Id.

\textsuperscript{26} The states that use the ABC test vary somewhat in the wording of the three prongs of the test. For example, in 2004, the Massachusetts legislature removed from the B prong the words “or is performed outside of all the places of business of the enterprise for which the service is performed”. M.G.L. c. 149, § 148B. Thus, under Massachusetts law, an alleged employer is an employer unless it can prove that the services performed by the individual are “outside [its] usual course of business”. This standard has led courts in Massachusetts to hold workers in a number of industries to be employees, regardless of the level of control exerted over them. See, e.g., Schwann et al v. FedEx Ground Package Sys., Inc., 2013 WL 3353776 (D. Mass. July 3, 2013) (holding delivery drivers to be employees of delivery company under § 148B); Chaves v. King Arthur’s Lounge, Inc., 2009 WL 3188948 (Mass. Super. Jul. 30, 2009) (holding exotic dancers to be employees of strip club); Awuah v. Coverall N. Am., Inc., 707 F. Supp. 2d 80 (D. Mass. 2010) (holding cleaning workers who were classified as franchisees to be employees).
contractor status must prove. Accordingly, the ABC test is generally understood to be more onerous to those claiming not to be an individual’s employer.

III. WHO IS AN “EMPLOYER?”

For purposes of “classification,” one must also determine who is an “employer.” “Employers” are important because they are the only individuals or entities who can be held liable for misclassifying individuals as independent contractors. As discussed below, there are several bases upon which one can be deemed an “employer” and franchisors should understand these different bases if they wish to avoid unexpectedly being held liable for their franchisees’ actions.

A. Single Employer

A “single employer” is the classic type of employer. When there is a single employer there is one and only one entity or individual who “employs” employees. That single entity or individual alone is responsible for complying with all employment-related laws, for withholding appropriate taxes for payroll and making all employer required tax payments. Applied in the franchise context, franchisees are considered to be the single employer of their employees and franchisors bear no responsibility or liability for franchisees’ “employer” liabilities or obligations.

B. Joint/Co-Employer

The joint employer test is not an employer-employee test per se, but rather a legal doctrine pursuant to which two otherwise independent entities are both considered to be “employers” of one entity’s employees. “[A] finding that companies are ‘joint employers’ assumes in the first instance that companies are . . . independent legal entities that have merely ‘historically chosen to handle jointly important aspects of their employer-employee relationship.’” Courts consider three criteria in determining whether a joint employer relationship exists: (1) whether the putative joint employer has the authority to hire and fire employees, promulgate work rules and assignments and set conditions of employment, such as compensation, benefits and hours; (2) if there is day-to-day supervision of the employee, including the ability to discipline employees; and (3) control over employee records, including payroll, insurance and taxes. The parties’ expectations must also be considered. As with

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27 See e.g., Coverall N. Am., Inc. v. Comm’r of Unemployment Assistance, 447 Mass. 852, 857 (2006) [hereinafter Coverall] (“[I]f an employer fails to establish any one of the three prongs, the services in question will constitute ‘employment’ within the meaning of [the unemployment statute.”]; Somers v. Converged Access, Inc., 454 Mass. 582, 590-91 (2009) (“[U]nless [the defendant] were to prove at trial the three criteria required to establish that the plaintiff was an independent contractor under G.L. c. 149, § 148B the [plaintiff], as a matter of law, was an employee of [defendant] even if he was not hired as an employee.”) (emphasis in original).


29 NLRB v. Browning-Ferris Indus. of Pa., 691 F.2d 1117, 1123 (3d Cir. 1982) (citation omitted).


31 Id.
the common law test, no one factor is determinative, although a single criterion, if sufficiently strong, can be enough to establish a joint employer relationship. If a joint employer relationship is established, both “employers” are equally liable for meeting any “employer” obligations.

In March of 2014, McDonald’s workers in California, Michigan and New York filed lawsuits against McDonald’s and some of its franchisees, alleging that they were underpaid because, among other things, hours were erased from their timecards, overtime was not paid, and employees were ordered to work off of the clock. In two of the lawsuits filed in Michigan, employees claimed they were told to arrive at work, but not clock-in for two hours until customers actually arrived. In three lawsuits filed in California, restaurant employees alleged that franchisees did not pay the employees for all of the hours worked, shaved hours from the pay records and denied them meal periods and rest breaks.

In these lawsuits, attorneys representing the plaintiffs are arguing that McDonalds should be considered a joint employer and be held liable, along with the franchisees, even though the franchisees are independent businesses. The plaintiffs are alleging that McDonald’s corporation is not only liable for violations at its corporate-owned stores, but also for violations at Franchised locations because of McDonald’s control over franchisee’s timekeeping, scheduling and other policies. In the Michigan lawsuits, the plaintiffs have alleged that McDonald’s is a “joint employer” and, on that basis, is also liable to the employees because it provides financial tracking computer software to franchisees, which allegedly guides when individual store managers may permit employees to be clocked in or on the clock.

Some believe these lawsuits are the result of a coordinated effort by plaintiffs’ attorneys and the Service Employees International Union to pressure fast-food restaurants to pay employees at least $15 an hour. One attorney has warned that “[i]f the plaintiffs are successful, then it really calls into question every franchise system that’s out there. “Theoretically that could mean that the franchisor becomes jointly responsible for every kind of labor law in employment, like wage-and-hour [laws], workers compensation or any kind of harassment that occurs at the [franchised] restaurant.” However, some commentators have noted that these putative class action lawsuits have some high hurdles to overcome before they

32 Id.
34 Id.
36 Id.
37 Id.
may be certified to proceed as system-wide class actions, given that the employment practices at each individual restaurant are likely to vary.\textsuperscript{40}

Just as this paper was going to press, the National Labor Relations Board’s ("NLRB") Office of the General Counsel issued a decision that could dramatically change the franchising landscape. On July 29, 2014, the NLRB’s General Counsel’s Office made a preliminary determination that employees of McDonald’s franchisees may properly name McDonald’s Corporation as a joint employer in complaints employees lodge for labor and wage violations at franchised restaurants.\textsuperscript{41} The decision was made following the NLRB legal department’s investigation of 181 McDonald’s franchised restaurant employee complaints over the past two years.

On July 29, 2014, the NLRB issued a press release stating that:

The National Labor Relations Board Office of the General Counsel has investigated charges alleging McDonald’s franchisees and their franchisor, McDonald’s USA, LLC, violated the rights of employees as a result of activities surrounding employee protests. The Office of the General Counsel found merit in some of the charges and no merit in others. The Office of the General Counsel has authorized complaints on alleged violations of the National Labor Relations Act. If the parties cannot reach settlement in these cases, complaints will issue and McDonald’s USA, LLC will be named as a joint employer respondent.

The National Labor Relations Board Office of the General Counsel has had 181 cases involving McDonald’s filed since November 2012. Of those cases, 68 were found to have no merit. 64 cases are currently pending investigation and 43 cases have been found to have merit. In the 43 cases where complaint has been authorized, McDonald’s franchisees and/or McDonald’s USA, LLC will be named as a respondent if parties are unable to reach settlement.\textsuperscript{42}

The NLRB’s General Counsel, Richard F. Griffin, was appointed by President Obama in 2013. Griffin oversees and directs investigations and prosecutions of alleged violations of labor laws. He previously held a leadership role for the International Union of Operating Engineers.\textsuperscript{43} A number of commentators have suggested that his decision to authorize prosecution of claims against McDonald’s Corporation as a joint-employer when acting as a franchisor may be a political move inspired by President Obama, due in part to Congress’s unwillingness to pass the increase in the minimum wage that the President has strongly advocated.\textsuperscript{44} If a single union


\textsuperscript{42} National Labor Relations Board Office of Public Affairs, NLRB Office of the General Counsel Authorizes Complaints Against McDonald’s Franchisees and Determines McDonald’s, USA, LLC is a Joint Employer, available at https://www.nlrb.gov/news-outreach/news-story/nlrb-office-general-counsel-authorizes-complaints-against-mcdonalds.

\textsuperscript{43} http://www.nlrb.gov/who-we-are/general-counsel/richard-f-griffin-jr

\textsuperscript{44} http://online.wsj.com/articles/obamas-big-mac-attack-1406850062
was organized that both McDonald’s Corporation and all franchises had to recognize and deal with, such a union would have significantly greater resources and power to force a change in minimum pay and labor conditions system wide.45

Little detail is publicly available yet as to the factual basis for McDonald’s liability. The former employees who lodged the complaints with the NLRB claimed that the franchisor was a joint employer because it ordered its franchisees to strictly comply with operations manuals, including provisions dealing with cleanliness and employment practices.46 The NLRB complaints alleged that employees were terminated for, among other things, protesting low wages.47

Wilma Liebman, who formerly served as chairwoman of the NLRB, noted that the decision could give employees at quick service restaurants and labor unions the leverage needed to secure higher wages.48 The Service Employees International Union (“SEIU”) has for many years been funding and organizing protests by and in support of fast food workers.49 For the most part, the SEIU’s efforts have been aimed at raising wages to a minimum of $15 per hour, but the NLRB decision supports its ultimate goal of unionizing fast food workers.50 Moreover, if the NLRB’s determination stands, it would open the door to unionization because it would be as if all the workers worked for one firm.51

The NLRB General Counsel’s decision comes at the same time it has been advocating for the replacement of its long-established “joint employer” test under the National Labor Relations Act (“NLRA”).52 The NLRA forbids employers from interfering with, restraining, or coercing employees in the exercise of rights relating to organizing, forming, joining or assisting a labor organization for collective bargaining purposes, or from working together to improve terms and conditions of employment or refraining from such activity.

In June, the NLRB’s General Counsel filed an amicus brief in *Browning-Ferris Industries of California, Inc.*53 *Browning* is not a franchise case, but instead involves a Teamsters union’s appeal of a NLRB Regional Director’s decision holding that only independent staffing company employees, and not the plant’s regular employees, could vote in a representation election at a California recycling plant. The amicus brief argued that the NLRB should cease applying the

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46 Id.


48 Id.

49 Id.

50 Id.

51 Id.


53 Available at http://mynlrb.nlrb.gov/link/document.aspx/09031d45817b1e83.
traditional joint employer test, citing franchise relationships as the basis for the suggested change. 54 The NLRB General Counsel’s office contended that “[f]ranchising . . . illustrates how the current joint-employer standard undermines meaningful collective bargaining . . . Although franchisors generally claim that they have no influence over the wages franchisees pay to their employees, some franchisors effectively control such wages by controlling every other variable in the business except wages.” 55 In lieu of the test which has been applied for decades, the NLRB General Counsel is advocating for the use of a pre-1984 “industrial realities” test, which focused on the economic dependence” between two companies and assumed that a company effectively controls another company’s labor decisions if it dictates standards for every other variable of its business. 56 If that standard becomes law, then many franchisors could in fact become liable in labor cases as joint employers.

The NLRB Office of General Counsel’s decision and amicus brief in Browning-Ferris is just the beginning of this story. The Taft-Hartley Act created a formal distinction between the National Labor Relations Board and the General Counsel of the NLRB. The General Counsel’s primary responsibility is to investigate and prosecute unfair labor practice claims. The Board is an adjudicative body which decides the unfair labor practice cases brought before it. Charges are filed by employees and former employees against unions or employers at a regional office. In response, the regional office will investigate the complaint and, if it finds that a violation likely exists, the case will then be heard before an Administrative Law Judge. Following a hearing, the Administrative Law Judge will issue a ruling which may be reviewed by a five member panel of the Board. Board decisions are reviewable by the United States Court of Appeals. 57

Importantly, the General Counsel’s position regarding McDonald’s status as a joint-employer is not yet law. The decision merely authorizes the filing of a complaint that includes the franchisor as a respondent. If the complaints are filed in September, 2014, a trial before an Administrative Law Judge could be held as early as December, 2014, with a conclusion sometime in the spring of 2015. 58 After the Administrative Law Judge issues its decision, the parties may appeal as a matter of right to a full panel of the Board, and then to the United States Court of Appeals. The losing party could then seek review to the Supreme Court by certiorari. Accordingly, a final decision on whether a franchisor like McDonald’s Corporation is a joint employer and whether the traditional standard has been changed, may still be several years away.

54 Id.
57 A helpful chart showing the complaint process from conception through the appeals process can be found at http://www.nlrb.gov/resources/nlrb-process/unfair-labor-practice-process-chart.
C. Integrated Employer

Franchisors also run the risk of being held liable for their franchisees’ acts as an “integrated employer.” The difference between the “joint employer” and “integrated employer” tests turns on whether the plaintiff seeks to impose liability on her legal employer or another entity.59 The former test looks to whether there are sufficient indicia of an employer/employee relationship to justify imposing liability on the plaintiff’s non-legal employer.60 The latter test applies where liability is sought to be imposed on the legal employer by arguing that another entity is sufficiently related such that its actions can be attributed to the legal employer.61 Factors considered in determining whether two or more entities are in integrated employer include: (i) common management; (ii) interrelation between operations; (iii) centralized control of labor relations; and (iv) common ownership.62 Accordingly, the factors seek to illuminate whether two putatively distinct businesses should be viewed as one corporate entity.

The integrated employer test is most commonly employed in FMLA cases. Where this test is met, the employees of all entities making up the integrated employer will be counted in determining employer coverage and employee eligibility. Thus, the integrated employer test is a mechanism to ensure that the appropriate employees are aggregated for the numerosity test of the FMLA.63

Some plaintiffs’ attorneys have attempted to employ the integrated employer test to impose liability on a franchisor for violations of employment laws allegedly committed by franchisees. For example, in Smith v. The Cheesecake Factory Rests., Inc.,64 employees at a Cheesecake Factory franchised restaurant filed a complaint against the franchisor and franchisee under the FLSA, claiming that the defendants’ policies, practices and procedures violated the minimum wage, overtime and credit provisions of the FLSA. Specifically, the plaintiffs alleged that the defendants limited or completely eliminated servers’ overtime hours, caused servers to work “off of the clock” without compensation and paid overtime at a reduced rate. The franchisor filed a motion to dismiss (which was ultimately converted into a motion for summary judgment) on the grounds that it could not be considered an employer under the FLSA. The court agreed, noting that it was undisputed that the franchisor did not directly employ any of the plaintiffs. In coming to this conclusion, the court entertained the plaintiff’s request that it employ the integrated employer test, but ultimately concluded that, even after applying the test, the franchisor could not be considered an employer of the franchisees’ employees.65

59 Engelhardt v. S.P. Richards Co., Inc., 472 F.3d 1, 4 n.2 (1st Cir. 2006).
60 Id.
61 Id.
62 Id. (citing 29 C.F.R. § 825.104(c)(1).
63 Grace v. Uscar, 521 F.3d 655, 664 (6th Cir. 2008).
64 No. 06-00829, 2010 WL 441562 (M.D. Tenn. Feb. 4, 2010).
65 Id. at *12-13.
IV. CONSEQUENCES OF “EMPLOYEE” AND “EMPLOYER” STATUS

Far from being a mere academic exercise of classification, the consequences of misclassifying individuals as independent contractors can be quite severe. Described below are some of the more significant consequences of misclassification.

A. Withholding

All “employers” are required to withhold income taxes from their “employees” and to remit those taxes to various taxing authorities. Accordingly, if a franchisor is deemed an “employer,” it would be liable if a franchisee fails to withhold and remit taxes for its employees or if an individual personally owns a franchise and fails to do so for him or herself. The penalties for misclassifying individuals as independent contractors (applicable for franchisees presumed to be independent contractors) and failing to withhold can be quite severe. Under federal law, employers that misclassify individuals based on “reasonable cause” are nonetheless liable for the amounts not withheld, interest on those amounts and penalties of 1.5% of the income tax not withheld and 20% of the social security tax due. If the misclassification and failure to withhold is based on “willful neglect,” the penalties increase to 3% and 40%, respectively.

B. Wage Damages

In addition, many states also impose sanctions for misclassifying workers, allowing workers to bring actions for wage damages. In Massachusetts, individuals have a private right of action for claims that they have been misclassified and not timely been paid their “wages.” If successful, misclassified workers are entitled to recover treble damages for any unpaid wages and attorney’s fees. A decision of the Massachusetts Supreme Judicial Court held that “wages” for purposes of Section 150 include holiday, vacation and overtime pay, Social Security and Medicare contributions, unemployment insurance contributions, workers’ compensation premiums and income tax withholding obligations. In reaching this determination, the Somers Court specifically rejected the putative employer’s argument that it had paid the individual far more than the minimum wage and overtime acts required, such that regardless of his classification, he had suffered no damage. Applied in the franchise context, regardless of how much a franchisee earns, this could mean that he or she is entitled to three times the value of a franchisor’s health insurance if the franchisee has been misclassified plus Social Security and Medicare contributions. In another decision, the Massachusetts Supreme Judicial Court held that misclassified workers could recover damages for payments they had to make as independent contractors that employees would not have had to make, including payments for insurance and franchise fees.

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66 See e.g., I.R.C. § 3111(a).
67 I.R.C. § 3509(a).
68 I.R.C. § 3509(b).
71 Id. at 590-91.
72 See Awuah, 460 Mass. at 484 (holding that charging of franchise fees was akin to requiring employees to pay for a job, which court held violates Massachusetts wage law and public policy).
C. Unemployment

A franchisor deemed to be its franchisee’s employer may also be liable for unemployment taxes for the franchisee. Again, a Massachusetts case demonstrates the real potential of such an outcome. In *Coverall North America, Inc. v. Commissioner of the Division of Unemployment Assistance*, Massachusetts’ highest court held that a franchisor was indeed a franchisee’s employer and therefore liable for payment of unemployment insurance premiums.73 In *Coverall*, an individual began working for a franchisee by cleaning a particular nursing home.74 For reasons not discussed in the opinion, the franchisee lost the nursing home account.75 As the individual wanted to continue cleaning the nursing home, she asked about purchasing a Coverall franchise. The individual ultimately did so and was assigned the specific nursing home account.76

Consistent with its general practice, Coverall negotiated the cleaning contract price and conditions directly with the nursing home.77 The contract was based on five hours of cleaning per day, Monday through Friday.78 Coverall also took care of all billing and collection functions for the franchisee and collected a fee for such services.79

The individual soon realized that the required cleaning duties could not be completed in twenty five hours per week. Despite complaining to the franchisor’s field representative, the individual was directed to work as long as required to complete the necessary cleaning.80 In addition, the individual was required to complete “special cleaning assignments” for the nursing home. Although promised additional compensation for such “special assignments,” the individual never received any additional payments.81 Frustrated with the additional work she was required to perform, the individual “quit” and filed a claim for unemployment benefits.82

Under Massachusetts law, only “employees” are eligible for unemployment benefits and employment is governed by the ABC Test.83 Skipping over the first two prongs of the test, the *Coverall* Court proceeded directly to the third prong: whether the “individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.”84 To apply this prong, the court “is to consider

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74  *Id.* at 854.
75  *Id.*
76  *Id.*
77  *Id.*
78  *Id.*
79  *Id.*
80  *Id.* at 855.
81  *Id.*
82  *Id.*
83  *Id.* at 856-57. Note that Massachusetts’ unemployment ABC Test differs from its Wage Act ABC Test discussed below, such that an individual could be an “employee” for purposes of the Wage Act, but not under the Unemployment Act.
84  *Id.* at 856-58.
whether the service in question could be viewed as an independent trade or business because
the worker is capable of performing the service for anyone wishing to avail themselves of the
services or, conversely, whether the nature of the business compels the worker to depend on a
single employer for the continuation of the services. Based on the fact that Coverall
negotiated all contracts with customers, including pricing, billed all clients and provided the
individual with a daily cleaning plan, the court concluded that she was not engaged in an
independent trade or business. In reaching this conclusion, the court rejected Coverall’s
arguments that the individual could expand her business if she chose and had been involved in
the cleaning business for six years before becoming a Coverall franchisee. The court did so
because each new customer became a Coverall customer and because the individual testified
that her cleaning business disappeared after Coverall “discharged” her.

As the United States continues to face high unemployment rates and states’
unemployed citizens face ever longer periods of unemployment, the search for new ways to
cover individuals and the resources to pay for such coverage will continue to grow. The
Coverall decision appears to present those states utilizing the ABC Test with just such an
opportunity. Franchisors should, therefore, be particularly aware of any claims for
unemployment benefits they may receive from their franchisees or their franchisees’ employees.

To compound matters, if an employer/employee relationship exists it raises the
additional issues of how to determine the amount of taxes due, how to address a franchisee’s
previous treatment of certain payments claimed as deductions on the franchisee’s tax returns,
and how to identify which individuals who have performed services for the franchisee are
employees and which are independent contractors. In the event a franchise owner has retained
numerous individuals in varying capacities to perform different services, the absence of any
payroll records may result in the creation of an “open checkbook” scenario where a franchise
owner is required to inquire with every individual who has previously performed services for a
list of locations and time worked.

D. Employment Discrimination

A franchisor deemed its franchisee’s “employer” could also be liable for employment
discrimination committed by its franchisee. Two cases illustrate this danger. In Myers v.
Garfield & Johnson Enterprises, Inc., a franchisee’s employee alleged that she was sexually
harassed by the franchise’s owners and managers and sought to hold the franchisor liable
under Title VII and her state’s anti-discrimination law. In support of her claim the employee
alleged that the franchisor provided her job training, issued a written code of conduct that
prohibited harassment and discrimination in the workplace and oversaw and approved all work
product that she prepared. There was, however, no allegation of any harassment by the
franchisor, the franchise agreement specified that the relationship was that of independent
contractors and the employee never complained to anyone at the franchisor about the alleged
harassment.

85 Id. at 857-58 (internal quotation marks and citation omitted).
86 Id. at 858.
87 Id. at 859.
The franchisor immediately moved to dismiss the claims against it, arguing that it did not “employ” plaintiff, as specified in the franchise agreement, and therefore could not be liable as an “employer.” Plaintiff responded by arguing that the franchisor was potentially liable under three distinct theories: (1) directly as a “joint employer” with its franchisee; (2) vicariously as its franchisee’s actual principal under an agency relationship; and (3) vicariously as plaintiff’s “ostensible or apparent employer.” Based on plaintiff’s allegations that the franchisor promulgated work rules by issuing a sexual harassment policy, engaged in day-to-day supervision by reviewing and approving each tax return plaintiff prepared and assumed some control over employee records by providing a computer-based employee records system, the court held that plaintiff alleged sufficient facts to establish a potential joint employer relationship.

Relying on decisions from other jurisdictions, the court also rejected the argument that franchise relationships could not give rise to vicarious liability for discrimination claims. “Although the mere existence of a franchise relationship does not necessarily trigger a master-servant relationship, neither does it automatically insulate the parties from such a relationship.”89 Finally, the court allowed plaintiff to proceed with her apparent or ostensible agency theory. Recognizing that apparent authority must be based on statements of the principal, not the alleged agent, the court focused on plaintiff’s allegations concerning communications she received directly from the franchisor, including the training and codes of conduct.

Another case, EEOC v. Papin Enterprises, Inc., also addressed a franchisor’s potential liability for employment discrimination.90 In Papin, the Equal Employment Opportunity Commission (“EEOC”) brought a religious discrimination claim against a franchisor based on the no facial jewelry policy contained in the Operations Manual. During a routine quality inspection, an inspector observed an employee wearing a nose ring and asked the employee to remove it pursuant to the policy. The employee refused based on its religious importance. When the franchisee asked for a waiver of the no-facial-jewelry policy, the franchisor requested documentation supporting the religious nature of the nose ring. The employee ultimately furnished a note from her mother and herself explaining the significance of the nose ring in the Nuwaubian religion, but did not, as requested, provide a “note from a minister” or any “religious text” supporting the request.

The franchisor responded to the proffered letters by denying the waiver request unless the employee could provide “some sort of bona fide documentation regarding the nose ring and its significance to her religion within five days.”91 When the employee did not provide any additional documentation within the five day period, the franchisee terminated her employment so as not to be in violation of the Operations Manual.

The franchisor moved for summary judgment on the basis that it did not employ the individual and therefore could not be liable. The EEOC responded by arguing that the franchisor was jointly liable with its franchisee because the franchisor and the franchisee were either a single employer/integrated enterprise or joint employers. Alternatively, the EEOC argued that the franchisor was directly liable because it “adversely affected” the individual’s employment by insisting upon adherence to its no-facial-jewelry policy. The court summarily

89 Id. at *40 (quoting Drexel v. United Prescription Ctrs., 582 F.2d 781, 786 (3d Cir. 1978)).
rejected the first argument, holding that there were no evidence of integrated operations between the franchisor and its franchisee, no centralized control of labor relations and no common management, ownership or financial control.

As in Myers, the Papin Court refused to accept the franchisor’s argument that it was not a joint employer with its franchisee. In disputing the alleged joint employer status, the franchisor relied on its franchise agreement that specifically disclaimed any franchisor responsibility for “recruiting, hiring, terminating or supervising” the franchisee’s employees. Refusing to rely upon the terms of the franchise agreement, the court instead focused on the facts that: (1) the franchisor, not the franchisee, retained ultimate control over whether to issue a waiver to the no-facial-jewelry policy; and (2) the franchisor had injected itself in the decision making process by specifying what would be acceptable to substantiate a waiver.

The court also held that the franchisor could be directly liable to the employee under Title VII for “adversely affecting” her employment. Holding that “more is involved in the unique circumstances of this case than the mere existence of a franchise relationship,” the court refused to limit the franchisor’s potential liability to the joint employer doctrine.

Ultimately, a jury rejected all claims brought against both the franchisor and the franchisee. The jury did so because it determined that the employee did not wear the nose ring for any sincerely held religious belief. While clearly a good outcome for all defendants, it in no way lessons a franchisors’ potential liability as “employers” for employment discrimination claims brought by franchisees’ employees.

E. Workers’ Compensation

Similar to unemployment benefits, “employers” in most states are required to provide employees with workers’ compensation coverage. The test for determining employer status under workers’ compensation laws is often identical to that for unemployment. As the Coverall and Somers decisions demonstrate, franchisors must be careful to analyze their franchisee relationships so as not to inadvertently be deemed “employers” and not in compliance with workers’ compensation statutes.

F. Vicarious Liability

Perhaps the most significant consequence to franchisors being deemed an employer is the potential for vicarious liability. As the Oregon Court of Appeals explained in Viado v. Domino’s Pizza, LLC, “[i]n general, a principal is liable for all torts committed by its employees while acting within the scope of their employment.” For years now, franchisors have fought vicarious liability claims; generally with great success. Those successes, however, have largely been based on establishing an independent contractor relationship between the franchisor and

92 Id. at *27.
93 Id. at *28.
94 Id. at *30.
95 2009 U.S. Dist. LEXIS 69787, at *2.
its franchisee. Absent an employment relationship, several courts have now held that a franchisor must have actual control over or the right to control “the daily operation of the specific aspect of the franchisee’s business as alleged to have caused the harm.”

By focusing on whether an employment relationship exists between franchisor and franchisee, a plaintiff can avoid the need to demonstrate control over the specific cause of his or her alleged harm. Indeed, in states such as Massachusetts that have adopted the ABC Test to determine employment status outside of the unemployment and workers’ compensation contexts, franchisors could be vicariously liable for almost all tortious acts committed by their franchisees.

Take, for example, a vicarious liability claim against Burger King Corporation based upon the tortious act of a franchisee’s employee. While Burger King would almost certainly move for summary judgment, the question of the alleged tortfeasor’s employment may be too confusing under the liberal ABC Test. If the question of employment status does get to the jury, Burger King would be in the unenviable position of explaining that it is not in the business of selling hamburgers, but instead in the business of franchising others to sell hamburgers. If a jury fails to appreciate this difference and concludes that Burger King is in the business of selling hamburgers, it would likely fail the “B” part of the ABC test because Burger King and its franchisee are in the same business. Having established an employer-employee relationship between Burger King and the tortfeasor, Burger King’s only defense would be establishing that the employee’s act were outside his or her scope of employment which is a difficult task at best.

G. Income Taxes Based on Presence in a State

Another potential implication of being deemed a franchisee’s employer under one of the various tests is an obligation to pay income taxes to a particular state. While generally beyond the scope of this paper, franchisors that have a “nexus” with a particular state are generally liable for income taxes on revenue earned from that state. While nexus analyses often focus on the presence of franchisees within a state, having employees in a state is also a basis for

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97 See e.g., Viado, 230 Ore. App. at 548 (holding that franchisee was not franchisor’s “employee”); Smith-Hoy v. AMC Prop. Evaluations, Inc., 52 A.D.3d 809, 811 (N.Y. App. Div. 2008) (“Absent proof of a principal/agency relationship or proof that a franchisor exercised a high degree of control over its franchisee, there is no basis for holding a franchisor responsible for its franchisee’s misconduct.”) (citation omitted); Papa John’s INT’L, INC. v. McCoy, 244 S.W.3d 44 (Ky. 2008) (holding that franchisor could not be vicariously liable based, in part, on lack of employment relationship with franchisor).

98 Kerl v. Denis Rasmussen, Inc., 682 N.W.2d 328, 332 (Wis. 2004); McCoy, 244 S.W.3d at 55 (adopting Kerl test); Viado, 230 Ore. App. at 549 (adopting similar test).

99 See e.g., Keith v. ManorCare, Inc., 2009 N.M. App. LEXIS 136 (Aug. 14, 2009) (holding that question of employment status must be submitted to the jury even under more strict common law employment test); but see Viado, 230 Ore. App. at 548 (“Given the complex nature of the franchise relationship between these two businesses, no reasonable juror could conclude on this record that [franchisee] was [franchisor’s] "employee."”)

100 See Restatement (Third) of Agency (2006) § 7.07 (1) (limiting principal’s liability to act committed within employee’s scope of employment).

101 See generally Quill Corp. v. North Dakota, 504 U.S. 298 (1992) (holding that nexus must exist, but that standard for establishing nexus may be different under Due Process and Commerce Clauses of the United States Constitution); KFC Corp v. Iowa Dep’t of Revenue, 792 N.W.2d 308, (2010) (holding that franchisees’ use of franchisor’s trademark in Iowa constituted sufficient nexus for taxation purposes).
establishing a nexus with that state.\textsuperscript{102} This, perhaps even more so than with unemployment insurance, may motivate states to aggressively pursue “employer” claims against franchisors as a way to establish the requisite nexus and thus an entitlement to additional tax revenues. As states face ever increasing budget deficits and lowering tax revenues, many are looking for any and all new revenue sources.

V. WHO IS BRINGING “EMPLOYEE” CLAIMS?

Employee misclassification claims are not new. For years, individuals and unions have raised misclassification claims in the construction, home health and high technology industries.\textsuperscript{103} Today, misclassification claims are being brought in a variety of industries, including many that had not traditionally seen such claims. Not surprisingly, franchised industries are now also the subject of misclassification claims.

A. Individuals and Classes

Massachusetts has seen a great deal of litigation regarding misclassification, particularly in the cleaning franchise industry. In \textit{Awuah v. Coverall North America, Inc.}, a federal court granted the plaintiffs’ motion for summary judgment, holding as a matter of law that cleaning worker franchisees were in fact employees under the Massachusetts independent contractor statute.\textsuperscript{104} In \textit{De Giovanni v. Jani-King Int’l, Inc.}, another federal court reached the same conclusion. Both cases were certified as class actions.\textsuperscript{105} The \textit{Coverall} decision is now pending on appeal at the First Circuit Court of Appeals.

The Massachusetts Supreme Judicial Court has weighed in three times on litigation surrounding the allegation that cleaning franchise companies have misclassified cleaning worker franchisees as independent contractors. In \textit{Coverall North America, Inc. v. Comm’r of Unemployment Assistance}, the Court affirmed an agency determination that a franchisee was an employee for purposes of unemployment and was thus eligible to receive unemployment at the end of her relationship with Coverall.\textsuperscript{106} In \textit{Awuah v. Coverall North America, Inc.}, the Court held that the misclassified workers could recover damages for insurance payments they had made, franchise fees, as well as other damages, such as for late payment of wages, and money withheld from them for “chargebacks” (i.e. amounts charged to franchisees when customers failed to pay their bills).\textsuperscript{107} In \textit{Depianti v. Jan-Pro Franchising International, Inc.}, the Court held that a national cleaning franchise company could be the employer, under M.G.L. c. 149 § 148B, of franchisees who had contracted directly with regional master franchisees if the work

\textsuperscript{102} Quill Corp., 504 U.S. at 306-07.


\textsuperscript{105} C.A. No. 07-10066 (D. Mass. June 8, 2012) (transcript of ruling granting summary judgment to the plaintiffs, at 78.


\textsuperscript{107} 460 Mass. 484 (2011).
performed by the franchisee workers was within the usual course of business of the national company.108

So far, however, this claim has not succeeded in California, which uses a multi-factor control test for determining whether a worker is an employee or independent contractor. In Juarez v. Jani-King of California, Inc., the federal court granted the defendant’s motion for summary judgment, holding that the franchisees are independent contractors under California law.109 That decision is now pending on appeal at the Ninth Circuit Court of Appeals.

B. Federal Government

Governments are also once again focusing on worker classification and stepping-up their enforcement activities. As discussed in a recent CFO.com article, the IRS has announced that it will conduct 6,000 audits over the next three years concerning employee misclassification.110 The motivation for this attention appears to go beyond “protecting” misclassified individuals. According to the article, the IRS expected to collect almost $64 million in 2008 taxes and penalties for misclassifying individuals.111 President Obama has also focused on the issue and stated that the federal government could collect $7 billion over the next ten years by better enforcing current rules and hiring new employees to do so.112

C. State Governments

Not to be outdone, states are also getting into the act. With unemployment swelling and reserves dwindling, states are trying to tap every available resource. The New York State Senate Labor Committee recently approved a bill that adopts the ABC test for all individuals working in the construction industry.113 Ohio has also announced a push to closely examine employee classification issues.114 Ohio is pursuing the issue because misclassification “costs” it approximately $790 million per year in forgone unemployment compensation, workers’ compensation and withheld income taxes. Given the dollars at stake and the deficits at hand, more and more states will likely focus on this in the near to medium term.

VI. LEGISLATIVE INITIATIVES CONCERNING FRANCHISEES’ EMPLOYMENT STATUS

Following the Coverall decisions, franchisors and advocacy groups such as the IFA have expressed concerns regarding the court’s findings, encouraging state legislatures to enact laws

111 Id.
112 Id.
to provide protection for franchisors. For example, in 2011, a Massachusetts bill was introduced (House Bill No. 3513) to amend state labor, unemployment insurance and workers compensation statutes by including the following language\textsuperscript{115}:

Notwithstanding the provisions of this section, an individual who owns a franchise, or is a party to a franchise agreement under which he or she is authorized to sell products and/or services (a) in accordance with prescribed methods and procedures; and (b) under service marks, trademarks, trade names and other intellectual property licensed under such agreement, shall not be considered an employee of the franchisor.

Ultimately, House Bill No. 3513 failed to gain the traction that franchisors were hoping for, and eventually failed to become law.

Virginia also unsuccessfully attempted to introduce legislation designed to clarify that franchisees were not employees of franchisors. In 2010, legislation entitled the Virginia Worker Misclassification Act (the "Act") was proposed. Under a three-prong test proposed in the Act, an employment relationship would not exist when: (1) an individual is free from the direction and control of the employer under contract and in fact; (2) the service provided by the individual is outside the usual course of business of the employer; and (3) the individual is customarily engaged in an independently established trade, occupation, profession, or business both in contract and in fact\textsuperscript{116}.

Following the Act’s proposal, a request was made to the Virginia Attorney General to clarify whether, under the proposed Act, franchisees would be considered employees rather than independent contractors. In January 2011, the Virginia Attorney General issued an advisory opinion in response to the request for clarification. In the advisory opinion, the Attorney General stated that the test proposed by the Act would not find an employment relationship between a franchisor and franchisee. In coming to this conclusion, the opinion stated that the franchisee is performing services not for the employer, but for the "profit and account of the franchisee." Additionally, the opinion noted that a franchisee is unlike a traditional employee because it is a corporation rather than an individual, and is not being compensated by the franchisor\textsuperscript{117}. Dashing the high hopes of franchisors, ultimately the Act did not pass.

While franchisors did not receive legislative aid in Massachusetts and Virginia, they did score a victory with recent legislation in Georgia. In April of 2012, the Georgia General Assembly unanimously passed House Bill 548, which codified the franchisor-franchisee relationship. The statute states that “individuals who are parties to a franchise agreement . . . shall not be deemed employees . . . ”\textsuperscript{118} The new law became effective on July 1, 2012.

VII. WAYS TO AVOID EMPLOYMENT RELATIONSHIPS IN FRANCHISING

In drafting franchise agreements, one must be mindful of the thin line between obligating the franchisee to abide by a “system” and exerting control over the day-to-day operations of the franchisee’s business. For example, provisions that clearly state the franchisee is not an agent of the franchisor can assist a court in determining the parties’ intent. However, “the label the parties attach to their relationship is informative but not dispositive.”\(^\text{119}\)

Franchisors can also more clearly define the relationship by requiring franchisees to incorporate and run their businesses as such.\(^\text{120}\) By requiring a franchisee to incorporate, the franchisor can then deal at arm’s length with a separate legal entity. It adds another legal layer of separation between the franchisor and the franchisee. Building on that line of reasoning, a franchisor can also require a franchisee to be employed by some entity. Again, the purpose is to add a legal layer of separation from the franchisor.

Another common policy of most, if not all, franchisors can be effective in avoiding potential tax liabilities resulting from franchisees’ failure to withhold and remit taxes relating to its employees. Enforcement of policies requiring franchisees to comply with all federal, state, local, and municipal laws, statutes, and regulations combined with appropriate audits stipulated in the franchise agreement can be beneficial when responding to federal or state inquires regarding income tax withholdings. Recurring audits for tax obligation compliance may also be beneficial to certain franchisees who perform such services without the assistance of outside services and who may be more likely to overlook certain tax payment obligations. Additionally, it can also add a layer of documentary evidence to argue that the franchisor does not have day-to-day control of the franchisee’s business.

Keep in mind that while franchisors can use some or all of these requirements as a shield against liability, they may also be used as a sword against franchisors. One can envision an argument that by requiring a franchisee to incorporate or to be employed by an entity is tantamount to controlling the day-to-day operations of the franchisee.

A franchisor must be able to balance its need to maintain a uniform system and protect its brand identity with the need to allow its individual franchisees the freedom to operate their independent businesses. The key is to understand which standards are mandatory and crucial to the success of the system and which standards can be left open to creative interpretation. Differentiating between these types of standards allows for franchisors to manage the franchise system while lessening their potential exposure to liability.\(^\text{121}\)

For purposes of determining vicarious liability, franchisor-enforced mandatory operational requirements are treated differently from discretionary recommendations. In Townsend v. Goodyear Tire & Rubber Co., the franchisee’s employee sustained fatal injuries installing tires on a customer’s motor home.\(^\text{122}\) The plaintiffs argued that both the dealer and

\(^{119}\) Kerl v. Rassmussen, 682 N.W.2d 328, 341 (Wis. 2004).

\(^{120}\) But see Amero, Civil Action No. 07-1080, Slip Op. at 5 n.4 (holding that plaintiff’s formation and use of a corporate entity did not preclude his wage claim as an “individual.”).

\(^{121}\) See Allen v. Choice Hotels Int’l, 942 So.2d 817, 825 (Miss. App. Ct. 2006) (concluding that a “franchise agreement . . . is meant to provide a system of uniformity,” and does not prove that the franchisor retained the “right of control”).

\(^{122}\) 249 Fed. App’x. 327, 328 (5th Cir. 2007).
trademark license agreements made the franchisor contractually liable to the employee and vicariously liable for the franchisee’s negligence. The court disagreed and held that “[m]erely exercising or retaining a general right to recommend a safe manner for the independent contractor’s employees to perform their work is not enough to establish liability.”

This reasoning is once again echoed in Hunter v. Ramada Worldwide, Inc., where the court held “retaining certain rights such as the right to enforce standards, the right to terminate the agreement for failure to meet standards, the right to inspect the premises, the right to require that franchisees undergo certain training, or the mere making of suggestions and recommendations does not amount to sufficient control.”

For example, premises security is often an area where the franchisor will provide recommendations, but not mandates. Providing a safe environment for customers and employees is critical to any bricks and mortar franchise chain. However, the manner in which safety is provided is generally not a key element of the franchisor’s brand identity. Consequently, many franchisors provide only voluntary guidelines for franchisees with respect to safety and security procedures. Courts have held that the voluntary nature of such guidelines makes imposing vicarious liability upon the franchisor improper as the franchisor does not have control of the “instrumentality of the harm.”

Another area where franchisors should only offer voluntary guidelines is with respect to employment practices. When determining whether a franchisor has exercised day-to-day control over the franchisee’s operations, courts will invariably look to the level of control over employment matters. For example, courts have stated that a franchisor will not be held liable when it imposes basic guidelines, but does not make the specific hiring and firing decisions. It is not sufficient for a franchisor to merely set out general standards for employees in order to find actual agency. The franchisor must control the precise methods. Where a franchisor had no control over hiring, retention, firing, scheduling, wages, benefits, and vacations, the franchisor was not held to be the plaintiff’s “employer.” Courts have also relied on franchise agreements which state that the franchisee is “solely responsible” for employment decisions.

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123 Id.
124 Id. at 329.
125 2005 WL 1490053, *6 (E.D. Mo. June 23, 2005); see also Corrales v. Days Inn Worldwide, Inc., Bus. Franchise Guide (CCH) ¶ 13,187 (D. Colo. Dec. 5, 2005) (imposition of system standards “establish no more than standards to safeguard the uniformity, value and integrity of the franchise system” and do not amount to day-to-day control of the franchisee’s operation necessary to impose liability).
126 See Vandemark v. McDonald’s Corp., 904 A.2d 627, 631 (N.H. 2006) (finding no direct or vicarious liability for employee injured in a robbery attempt where franchisor’s O&T manual specifically provides that security procedures are mandatory for company-owned restaurants while “[i]ndependent owner/operators are encouraged to adopt appropriate policies”); Wu v. Dunkin’ Donuts, Inc., 105 F. Supp. 2d 83, 91 (E.D.N.Y. 2000) (no vicarious liability where the “undisputed evidence” shows that franchisor “merely made security equipment available for purchase and suggested that alarm systems…were important”).
In *Alberter v. McDonald’s Corp.*, a 15-year-old employee sued a McDonald’s franchisee and McDonald’s Corporation alleging a hostile work environment under Title VII.  

The court granted McDonald’s Corporation’s motion for summary judgment. Although McDonald’s Corporation provided employment recommendations in its manuals, the recommendations were clearly voluntary and the franchisee was not required to follow or adopt those policies. The franchisee employed the individuals who worked at the restaurant and made all of the decisions concerning hiring and firing, employee discipline, performance evaluations, awards, promotions, demotions, scheduling, work assignments, training, time off, and compensation.  

Because McDonald’s Corporation exercised no control over employment matters at the restaurant, it was not the plaintiff’s “employer” for Title VII liability. 

Another way in which a franchisor can police and protect its brand is through protecting its trademarks. Pursuant to the Lanham Act, a “trademark owner must preserve his asset and protect the public against deceptive uses of the trademark, which typically means the franchisor must regulate the franchisee.”

Finally, franchisors should consider making certain changes to their disclosure documents and franchise agreements. Chief among these is a careful review and revision of the business description in Item 1 and any description in the franchise agreement. Franchisors should describe their business as selling franchises and developing brand products or services. Franchisors should also consider affirmatively stating that they do not directly sell any of the products or services they license franchisees to sell. While not dispositive, this approach should help guard against *Awuah*-like decisions that focus on FDD and franchise agreement descriptions to hold that a franchisor is in the same business as its franchisees.

Franchisors should also consider eliminating their in-term and post-term covenants against competition. Such covenants may strengthen plaintiffs’ arguments on the “C” prong of the ABC test because they limit a franchisee’s ability to sell the products or services to others, such that they are not truly “independent.” Trade secret and trademark protection would still be available to franchisors, but this approach otherwise adopts the California and Georgia models on non-competition covenants.

**VIII. CONCLUSION**

Since the original Massachusetts decision holding that a franchisee was an employee entitled to unemployment benefits there have been countless cases, papers and discussions on how this would affect franchising. Six years later it remains an unanswered question. Some believe the issue is confined to the janitorial services space while others see nothing in the decisions to date suggesting such a limitation. As the discussion above hopefully makes clear,

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131  *Id.* at 1143–44.

132  *See also Kennedy v. Western Sizzlin Corp.*, 857 So.2d 71 (Ala. 2003) (although franchisor trained employees, the franchisee had sole control over the employment decisions at the restaurant and therefore, franchisor not vicariously liable).

133  *Allen v. Choice Hotels Int’l*, 942 So.2d 817, 826 (Miss. Ct. App. 2006); *see also Oliveira-Brooks v. Re/Max Int’l, Inc.*, 865 N.E.2d 252, 258 (Ill. App. Ct. 2007) (“mere protection of a trade name does not create an agency relationship”); *Kerl*, 682 N.W.2d at 338 (“[O]perational standards and inspection rights specified in the franchise agreement are integral to the protection of the franchisor’s trade or service mark under the Lanham Act”).
while there are no simple answers, franchisors in all market segments are well advised to keep abreast of developments in this particular area of the law.
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Gregg Rubenstein is a litigation partner and member of the Franchise and Distribution team at Nixon Peabody LLP. Gregg has focused his practice for over ten years on helping franchisors and commercial clients resolve their disputes. Mr. Rubenstein has co-authored multiple papers on franchise matters. These papers include The International Franchise Association’s 2013 Annual Franchise Update and Review which was presented at the 2013 Legal Symposium. Mr. Rubenstein also has experience with and represents clients in a variety of labor and employment matters, including arbitration proceedings and defense of wrongful termination and employment discrimination claims before federal and state courts. In 2013 and 2014, Gregg was recognized as a “Legal Eagle” by Franchise Times, an honor accorded the top franchise lawyers in the United States based on peer and client nominations.

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