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FRANCHISEE OR EMPLOYEE?
THE RISKS OF MISCLASSIFICATION IN FRANCHISE RELATIONSHIPS

Arthur L. Pressman
NIXON PEABODY LLP
Boston, MA

and

Carla Wong McMillian
SUTHERLAND ASBILL & BRENNAN LLP
Atlanta, GA

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I. OVERVIEW: THE INDEPENDENT NATURE OF THE FRANCHISE RELATIONSHIP IS UNDER CHALLENGE.¹

Virtually every franchise agreement contains a provision that restates what is obvious to franchisors – an acknowledgment that the franchisee is an independent contractor, and not a partner, joint venturer, agent or employee of the franchisor. This independent contractor status is also obvious to franchisees who have made a significant investment of money and personal resources into a franchise offering with the goal, in part, at least, to be in business for themselves, and no longer be an employee. Sometimes, a franchisee’s status as an independent businessperson, and not an agent or employee of the franchisor, is not as clear to members of the public as it is to the franchisor and franchisee. When that occurs, and an accident or injury takes place at the franchised business or in connection with the franchisee’s business operations, vicarious liability issues arise. Most franchisors are familiar with the risks of vicarious liability, and have taken steps to minimize the risks (for example, requiring franchisees to post conspicuous signage alerting the public that the franchise is owned by an independent businessperson, and not by the franchisor) or insure against the risks (for example, requiring indemnification and additional or named insured coverage on franchisee insurance policies).

Some risks associated with a franchisee’s independent contractor status are not so easily understood or insured against as the risks associated with claims of vicarious liability. Chief among those risks in 2009 is risk that a franchisee’s independent contractor status will be disregarded in its entirety by state agencies charged with the responsibility of protecting workers from injury (workers compensation), unemployment (unemployment compensation) or from employers who do not fairly pay employees in accordance with wage payment and collection laws. If this happens, not only will franchisors find themselves liable for payment of the expenses on a going-forward basis (which can be substantial depending on the number of “employees”), but also premiums and expenses for past years and statutory penalties.

The current economic climate has encouraged troubled franchisees and revenue starved government agencies to dispute or ignore the independent contractor relationship existing between a franchisor and franchisee. This paper is about the legal framework that governs those disputes, including the recent trends that are particularly troubling to franchisors. Section Two below provides an overview of the problem that franchisors face when the independent contractor designation is challenged, including the factual context in which the problem is most likely to arise and the substantive areas of law in which the “franchisee or employee” distinction are most likely to matter. Section Three describes the various legal tests used to determine whether a franchisee is an independent contractor or employee of the franchisor. Finally, Section Four discusses of the future context in which litigation of these issues may arise, class actions.

¹ The authors also gratefully acknowledge the research and writing assistance of Kelly J. Baker, Senior Counsel, Asbury Automotive Group, Inc. and Sam Casey, third year law student at the University of Virginia School of Law, as well as the contributions of Gregg A. Rubenstein, a franchise litigation partner at Nixon Peabody LLP.
II. THE PROBLEM: COURTS AND GOVERNMENT AGENCIES APPLY THEIR OWN CRITERIA, RATHER THAN THE TERMS OF THE PARTIES’ AGREEMENT, IN DETERMINING WHETHER AN EMPLOYMENT RELATIONSHIP EXISTS.

A. The Legal Contexts in Which the Challenges to a Franchisee’s Status as Independent Contractor Typically Arise

While the independent nature of the franchise relationship provides clear benefits to companies (and individuals), the classification of workers as independent contractors may draw attention from governmental regulatory agencies. Some governmental agencies have found an employee-employer relationship, even when the parties have a carefully crafted franchise agreement in place and followed its provisions to the letter. Courts and government agencies routinely look beyond franchise agreements when analyzing whether an individual is a true independent contractor or an employee.

The issue of worker classification matters first and perhaps foremost in the context of employment related taxes such as income tax withholdings, FICA, federal unemployment tax (FUTA) and state unemployment tax. Classifying a worker as an independent contractor when the worker should have been classified as an employee means that the employer has not paid employment taxes for that worker. In addition, if the worker is misclassified as an independent contractor, the employer will have failed to pay federal unemployment tax (FUTA) and state unemployment tax.\(^2\) If the employer had no reasonable basis – as recognized under law – for misclassifying the worker, back taxes will be owed for the employee. If the worker, while improperly classified as an independent contractor, paid all of the appropriate taxes to the appropriate taxing authority, then there should be no back tax liability for the employer; however, if the worker has not paid all such taxes, the unpaid taxes become the responsibility of the employer. Interest would be added and penalties may also apply.

In addition to tax liability, a determination that a worker is an employee rather than an independent contractor may have the following additional implications:

- **Fair Labor Standards Act ("FLSA")** – “Employees” are covered by the FLSA (and by the State labor laws). As such, they may claim that they are owed minimum wage and/or overtime for all hours worked.

- **Employee Retirement Income Security Act ("ERISA")** – “Employees” are covered by ERISA’s protections and are entitled to the rights guaranteed under ERISA. As such, they may be entitled to benefits otherwise provided to other employees, including health and medical insurance coverage. Eligibility for benefits would be governed by the terms of the company’s plans and policies.

- **Federal, state and local anti-discrimination laws** – “Employees” are protected by city, state and federal anti-discrimination laws. As such, they may bring claims of discrimination or harassment against the company, either in court or before state agencies.

\(^2\) As a result of these tax liabilities, it is not uncommon for businesses to require independent contractors who work for them on a regular basis to sign certifications of tax compliance.
• **Occupational Safety and Health Act ("OSHA")** – All employers are obligated to provide a safe workplace to their "employees" and to comply with a variety of hazard-specific requirements, as applicable. Employees may claim violations of OSHA.

• **State unemployment insurance** – State unemployment insurance laws require employers to make contributions for each "employee." The company would not have made contributions on behalf of an independent contractor. Thus, it may be liable for back contributions, interest, and possibly penalties.

• **State workers’ compensation** – State workers’ compensation laws require employers to secure workers’ compensation for their "employees." The company would not have made contributions on behalf of an independent contractor. The failure to secure coverage may result in penalties and/or may permit an employee who is injured on the job to elect either to claim compensation under the statute or to maintain an action in court against the employer.

• **Tort liability** – An employer would have *respondeat superior* liability for the tortious actions of an employee.

**B. The Factual Context in Which Challenges to a Franchisee’s Independent Contractor Status Typically Arise**

As a practical matter, courts and state agencies are not usually concerned with substantial franchisees which themselves have multiple employees on whose behalf the franchisee-employer makes contributions to state workers compensation and unemployment benefit programs, and pays employees overtime and other benefits as required by law. Small franchisees are, however, increasingly getting attention from state attorneys general charged with enforcing wage and labor laws. Many times these smaller franchisees have few, if any, employees, and are conducting business as sole proprietorships. They may view the franchise business as supplemented income, working at night, from home offices or from a panel truck bearing the franchisor’s trademark while they drive from customer to customer, doing home repair, cleaning houses, bathing pets or performing any of the myriad activities that have been successfully franchised. Sometimes, the total franchise investment required is comparatively modest, at least, as compared to a McDonald’s Restaurant; sometimes, the franchisor will finance the franchise investment.

The universe of franchise systems whose franchise offering falls within some or all of these buckets (relatively smaller investment, mobile workspace, relatively unskilled service) is significant. That’s why the issues prompted by states’ efforts to severely limit who can legitimately call themselves an independent contractor should be of critical concern to all smaller investment franchisors with a franchisee profile that frequently includes, or is predominated by, one or two person ("Mom and Pop," operators. Moreover, the analysis that state attorneys general and courts make when faced with independent contractor issues often turns on legal issues that larger investment franchisors have in common with smaller investment franchisors.

As is the case with many franchisor-franchisee relationship issues, the problem of franchisees’ independent status often arises in connection with other relationship problems; most notably termination. When franchisees are profiting from their business and prospects for continued growth look good, issues concerning their independent status rarely arise. When
business is either failing or has failed and a franchisee finds him or herself without an income and no possibility of recouping costs sunk in the franchise, status as an "employee" of the franchisor may provide a financial lifeline not otherwise available. Needless to say, as economic conditions remain challenging or further worsen, these types of claims are only likely to increase. Alternatively, when a franchisee is unable to perform business due to a disability and no insurance is available either to pay the medical bills or replace lost income, a status claim may follow as the franchisee seeks the protection of state's workers' compensation law.

III. THE LEGAL CRITERIA FOR DETERMINING WHETHER A FRANCHISEE IS AN INDEPENDENT CONTRACTOR

Courts and government agencies use a variety of tests in different contexts to determine whether a worker is properly classified as an employee or an independent contractor. Of course, the employer-employee relationship is governed by a number of different federal, state and local statutes that impose various responsibilities upon employers. In the event that a government agency or court finds a worker to be an employee, the nature of the employer’s liability would depend upon the specific statute at issue. The relevant government agencies utilize different tests to determine a worker’s employee/independent contractor status. As a consequence, a worker may be classified as an employee for one purpose, and an independent contractor for another.

While different agencies and courts use different (and in some cases, inconsistent\(^3\)) criteria in determining the independent contractor status, the tests distill to a few common themes. First, the more a company controls the manner and means by which a worker accomplishes the product or result, the more likely the worker will be deemed an employee. (Notably, in some instances it may not be necessary that an employer actually exercise the right to control; an employment relationship may exist if the employer merely has the right to control the person performing the work.) Second, the more a worker performs tasks that are part of the company’s core business and is integrated with company employees, the more likely the worker will be an employee. Finally, the label given to the relationship by the parties is not determinative; rather, the nature of the relationship that actually exists will be determinative control.

In this section, we discuss the legal tests used by different reviewing agencies and courts to determine whether a franchisee is truly an independent contractor rather than employee.

A. The "Employee" Criteria in Unemployment Claims Actions

States generally employ one of two standards for determining "employee" status under unemployment compensation statutes, the common law test and the so-called "ABC" test. In

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\(^3\) In other words, a finding of employment status under one statute is not determinative of the worker's status under another statute. See Simonelll v. Adams Bakery Corp., 286 A.D.2d 805, 806, 730 N.Y.S.2d 358 (2001) ("it is settled law that an administrative determination under one statute is not binding on another agency when the same question arises under another statute."); Engel v. Celgon Corp., 114 A.D.2d 108, 111-12, 498 N.Y.S.2d 877 (1986) (the finding of an employment relationship under one law is not given collateral estoppel effect under a different law, because "employment" is an ultimate fact involving a mixed issue of law and fact).
this section, we discuss each test. Further, we discuss several recent developments in Massachusetts, where the independent contractor designation has been recently litigated.

1. The Common Law Test

The first standard is the "common law" test which 24 states and the District of Columbia utilize. The common law standard is based on whether the putative employer has "the right to control" the worker's actions. See e.g., Hertz Corp. v. Comm'r of Labor, 811 N.E.2d 5 (N.Y. 2004) (recognizing common law standard as test governing eligibility for unemployment benefits). Although the common law test varies slightly from state-to-state, its common elements include, among others: (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.

2. The "ABC" Test

The standard utilized by the remaining 26 states is the "ABC" test. 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. Although the "A" part of the ABC Test generally corresponds with the common law test, it imposes the additional burdens of the "B" and "C" components, all of which a challenging party must prove to avoid being held an "employer" under the unemployment statute. 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.]"). Accordingly, the ABC test is generally understood to be more onerous to those claiming exemption from an unemployment statute.

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4 The states that utilize the common law approach are: Alabama, Arizona, California, District of Columbia, 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.

5 The states that utilize the ABC Test or some variant thereof are: Alaska, Arkansas, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho, Illinois, Indiana, Louisiana, Maine, Maryland, Massachusetts, Nebraska, New Hampshire, New Jersey, New Mexico, Oregon, Pennsylvania, South Dakota, Tennessee, Utah, Vermont, Virginia, and West Virginia.
Employment Department v. National Maintenance Contractors of Oregon, Inc. provides a very recent application of the ABC test in the franchise context. In this case the Oregon Court of Appeals had to determine whether National Maintenance Contractors of Oregon ("NMC") correctly classified janitorial staff as franchisees under an independent contract, or whether they were employees. In the franchise agreement, the building owners paid NMC directly; thereafter, NMC deducted royalties, a "management fee" and liability insurance premiums from payments before compensating the janitors directly.

The court developed a two-part test based on the Oregon unemployment statute to determine whether the franchisees were considered to be employees. Oregon state law defines an employee as one who provides "services" for an employer which is performed for "remuneration" under a contract for hire. Thus, there must be proof that (1) services were rendered, (2) for remuneration of work.

First, the court determined that the janitors provided a "service" to NMC. It determined that the legislature intended "services" to be broadly construed as any act for the benefit of another. The franchise agreement indicated that NMC contracted with clients to provide janitorial services; then, the NMC would contract with franchisees to perform janitorial services and therefore meet NMC’s contractual obligations to the clients. The court explained that the legislature intended this type of arrangement to fall within the definition of service. Thus, the NMC janitors were considered to provide a "service" under the first part of the test.

The second element of the test, "remuneration," was also intended to be broadly construed. The Oregon unemployment statute defines remuneration as paying for services, loss or expenses. The administrative law judge in the lower court concluded that though there were services rendered, NMC did not pay janitors remuneration for those services. The clients did not pay the franchisees directly for janitorial services; they paid NMC. Then, NMC deducted fees and paid the franchisees for fulfilling their duties. However, the Oregon court of appeal disagreed. The court took this as a probative element in the second part of the test and concluded that the janitors were "remunerated" for their "services."

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7 Id. at 153.
8 Id. at 155. (citing OR. REV. STAT. § 657.030 (2007)).
9 Id.
10 Id. at 156.
11 Id.
12 Id., n.3.
13 Id. at 157.
14 Id.
Most notably, the decision in *Employment Department* indicates that franchisors should be mindful of the written agreements they have with clients. The court looked at the agreement between NMC and the clients for evidence on whether the franchisees provided services for remuneration. In particular the language of the agreements suggested that, in fact, NMC provided the janitorial services itself rather than the franchisees. For example, one service agreement described NMC as engaging "in the business of furnishing building services, including cleaning services, parking lot maintenance, construction and associated maintenance services." The agreement appears to be tantamount to the traditional master-servant relationship. NMC agreed to provide a service to the clients, and then it paid the franchisees for performing the service on its behalf. To the court, this exemplified that NMC operated as an employer and the janitorial staff were employees that receive "remuneration" for their services.

Yet the court considered the exception to the employee definition. Specifically, the court wanted to determine whether the context of the franchise agreement required it to depart from the traditional definition of employment. The Oregon unemployment statute requires the court to follow the definition provided unless "context requires otherwise." The court eventually decided that, though NMC provided services for remuneration, the administrative law judge should have considered NMC’s argument that their franchisees were exempt from the statutory definition of employee because they met the exclusion provided for independent contractors. The court remanded to the ALJ for a determination of whether that exclusion applied to the facts here. Following the traditional interpretation of franchisor-franchisee relationships, even though a franchisee appears to fall under the broad statutory definition of "employee" per se, the independent contractor status may allow the employer to be exempt from unemployment insurance taxation.

3. **The Massachusetts Trilogy**

Within the last seven years, Massachusetts’ appellate courts have on three occasions addressed whether persons working in particular occupations qualified as independent contractors under the Massachusetts’ unemployment statute. *See Coverall, 447 Mass. at 852; Athol Daily News v. Bd. of Review of Employment & Training, 439 Mass. 171 (2003); Boston*

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16 *Id.*

16 *Id.* at 158.

17 *See Id.*

18 *Id.* at 160. The Oregon Revised Statutes defines an independent contractor, among other things, as one who “[i]s free from direction and control over the means and manner of providing the services, subject only to the right of the person from whom the services are provided to specify the desired results.” *See OR. REV. STAT. § 670.600(2)(a) (2007).*

19 The NMC court, however, seemed to suggest in dicta that it is possible to be both an employee and a franchisee. The court briefly discussed the Oregon statute governing the sale of franchises but finding that statute did not "provide any guidance concerning the nature of the ongoing relationship between franchisor and franchisee that results *after* the sale of the franchise. Nor are we aware of any other relevant Oregon statutes that ... inform the question whether a franchise relationship and an employment relationship are necessarily mutually exclusive." *Id.* at 159.
Bicycle Couriers, Inc. v. Deputy Dir. of Employment & Training, 56 Mass. App. Ct. 473 (2002). Given Massachusetts' policy of liberally construing its unemployment statute in favor of affording coverage (an approach that is common among states addressing these issues), these cases provide a conservative road map for franchisors as to how plaintiffs in other jurisdictions may contend that they are employees rather than franchisees. If a franchisor wants to react to these cases, they may suggest some ways to structure a franchise to differentiate its system from the defendants' businesses' in these cases.


In *Boston Bicycle Couriers, Inc. v. Deputy Dir. of the Div. of Employment & Training* [hereinafter *Boston Bicycle*], the Massachusetts Appeals Court addressed whether on-call package messengers were covered by the unemployment statute. 55 Mass. App. Ct. at 473. Under Boston Bicycle Couriers' ("BBC") business model, customers would call BBC for service, which in turn would radio jobs to messengers who performed the actual package deliveries. *Id.* at 476. The case arose when a messenger who provided services for BBC was terminated and then applied for unemployment benefits. BBC claimed that each messenger was an independent delivery contractor with whom it contracted for individual package deliveries. In determining that the messengers were "employees" and therefore entitled to benefits, the Appeals Court accepted the following facts based on the administrative record20 below:

- BBC and claimant/messenger were parties to a written agreement specifying that the messengers were independent contractors.
- BBC utilized the services of approximately 12 messengers to deliver packages.
- Claimant/messenger was unable to operate a delivery business without the benefit of his relationship with BBC.
- Claimant/messenger did not have his own clientele.
- Claimant/messenger did not use own business cards or invoice customers.
- Claimant/messenger did not advertise his services, or maintain a separate place of business or telephone listing.
- Claimant/messenger had no proprietary interest in a going concern that could be sold or transferred.
- BBC provided claimant/messenger, pursuant to a rental agreement, with all equipment essential for the on-call delivery business.
- BBC paid for workers' compensation insurance for claimant/messenger.
- The services claimant/messenger provided were an integral part of BBC's business.

The Appeals Court applied Massachusetts' ABC test, which it noted "ha[d] not been the subject of [] substantive review and analysis in Massachusetts[]." *Id.* at 474 n.3. As a result, the *Boston Bicycle* Court cited extensively to decisions in other jurisdictions applying the ABC

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20 Most of these cases are heard initially at administrative hearings where participants are often not represented by counsel, or counsel performs perfunctorily at best. The record that is created at the administrative hearing is usually the record that the parties are bound by, and that is reviewed by appellate courts. More meaningful participation by franchisor counsel at the administrative hearings that formed the appellate record may improve the opportunity to influence the case outcome by creating a better record.
test. While noting that the party claiming independent contractor status bears the burden of proof on all three prongs, the court dealt exclusively with part “C” which requires a finding that “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.” Supra, at 8; Mass. Ann. Laws ch.151A, §2(c) (2009). 151A, § 2(c). Summarized below are the specific facts the Boston Bicycle Court relied upon in applying part “C” of the test to conclude that the messenger was an employee, with corresponding suggested adjustments which a hypothetical franchisor may consider as modifications to its system in an effort to avoid the same outcome.

<table>
<thead>
<tr>
<th>Fact Supporting “Employee” Status for Messenger</th>
<th>Potential Hypothetical Franchise System Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Messenger was in the same business as employer, i.e., on-call delivery of packages</td>
<td>Define franchisor’s business to create room for franchisee to operate separate business lines; define franchisor’s business as “franchising others to operate businesses using franchisor’s proprietary marks and system”</td>
</tr>
<tr>
<td>Messenger had no business cards or invoices.</td>
<td>Franchisees may have own business cards and invoices.</td>
</tr>
<tr>
<td>Messenger did no independent advertising.</td>
<td>Encourage franchisee promotion and advertising.</td>
</tr>
<tr>
<td>“Employer” set prices.</td>
<td>Involve franchisee in setting prices for services.</td>
</tr>
<tr>
<td>“Employer” guarded customer lists by non-solicitation and non-competition agreements.</td>
<td>Narrow/eliminate non-solicitation and non-competition agreements.</td>
</tr>
<tr>
<td>“Employer” had the right to discharge messenger for any reason upon 30-days notice.</td>
<td>Further limit the terms upon which franchisor can terminate franchise agreements – perhaps have a “business” buy-back option instead of termination.</td>
</tr>
</tbody>
</table>


Just five months after the Boston Bicycle decision, Massachusetts' highest court, the Massachusetts Supreme Judicial Court (“SJC”) appeared to relax the stringent standards articulated by the Appeals Court in Boston Bicycle and to adopt a more expansive definition of independent contractor in Athol Daily News, 439 Mass. 171. In Athol Daily News, the SJC determined that adult newspaper carriers, who bore many similarities to the messengers in Boston Bicycle, were not covered by the unemployment statute because they were true independent contractors. Athol Daily News, 439 Mass. at 172. In reaching this determination, the SJC reviewed all three prongs of the ABC test and relied upon the following factual determinations:
Carriers entered into an independent contractor agreement that specified newspapers must be delivered, in good condition, no later than 4:30 p.m. on weekdays and 8:30 a.m. on Saturday.

- Carriers received customer names from the newspaper and agreed not to give away or sell the customer list.
- Carriers could increase the number of subscribers on their route without permission, so long as they kept a current list of all customers and provided it to the newspaper.
- Carriers were free to engage in delivery services for companies other than the newspaper, including other newspapers.
- Although each carrier was permitted to establish his or her own price for the newspapers, most, if not all, used the price suggested by the newspaper.
- The majority of customers paid the newspaper directly, which then distributed proceeds to the carriers.
- Customers directed complaints to either the carrier or the newspaper.

The SJC began its analysis with part “A” of the test, which it equated with the common law master-servant test. *Id.* at 177. Because the carriers enjoyed complete discretion as to how they delivered papers, so long as papers were delivered by a certain time and in “good condition,” the court held that the newspaper satisfied this first prong.\(^{21}\) *Id.* at 178 ("[O]nce carriers receive their newspapers from the News, they are entirely free from its supervision in performing the services for which they were engaged."). The court also specifically rejected as determinative for the “A” prong that: (1) the newspaper set the suggested retail price; (2) subscribers could complain directly to the newspaper, and (3) the newspaper could terminate its relationship with a carrier at any time. *Id.*

Turning to the “B” prong (whether the worker’s 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), the court first recognized that a putative employer could satisfy the requirement by showing that “the services are performed outside of the usual course of business of the enterprise or [] the services are performed outside of all the places of business of the enterprise.” *Id.* (emphasis added). Relying on the second half of this test, the court held that the newspaper satisfied the “B” prong because newspapers were delivered outside of the newspaper’s place of business. *Id.* at 179. The court also rejected the argument that the newspaper’s place of business included the geographic areas covered by the delivery routes. *Id.* at 179 n.11.

Finally, the court addressed the “C” prong (whether the worker is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed), upon which the *Boston Bicycle Court* based its decision. First, the *Athol Daily News* Court rejected as “too stringent” the contention, adopted by the

\(^{21}\) Also significant to the court was the fact that the carriers could perform other services, not related to delivery of newspapers, for their customers and charge separately for such services. The carriers’ “capability” of having a separate business relationship with customers tended to prove that newspaper had no “right to control” the carriers. *Id.* at 178.
intermediate appeals court that the Newspaper must prove the carriers had, in fact, an enterprise capable of operating without the benefit of their relationship with the Newspaper. *Id.* at 179-80.

"The better approach to the evaluation required by part (c) is to consider whether the service in question could be viewed as an independent trade or business because the worker is capable of performing the service to 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."

*Id.* at 181 (emphasis added) (this is the so-called "capability" test that the court rejected three years later in *Coverall*). The court distinguished *Boston Bicycle* on the basis that "[t]here, the plaintiff's business consisted entirely of the pick up and delivery of letters and packages on an on-call basis." *Id.* In the case of the carriers, however, "the business of delivering newspapers is not limited to a single employer, and nothing with respect to the carriers' job performance . . . is unique to one certain newspaper publisher." *Id.* at 181-82. The newspaper had, therefore, satisfied the "C" prong. Based on the above analysis, the following facts supported the court's conclusion that each carrier was an independent contractor, and lead to the following possible adjustments to a hypothetical franchisor's system:

<table>
<thead>
<tr>
<th>Fact Supporting &quot;Independent Contractor&quot; Status</th>
<th>Potential Hypothetical Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carriers permitted to perform additional services for customers and charge for such services.</td>
<td>Franchisee may perform additional services for franchise customers, that would not be subject to franchisor contract rights.</td>
</tr>
<tr>
<td>Activities that carriers performed did not exactly match with business of newspaper.</td>
<td>Define primary business as &quot;franchising&quot;.</td>
</tr>
<tr>
<td>Carriers had complete discretion as to how to deliver newspapers, and were free from supervision.</td>
<td>Subject to needs of customers, give franchisee latitude to determine methods and hours necessary to render service and reduce franchisor oversight and complaint procedure.</td>
</tr>
<tr>
<td>Business of delivering newspapers was not limited to a single newspaper.</td>
<td>Allow franchisees to perform services for customers outside the franchise system.</td>
</tr>
</tbody>
</table>


Just three years after the *Athol Daily News* decision, the SJC again addressed the employee/independent contractor distinction in *Coverall*. *447 Mass.* at 852. This time, however, the SJC retreated from its analysis in *Athol Daily News* and again moved closer to the stringent standard adopted in *Boston Bicycle*. At issue in *Coverall* was the status of a particular
franchisee and her entitlement to unemployment benefits following “termination.” Based on the administrative record developed below, the Coverall Court noted the following facts about the claimant:

- Claimant first performed cleaning work at a nursing home (“Sunrise”) as an employee of another franchisee.
- Following the original franchisee’s loss of the Sunrise account, claimant purchased a franchise to allow her to continue cleaning at Sunrise.
- Sunrise was claimant’s only account. She was assigned to work there Monday through Friday, five hours per day.
- Franchisor negotiated the terms of the cleaning contract with Sunrise, including the value of the contract, and billed Sunrise directly for claimant’s services without claimant’s involvement.
- All Sunrise complaints concerning claimant’s performance were channeled through franchisor and resolved by a franchisor’s field consultant.
- Claimant had no business cards or clientele separate from franchisor.
- Claimant was required to check in and out of work each day with a Sunrise employee who closely supervised her activities.
- Claimant had to work in excess of 25 hours per week to perform the tasks assigned to her.
- Claimant completed “special projects” for Sunrise at franchisor’s insistence without receiving promised additional compensation.
- When claimant refused to continue working beyond the agreed-upon 25 hours per week, franchisor “discharged” her.

The SJC again applied Massachusetts’ ABC test. As in Boston Bicycle, the SJC limited its analysis in Coverall exclusively to the “C” part of the test, which requires that the putative employer establish that 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.” Id. at 856 n.6; Mass. Ann. Laws ch. 151A, § 2(c). While Coverall argued that the court should look to the “capability” of the franchisee to have an independent business, the court instead focused on what, in fact, the franchisee did or did not do. Summarized below are the specific facts the Coverall Court relied upon in applying part “C” of the test and suggestions how other franchisors may modify their system to help avoid franchisees being classified as “employees.”

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22 Perhaps recognizing the potential implications of holding that a franchisee was an employee under the Act, the Coverall Court specifically limited its decision to the facts before it. 447 Mass. at 854 n.4 (holding that this decision “do[es] not reflect a determination concerning the nature of other Coverall contracts beyond the contract at issue in this case.

23 We have adopted the Coverall Court’s use of the term “claimant” instead of “franchisee.” 447 Mass. at 853 n.2 (“Typically, we would refer to the claimant as a franchisee; however, because we conclude that this individual is not a franchisee, we refer to her as the claimant.”).
<table>
<thead>
<tr>
<th>Fact Supporting “Employee” Status</th>
<th>Potential Hypothetical Franchise System Adjustments</th>
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<tbody>
<tr>
<td>Franchisee had no contractual relationship with customer.</td>
<td>Make franchisee a party to customer contract.</td>
</tr>
<tr>
<td>Franchisee required to allow Coverall to negotiate contracts and pricing with customers.</td>
<td>Allow franchisee to play a role in determining customer pricing.</td>
</tr>
<tr>
<td>Coverall provided daily cleaning plan which franchisee was required to follow.</td>
<td>Allow franchisee to determine methods and hours necessary for achieving contract compliance.</td>
</tr>
<tr>
<td>Franchisee’s business “ended” once Coverall “discharged” her.</td>
<td>Allow franchisee to perform additional services for customers, such as watering plants,</td>
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<td>recycling or selling supplies that would be independent of franchisor and potentially</td>
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<td>survive franchise termination.</td>
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B. Franchisee Reclassification Issues under Federal Law

1. Actions Under Employment Laws by Franchisee / Dealer, Franchisee Employees, and EEOC

Some franchisors who fit within the small investment range may increasingly be the target of plaintiffs' employment lawyers. These lawyers have attempted to set aside the franchisor-franchisee structure and replace it, through litigation on either a class action or individual basis, with an employer-employee structure.

The primary impediment to these types of employment actions is that the franchisor-franchisee relationship has generally not been considered an employment relationship governed by Title VII and other employment discrimination statutes.\(^ {24} \) Though filing suit under Title VII may be more attractive to some plaintiffs, as it protects against discrimination based on a broad spectrum of classes including color, religion, sex and national origin in addition to race, it will not likely be available to parties in a franchise agreement as they are not engaged in a traditional

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\(^ {24} \) 42 U.S.C. § 2000e. See e.g., Adcock v. Chrysler Corp., 166 F.3d 1290, 1294 (9th Cir. 1999), holding that because Chrysler did not control day-to-day operations of dealership, dealer would not be considered employee for sex discrimination claim); Mengram v. General Motors Corp., 108 F.3d 61, 63 (4th Cir. 1997) (holding that General Motors dealers are not employees of General Motors and that the plaintiff, at best, demonstrated that as a participant in General Motors' Minority Dealership Development Program he was a trainee for a non-employment relationship with General Motors for purposes of age discrimination claim). Although it is beyond the scope of this Article to discuss the circumstances under which a franchisor may be held vicariously liable for discrimination claims brought against franchisees, please see Claudia K. Levitas & Mercedes Gonzales Hale, Vicarious Liability for Gender Discrimination & Sexual Harassment, 26 Franchise L.J. 71 (Fall 2006), for an analysis of these issues.
employment relationship. In order for the protections of Title VII and other employment laws to apply there must be a finding of an employer-employee relationship. Franchisor-franchisee relationships are ordinarily deemed to be outside the scope of the employer-employee relationship, however, the true scope of the relationship under a franchise agreement can only really be determined by considering each statute that may be applied to it. A franchisor cannot rely merely on contract language in feeling assured that his independent contractors or franchisees will be treated as such by the EEOC and other employment agencies. In the franchise context, the statutory definitions of employee and employer, and the tests developed by the courts to make sense of those definitions, emphasize the realities of the relationship between franchisee and franchisor in determining whether they actually have an employment relationship covered by applicable laws.

a. Statutory Definitions of Employee Under Title VII, ADA, ADEA, FMLA and State Employment Laws

For franchisors attempting to gauge their potential for liability under the various state and federal employment laws the statutory definition of employee offer little in the way of insight into the dividing line between an employee and an independent contractor. Federal employment law under Title VII, the ADA, ADEA, and FMLA all use similar definitions and all are similarly unhelpful. They each use language which circularly defines an employee as “an individual employed by an employer,” without going so far as to explain the extent of the relationship necessary or even what “employment” means. Further, each law can affect workers differently. For example, a state unemployment law must necessarily include within the definition of employee former employees, whereas the same term under ADEA may not be interpreted to include the same groups of workers.

While the federal employment laws are unhelpful on their face in determining who is an “employee,” some state employment laws offer definitions of “employee” that contain substantially more guidance on exactly which workers the term refers to. These statutes often incorporate common law definitions based on a master servant relationship or a “control test.” While these statutes initially use the same circular definition of an employee as “an individual employed by an employer,” they then further refine that definition by adding that the

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27 In Robinson v. Shell Oil Co. the Supreme Court overruled a 4th Circuit determination that Title VII protections applied only to current employees finding that an employers actions after termination may still lead to violations of Title VII protections. 519 U.S. 337, (1997).

employment must be such that the relationship of master and servant exists between them or by
specifically excluding independent contractors and others from the definition of "employee." 29
For example, Arizona's unemployment statute defines an employee as "any individual who
performs services for an employing unit and who is subject to the direction, rule or control of the
employing unit as to both the method of performing or executing the services and the result to
be effected or accomplished" and further goes on to exclude certain groups, including
independent contractors. 30 A number of states, however, contain nc definition of "employee"
whatever. 31

b. Tests used to define employee in the context of
discrimination claims

Within the franchise relationship, the lack of a clear delineation of who is subject to these
employment statutes has led to a fair bit of litigation turning on the meaning of "employee" within
the appropriate statute. These cases have split into two main groups: (1) those involving a suit
brought by a third party attempting to impute the acts of the franchisee's employees to the
franchisor and (2) actions by the franchisee itself, against the franchisor, alleging discrimination
by an employer (the franchisor) against an employee (the franchisee). These suits generally
involve an attempt to show that while there is purportedly only a franchise agreement binding
the two parties, the franchisor enjoys many of the same powers as a traditional employer and
should therefore be treated as such under the employment laws.

When the Supreme Court has considered the definition of "employee" under an
employment law such as the ADA, FMLA, or Title VII they have looked ultimately to the common
law in order to determine exactly which features define the employer-employee relationship. In
doing so, the Court has returned again and again to its description of the common law test for
agency initially described in Community for Creative Non Violence v. Reid. For example, in
Nationwide Mutual Ins. v. Darden, the Supreme Court reiterated that "when Congress has used
the term 'employee' without defining it, [the Court has] concluded that Congress intended to
describe the conventional master-servant relationship as understood by common-law agency
doktrine." 32 The primary inquiry in determining the extent of the employment relationship under
common law agency is whether the hiring party controls the "manner and means" through which
the work is done, an inquiry often termed a "control test." 33 In delineating the "control test" the
Court has also described a non-exhaustive list of factors to be considered, including: "[1] the
skill required; [2] the source of the instrumentalities and tools; [3] the location of the work; [4] the
duration of the relationship between the parties; [5] whether the hiring party has the right to
assign additional projects to the hired party; [6] the extent of the hired party's discretion over
when and how long to work; [7] the method of payment; [8] the hired party's role in hiring and
paying assistants; [9] whether the work is part of the regular business of the hiring party;

31 Fla. Stat. Ann. § 443.036 (2009);
33 Reid, 490 U.S. at 751-52.
[10] whether the hiring party is in business; [11] the provision of employee benefits; and [12] the
tax treatment of the hired party." These factors, as expressed in Darden, characterize the
common law inquiry practiced by many courts and have been applied in interpreting the
definition of employee under a number of different employment laws.

Courts have also used various other common law tests of agency to determine the exact
bounds of the statutory employer-employee relationship. Often invoked when the status of a
purported employer such as a franchisor is at issue, these tests focus on the degree of
integration between the affairs of the two entities and determine when a franchisor can be
considered the employer of an employee of its franchisee. The two main tests are whether the
franchisor is an integrated entity with its franchisee and, alternatively, whether the two can be
considered a joint employer; two findings that can impute the status of the franchisee's workers
to the franchisor.

The prevailing trend in considering an integrated enterprise claim is to use the standards
issued by the NLRB to decide whether the two entities should be determined to be a single or
joint employer. The level of integration needed has been deemed to require the two entities to
be "highly integrated with respect to ownership and operations." In considering whether this
high level of integration exists, four factors are to be considered: "(1) interrelation of operations,
(2) centralized control of labor relations, (3) common management, and (4) common ownership
or financial control." Courts adopting this test have generally emphasized that the broad
remedial purpose of Title VII should be given effect to the employer-employee provisions by
interpreting them broadly.

A second, though related, test looks to whether the two entities can be considered a joint
employer. Under this theory joint employment exists when "one employer[,] while contracting in
good faith with an otherwise independent company, has retained for itself sufficient control of
the terms and conditions of employment of the employees who are employed by the other
employer." (Virgo v. Riviera Beach Assocs., Ltd., 30 F.3d 1350, 1360 (11th Cir. 1994) (quoting

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34 Darden, 503 U.S. at 323-24.

35 See Weary v. Cochran, 377 F.3d 522 (6th Cir. 2004) (applying Darden test in ADEA discrimination context);
Dresscher v. Shatkin, 280 F.3d 201, (2d Cir. 2002) (applying Darden test in Title VII context).

36 Supra, at 24-25.

37 McKenzie v. Davenport-Harris Funeral Home, 834 F.2d 930, 933 (11th Cir. 1987). See also E.E.O.C. v. Wooster
Brush Co. Employees Relief Ass'n, 727 F.2d 566, 572 (6th Cir.1984); Childs v. Local 18, Int'l Bhd. of Elec. Workers,
719 F.2d 1379, 1382 (9th Cir.1983); Trevino, 701 F.2d at 397, 404 n.9 (5th Cir 1983); Mas Marques v. Digital Equip.
Corp., 637 F.2d 24, 27 (1st Cir.1980); Baker v. Stuart Broad. Co., 550 F.2d at 389, 392 (8th Cir. 1977); Fike v. Gold

38 Fike, 514 F. Supp. at 726.

39 McKenzie, 834 F.2d at 933 (citing Radio and Television Broadcast Technicians Local 1264 v. Broadcast Serv. Of
Mobile, Inc., 380 U.S. 255, 256 (1965), for the creation of the four factor NLRB integrated enterprise test). See also
Evans v. McDonald's Corp., 936 F.2d 1087, 1089-90 (10th Cir. 1991) (determining whether restaurant franchisor was
employer of franchisee's employee under Title VII).

40 Matthews v. Int'l House of Pancakes, Inc., 597 F. Supp. 2d 663, 671 (E.D. La. 2009);
NLRB v. Browning-Ferris Indus., 691 F.2d 1117, 1122 (3d Cir. 1982). Language contained in a franchise agreement purporting to create a relationship other than employer-employee will not be dispositive in determining “joint employer” liability. EEOC v. Papin Enterprises., No. 6:07-CV-1548-Orl-28GJK, 2009 WL 961108, at *8-*9 (M.D. Fla. Apr. 7, 2009). The level of control necessary to implicate joint employer liability is a factual issue to be determined at trial. Virgo, 30 F.3d at 1360.


Recently, in E.E.O.C. v. Papin Enter., Inc., a Florida District Court reviewed two theories of agency other than the “control test” applied in Darden. Papin involved a Subway employee filing a charge of discrimination against Papin Enterprises, a Subway owner and franchisee, as well as DAI, the Subway franchisor, for employment discrimination under Title VII. Ms. Santiago, the employee, was fired after refusing to remove a nose ring, which she claimed to wear on religious grounds. Id. at 7. EEOC’s suit against DAI proceeded on two theories of imputed liability: (1) that DAI and Papin were a single employer/integrated enterprise, and/or (2) that they acted as a joint employer as to Ms. Santiago.

In order for the court to find that two entities are an integrated enterprise they must be “highly integrated with respect to ownership and operations.” Courts inquiring into the degree of integration of two enterprises employ four factors that look to the “(1) interrelation of operations, (2) centralized control of labor relations, (3) common management, and (4) common ownership or financial control.” The Papin court found the EEOC’s claim regarding the integrated enterprise lacking because the agency failed to make any factual showing that there was an interrelation of operations, centralized control of labor decisions, or common control between the two entities.

The EEOC’s joint employer claim fared significantly better. A joint employer claim “recognizes that the business entities involved are in fact separate but that they share or co-determine those matters governing the essential terms and conditions of employment.” DAI argued that it could not be found to be a joint employer because its status as a franchisor, as determined in the franchise agreement, would typically preclude such a finding. The court found DAI’s reliance on the language of the contract unavailing, as the correct inquiry was a factual one looking to the amount of control exercised by DAI over the employment practice at

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42 Id. at *1-*2.


44 McKenzie, 834 F.2d at 933 (11th Cir. 1987).


46 Virgo v. Riviera Beach Assocs., Ltd., 30 F.3d 1350, 1360 (quoting NLRB v. Browning-Ferris Indus., 691 F.2d 1117, 1122 (3d Cir. 1982).

issue. In this instance, DAI held ultimate control over the waiver of the no-facial-jewelry policy if the problem could not be resolved at the franchise level, a policy which created factual issues to be considered at trial.

A similar issue was considered in Matthews v. International House of Pancakes, Inc., when former employees of an IHOP franchisee sued both the franchisee and IHOP, as franchisor, under Title VII. The Third Circuit, noting that few courts had recognized the ability to sue a franchisor under Title VII, noted that where the cause of action had been recognized, the franchisor generally required the franchisee to adopt specific employment policies or "to hire, train, and supervise employees in accordance with extensive guidelines and reserves the right to impose discipline upon employees engaging in discriminatory acts." After reviewing the evidence presented the court held that because the plaintiff had not refuted evidence that IHOP had never shared employees, hiring responsibility, control of scheduling logistics or responsibility for payment of the employee’s their claim under Title VII failed to raise a genuine issue of material fact regarding whether IHOP was in fact their employer. The plaintiffs also attempted to argue that IHOP and its franchisee were an integrated enterprise, however, the failure to counter the aforementioned evidence of non-integration was fatal to this claim as well.

d. Disappointed franchise applicants bringing claims of discrimination

While former and current workers under a franchise agreement may have a broader recourse to employment laws than it seems at first blush, disappointed franchisee applicants will not likely have much success in the use of employment laws outside of § 1981. A prospective franchisee is unlikely to be able to prove that an employer-employee relationship existed during initial negotiations or pre-contractual training. This situation was evidenced in the recent ADA case of Beuff Enterprises Florida, Inc., v. Villa Pizza, LLC, Civil Action No. 07-2159 (PGS), 2008 WL 2565008 (D.N.J. June 25, 2008) involving a franchisee allegedly dismissed from the franchisor’s training course for medical reasons. The disputed action that took place during the period before plaintiff’s franchise was ultimately awarded. The court noted that, under the ADA, employment discrimination liability could only be imposed upon employers but not other contractual relationships such as franchisor-franchisee relationships. The court found that the relationship existed between the two entities was contractual, even though the disputed conduct took place prior to awarding the franchise. The court rejected plaintiff's invitation to apply the common law and IRS factors for determining whether an employment relationship existed, as "not helpful to an analysis dealing with an antidiscrimination statute such as the ADA." In

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48 Id.
50 Id. at 670. (citing Freeman v. Suddle Enters., Inc., 179 F. Supp. 2d 1351, 1356 (M.D. Ala. 2001); Miller v. D.F. Zee's, Inc., 31 F. Supp. 2d 792, 808-07 (D. Or. 1998)).
51 Matthews, 597 F. Supp. 2d at 670.
52 2008 WL 2565008, at *2.
53 Id. at *8.
reaching its conclusion that defendant was not plaintiff's employer, the court focused instead upon the contractual nature of the relationship, including the franchise agreement itself, which specifically stated that the franchisee was an independent contractor, not employee. Ultimately, the court ruled that there was no authority that in a true franchise relationship the franchisor could be held to be the employer of the franchisee under the ADA.\(^5^4\)

2. **Defining "Employee" Under the Fair Labor Standards Act**

In contrast to most federal statutes, the Fair Labor Standards Act (FLSA) has a specific and more expansive definition of the term "employ." The Supreme Court has found that the statute stretches the meaning of "employee" to cover some parties who might not qualify as such under a strict application of traditional agency law principles. See *Nationwide Mut. Ins. v. Darden*, 503 U.S. 318, 322-25 (1992). The essential inquiry is an "economic realities" test, which courts use to determine whether the workers are economically dependent upon the alleged employer. See *Bartels v. Birmingham*, 332 U.S. 126, 130 (1947). The analysis includes the following factors: (1) the degree of control exercised by the employer over the workers; (2) the workers' opportunity for profit or loss and their investment in the business; (3) the degree of skill and independent initiative required to perform the work; (4) the permanence or duration of the working relationship; and (5) the extent to which the work is an integral part of the employer's business. See *United States v. Silk*, 331 U.S. 704, 716 (1947); *Rutherford Food Corp. v. McComb*, 331 U.S. 722, 730 (1947).

Several cases have applied the FLSA's economic realities test to real estate brokers, agents or salespeople. Those cases that have been decided are not favorable to supporting independent contractor status. See *Esquivel v. Hillicore Props., Inc.*, 484 F. Supp. 2d 582, 584 (W.D. Tex. 2007) (denying real estate firm's motion to dismiss FLSA claims brought by two former real estate agents, rejecting firm's argument that the agents' should be found exempt under the FLSA based on their exempt status under the Internal Revenue Code and the Texas Unemployment Act); *Luther v. Z. Wilson, Inc.*, 528 F. Supp. 1166 (S.D. Ohio 1981) (holding that a real estate office manager and sales agent was an employee for purposes of the FLSA).

As described in 29 C.F.R. § 541.700(a), an employee's "primary duty" must be the performance of exempt work. The term "primary duty" means the principal, main, major or most important duty that the employee performs. The regulations governing the outside sales exemption provide, in part: "work performed incidental to and in conjunction with the employee's own outside sales or solicitations, including incidental deliveries and collections, shall be regarded as exempt outside sales work. Other work that furthers the employee's sales efforts also shall be regarded as exempt work including, for example, writing sales reports, updating or revising the employee's sales or display catalogue, planning itineraries and attending sales conferences." 29 C.F.R. § 541.500(b).

The Wage and Hour Division has specifically recognized certain incidental activities that real estate sales employees may perform at the employer's place of business in conjunction with outside sales work without losing the outside sales exemption.\(^5^6\) As long as the employee's activities are incidental to the outside sales work, this should be regarded as exempt work.

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\(^5^4\) *Id.* at *9.

\(^5^6\) These activities include: (1) bringing a multiple listing book up to date; (2) calling prospects with whom the sales employee has been dealing during outside sales activities; (3) dictating or writing letters to such prospects; (4) talking
3. Other Potential Classification Issues Under Federal Law

a. The IRS "Right to Control" Rule

Franchisors may also face issues as to the classification of franchisees for purposes of payment of federal unemployment taxes (FUTA), social security taxes (FICA), and withholding of federal income taxes. The IRS generally uses the common law "right to control" test to distinguish between employees and independent contractors. In other words, the greater behavioral and financial control a company has over a worker, the more likely he or she is to be an employee and not an independent contractor. The IRS has identified twenty factors that may be considered in determining whether a company has the right to control a worker (sufficient to establish an employer/employee relationship). These factors are as follows:

1. **Instructions.** When the company has the right to direct when, where and how the work is to be performed, this indicates employee status. Significantly, even if the right is not exercised, simply having the right to control indicates employee status.

2. **Training.** When the worker is required to develop skills as a result of meetings or instructions furnished by the company, this indicates employee status. Requiring, for example, attendance at training sessions or that a more experienced worker train the worker usually indicates employee status.

3. **Integration.** When the worker performs services which are integral to the company's business, such that the success or failure of the business depends on the worker's performance, this indicates employee status.

4. **Services Personally Rendered.** If the worker must personally render the services, this indicates employee status. If, on the other hand, workers are permitted to delegate the task to other workers, this indicates independent contractor status.

5. **Hiring, Supervising and Paying Assistants.** Independent contractor status is indicated where the worker is responsible for the results only, and provides his or her own materials and labor and has the right to hire, supervise and pay assistants.

6. **Continuity of Relationship.** The longer a relationship continues between the worker and the company, the more likely the worker is an employee. Independent contractor status is indicated where the worker performs infrequently and at irregular intervals.

7. **Hours of Work.** The more formal and rigid a worker's hours, the more likely the worker is an employee. Where the worker is expected, or required to work a set schedule, this indicates employee status. Independent contractor status is indicated where the worker is free to work when he or she chooses.

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to such prospects in the office about their particular transactions; (6) calling a list of prospective buyers or sellers of homes with whom the sales employee has had no prior contact; (6) preparing a contract and other forms required for a sale negotiated during the sales employee's outside sales activity; and (7) talking to a "walk-in" prospect with whom the employee has had no prior contact and showing photographs and discussing terms on specific houses, if such activity results in subsequent outside sales activity with the prospect. See Field Operations Handbook (FOH) § 22e06(e). See also Wage and Hour Division Opinion Letters, FLSA 2007-2 and 2006-11.
8. **Percentage of Time Required.** When the worker must devote substantially full-time to the work for the company, this indicates employee status. This is especially true if the commitment is ongoing. However, it is possible to work full-time for some period and still be an independent contractor. Often, even independent contractors will dedicate a full-time effort to one employer in order to finish a job.

9. **Location of Performance.** When a company can designate the place where work is to be done and the company has control over that environment, this indicates employee status.

10. **Sequence of Work.** Where the worker must follow the order of sequence set by the company for the work to be performed (and the type of work does not naturally dictate an order of sequence), this indicates employee status. Independent contractor status, on the other hand, is indicated where only the final result is dictated.

11. **Oral or Written Reports.** The more often and formally a worker reports to an employer, the more likely it is that the worker is an employee. A requirement that a worker submit regular, written reports indicates employee status.

12. **Means of Determining Compensation.** When compensation is paid based on time worked, rather than by the job or on a straight commission, this indicates employee status. Payment by the hour is, for example, a strong indicator of employee status.

13. **Business and Traveling Expenses.** When a company controls expenses through payment or reimbursement, this indicates employee status.

14. **Tools and Materials.** The more tools and materials supplied by the company, the more likely the worker is an employee. Independent contractor status is indicated when the worker provides the tools and materials. This factor is of particular relevance where the use of expensive tools is critical. On the other hand, the factor is often inapplicable to most office type settings.

15. **Investment in Facilities.** Independent contractor status is indicated when the worker invests in his/her own facilities such as offices or equipment rented at fair value. Where the company provides the facilities (i.e., office, copy machine, telephone, fax, etc.), this indicates employee status.

16. **Entrepreneurial Risk.** Independent contractor status is indicated if the worker can realize a profit or loss from performing the services. This typically occurs where the worker is not paid by the hour.

17. **Number of Organizations Worked for Concurrently.** Independent contractor status is indicated if the worker concurrently performs services for multiple unrelated persons.

18. **Availability of Services to General Public.** Independent contractor status is indicated where the worker makes his or her services available to the general public on a regular basis. Advertising the worker's availability through trade journals, yellow page ads, business cards or other methods is extremely helpful in demonstrating independent contractor status.

19. **Right to Discharge.** Where the company has the right to threaten dismissal, particularly where contractual terms are being satisfied by the worker, this indicates employee status. Thus, if a worker can be discharged "at-will," this is strong evidence of employee status.
20. **Right to Terminate.** Where the worker has the right to end the relationship at any time without incurring liability, this indicates employee status. If, however, the company would have a cause of action against the worker (i.e., for breach of contract), this indicates independent contractor status.\(^{56}\)

As with the other tests based upon the common law "right to control" test, the totality of the working relationship must be considered and each factor must be analyzed independently in making the employee-independent contractor determination.\(^{57}\)

b. **Employee Retirement Income Security Act**

Franchisors may also face issues under the Employee Retirement Income Security Act of 1974 ("ERISA"), which provides special protections and special rights to "employees" who participate in certain company sponsored benefit plans. A threshold issue under ERISA is whether an individual qualifies as an "employee" and therefore can avail himself of ERISA's protections.

In 1992, the Supreme Court adopted the common-law test for determining whether a worker qualifies as an "employee" for purposes of ERISA. *Nationwide Mutual Ins. Co. v. Darden*, 503 U.S. 318 (1992). There have been a number of cases in which contract workers, leased employees and similarly situated workers argued that they should receive benefits under company sponsored benefit plans.

**The Microsoft Case:** In the early 1980s, Microsoft hired numerous temporary workers to work on specific projects. Microsoft treated the workers as independent contractors who had no right to receive Microsoft sponsored employee benefits. The workers signed "Independent Contractor Agreements" which memorialized the work relationship. In 1989-90, the IRS audited Microsoft and determined that these workers were "employees" for employment tax purposes. Microsoft agreed, paid the applicable Social Security taxes, and rearranged their relationship with the project employees.

This case arose when the former project workers claimed that, as employees, they should have been allowed to participate in Microsoft's 401(k) and stock purchase plans. The plan administrator denied benefits on the grounds that the workers were independent contractors and, in any event, had waived all benefits by signing the employment agreements. The administrator did not consider the 401(k) plan's terms, which stated that coverage was provided only for persons "on the United States payroll." This provision was key because the workers were never paid through payroll, but through accounts payable.

The Ninth Circuit concluded that terms of the independent contractor agreements carried no weight because the agreements' underlying premise that they established an independent

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contractor relationship was erroneous. *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006 (9th Cir. 1997). Thus, the terms of the agreements, which expressly recognized that the workers were not entitled to Microsoft benefits, were disregarded. The court refused to decide whether the workers were entitled to participate in the 401(k) plan. It decided that the plan administrator must first decide whether these workers were "on the United States payroll" as required by the plan document and that the court's role was not to determine the issue in the first instance but only to review the administrator's decision. The court also held that the workers should have been allowed to participate in Microsoft's employee stock purchase plan.

ERISA does not prohibit an employer from providing benefits to certain groups or categories of employees and not to others under its plan documents. In the wake of *Vizcaino*, many companies have revised their plan documents in an effort to avoid liability. However, workers classified as independent contractors continue to bring lawsuits under ERISA seeking the right to participate in various benefits plans.68

C. Additional Considerations for Properly Classifying Franchisees

In addition to the practices discussed in connection with the Massachusetts trilogy, a franchisor may take two additional steps to further reduce the likelihood of "employer" status under federal or state law.69 First, a franchisor could require all franchisees to own their franchise through a corporate entity, e.g., a limited liability company or S-corporation. This will allow a court to have two potential corporate "targets" when evaluating who is responsible for making unemployment contributions. Many of the cases we reviewed exhibit a strong, if unstated, preference for not holding an individual responsible for making unemployment contributions, especially when that individual is then seeking benefits due to unemployment.

Second, and as a necessary corollary to corporate ownership, a franchisor could require its franchisees to treat themselves as "employees" of their corporate entity. This additional requirement has many advantages. One advantage is that as an "employee," the franchisee's corporate entity will make unemployment contributions on his or her behalf. As a practical matter, if unemployment compensation contributions have been made, a discharged worker (even one with a franchise agreement) will usually receive unemployment benefits, and the issue of whether a worker is an employee or an independent contractor will not arise.

Our research discovered no case where a worker generally challenged his or her status as an employee without unemployment, worker's compensation, or some other benefit riding on the result. Rather, cases typically (including all of the Massachusetts "trilogy") arise in the context of no employer contributing on a claimant's behalf, such that an employer must be

68 See, e.g., Oplchenski v. Parfums Givenchy, Inc., 2009 WL 440569, at *3 (N.D. Ill. Feb. 19, 2009) ("Plaintiffs contend, despite Defendants' characterization of them as independent contractors, they are common-law employees entitled to benefits under these Plans."); Barnard v. Advance Pension Plan, 2008 WL 4838844, at *1 (D. Or. Nov. 4, 2008) ("The parties' agreements to classify Barnard as an independent contractor were not waivers of ERISA plan benefits and do not control the question of whether Barnard was an employee of The Oregonian within the meaning of The Oregonian's ERISA plans.").

69 Importantly, we found no judicial decision which addresses either of these additional steps as hallmarks of an independent contractor relationship. The absence of any judicial decision focusing on these steps suggests to us that a franchised corporate entity which pays unemployment compensation on behalf of its employees, including its sole shareholder or limited liability member, is unlikely to find itself involved in litigation over the status of its "employees."
“found” in order to afford the claimant coverage. So long as some entity is making contributions on a person’s behalf, there is no reason to “find” another employer.

Requiring franchisees to treat themselves as employees may have business and competitive disadvantages. Requiring a franchisee to adopt a particular form of ownership may weigh heavily on the issue of franchisor control for vicarious liability purposes, although monitoring liability insurance coverages would minimize the impact of such issue. Moreover, the payment of unemployment compensation taxes and corporate formation expenses may pose entry barriers to some thinly capitalized potential franchisees, and lead others to choose to purchase a franchise from less demanding competitors.

IV. CLASS ACTIONS: THE NEXT WAVE?

Recent developments suggest that plaintiffs’ attorneys are now actively looking to organize state-wide and nationwide classes of franchisees to challenge their independent contractor status. While plaintiffs’ attorneys have had relatively little success to date in these endeavors and there are not significant published cases on the issue, the limited success they have had strongly suggests that the number of attempts will only increase as will the success ratio. In short, putative class actions on behalf of franchisees are in the pipeline.

Franchisees, like all plaintiffs seeking to proceed as a class, face several procedural hurdles in having their putative class certified. Pursuant to Rule 23 of the Federal Rules of Civil Procedures, franchisees must first demonstrate numerosity, common questions of law or fact, typicality and adequate representation. Of these, numerosity and commonality are often the least challenging. Classes as small as 30 are not uncommon and the very nature of class actions generally satisfies the commonality requirement.

The first real hurdle that franchisees are likely to face is typicality. “A plaintiff’s claim is typical if it arises from the same event or practice or course of conduct that gives rise to the claims of other class members, and if his or her claims are based on the same legal theory.” This can pose real challenges for a franchisee class because, despite the similarity of their claims, they may have operated their businesses in different ways. For example, some class members may have hired others to perform certain services while others did all the work themselves. Alternatively, some franchisees may have issued Form 1099s to those performing services, while other issued W-2s and still others paid under the table.

Another issue that can affect typicality is whether affirmative defenses, such as releases franchisees signed, make the claims atypical. Franchisees will likely respond to these typicality claims by arguing that trivial differences are not material in the larger context of

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61 See generally, Alba Conte & Herbert Newberg, Newberg on Class Actions ss. 3.3 and 3.10 (4th ed. 2002).


whether they are employees subject to their franchisor's right of control. Also, to the extent some members may be subject to certain affirmative defenses, those defenses are likely to affect typicality and therefore suggest the creation of sub classes, not rejection of the class writ large.

The next common hurdle is whether the putative class representatives can adequately represent the proposed class. Franchisees must be careful in selecting their class representatives. The franchisees most willing to volunteer their time to serve as representatives may have factual circumstances that make them particularly ill-suited to be a representative. For example, if success depends in part on whether franchisees are required to wear uniforms and the class representative never wore one, the class's claim may fail. Alternatively, a representative's decision to hire employees or hold the franchise through a corporate entity may make her an inadequate representative. Despite this, class certification will not typically fail if an alternative, more suitable representative can be substituted.

Once a franchisee class satisfies the four requirements of Rule 23(a) of the Federal Rules of Civil Procedure, it must then satisfy one of the three 23(b) tests. The most common and likely 23(b) class for alleged franchisee employees is 23(b)(3). Rule 23(b)(3) requires in pertinent part that "questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy." Where individualized questions of fact will predominate, Rule 23(b)(3) is not satisfied and certification must be denied. To date, it appears that franchisees are trying to meet their Rule 23(b)(3) obligations by relying upon the common terms of the franchise agreement at-issue. Their argument is that: (1) the "right" to control is determined by the "rights" the franchisor and franchisee allocate to each other in their franchise agreement and; (2) the rights are allocated in an identical way because a common form of franchise agreement is utilized, therefore common questions of both law and fact predominate.64

The success of this argument often depends upon the substantive law governing individuals' status as independent contractors or employees. As detailed above, depending on the specific context, a variety of substantive tests exist to determine a person's status. Under those tests that rely solely upon the "right" to control and not the actual actions of the parties, we expect that classes will be certified based on the uniform terms of the class members' contracts. On the other hand, we anticipate that certification may be denied where the applicable rule looks to the parties' actual conduct. Where the actual conduct is at issue, the likelihood of establishing common questions of fact drops dramatically due to the inevitable variety in how people operate their franchises and the conditions under which they operate them.

64 Outside of the employee classification context, courts have been skeptical that franchisees seeking class certification across different states, and sometimes even with different franchise agreement, could satisfy the Rule 23(b)(3)'s requirement of a common question of law and fact. See, e.g., Danvers Motor Co. v. Ford Motor Co., 543 F.3d 141 (3d Cir. 2008) (reversing certification of franchisee class asserting claims under Robinson-Patman Act, Automobile Dealer's Day in Court Act, numerous state franchise laws and for breach of contract and breach of covenant of good faith and fair dealing based on individualized issues of each franchisee's claims).
V. CONCLUSION

The impact of litigation-imposed changes on a franchisor's business structure could be significant, would impact vicarious liability and tax issues, and could trigger mass claims for rescission and return of franchise fees. The benefits of classifying workers as independent contractors are many -- costs savings in the form of avoided social security, Medicare and unemployment insurance taxes, workers' compensation, statutory disability benefits premiums, fringe benefits, and avoidance of other requirements imposed by law on employers, including pay and record keeping obligations, Occupational Safety and Health Act duties, and prohibitions on discrimination. As a result of these business risks which flow from "employee" status, some franchisors may want to consider changes to their business structure proactively to best avoid the imposition of "employee" status on its franchises.
Arthur L. Pressman

Partner
100 Summer Street • Boston, MA 02110
Phone: 617-345-1158 • Fax: 866-829-9268
apressman@nixonpeabody.com
www.nixonpeabody.com

Practice Areas
Franchise & Distribution
Intellectual Property
Technology

Experience
For more than thirty years, Arthur L. Pressman has been recognized as a leading franchise lawyer with a nationwide practice, specializing in the representation of franchisors.

Mr. Pressman leads an international franchising practice that represents world leaders in franchising and retail distribution, and numerous hotel, real estate, and consumer services systems. Under his leadership, the group has handled litigation and transactions for clients in more than seventy countries on six continents, including the United States and its territories.

In its 2008 edition Chambers USA wrote that Mr. Pressman is "a great litigator with an enviable market reputation," and "widely acknowledged for his expertise as a trial lawyer, he has acquired renown for his high level of client care and has acted for clients across the globe." Mr. Pressman was identified in 2008 Chambers USA as one of the top 6 individual franchise lawyers in the United States.

In 1994, Mr. Pressman was named first chair of the American Bar Association Forum on Franchising, Litigation, and Dispute Resolution division, and in 1997 was elected to the American Bar Association Governing Committee of the Forum on Franchising, on which he served through 2001.

Mr. Pressman is a member of the CPR Institute for Dispute Resolution's Franchise Panel of Distinguished Neutrals and a certified JAMS-trained mediator.

Mr. Pressman has been named one of the top 100 franchise lawyers in the country by Franchise Times every year since its inception, was selected by his peers as a Massachusetts Super Lawyer in 2005 through 2009, and recognized as a “New England Super Lawyer” in Franchise based on a peer-review survey by Boston Magazine. He was also selected by peer-review for inclusion in The Best Lawyers in America 2007-2010 (Copyright 2009 by Woodward/White, Inc. of Aiken, S.C.).

Admissions
Mr. Pressman is admitted to practice in state and federal courts in Massachusetts, New York, and Pennsylvania, the U.S. Supreme Court, and the U.S. Court of Appeals for the First, Third and Eleventh Circuits. Additionally, he has appeared pro hac vice in approximately twenty jurisdictions.

Affiliations
From 2004-2007, Mr. Pressman was an Adjunct Professor at Babson College, Wellesley, MA in the Entrepreneurship Division of its MBA Program, co-teaching “Franchising: Pathway to Wealth Creation.”

Previously, Mr. Pressman has taught franchising law courses at the Temple University School of Law as an adjunct faculty member.
CARLA WONG McMILLIAN

carla.mcmillian@sutherland.com I Partner I Atlanta I P: 404.853.8120

Carla Wong McMillian, a member of Sutherland’s Litigation Practice Group, focuses her practice in the areas of franchise and dealer litigation and counseling; accountants’ and professional liability defense; and other complex business litigation. She has represented automobile and motorcycle manufacturers nationwide in state and federal court litigation and state administrative proceedings in terminations, relocations, add points and warranty reimbursement matters. Her professional liability practice has focused on representing Big Four accounting firms in litigation across the United States.

Carla has litigated a number of complex business torts, including representing a major automobile manufacturer in an appeal of a products liability action. Also, Carla has defended insurance companies and automobile manufacturers against fraud-based Racketeer Influenced and Corrupt Organizations (RICO) Act claims.

Carla serves as the Diversity and Inclusion Partner for Sutherland’s Litigation Group. She also founded Sutherland’s Asian Attorney affinity group. Before joining the firm, Carla served as a law clerk for the Honorable William C. O’Kelley of the U.S. District Court for the Northern District of Georgia.

REPRESENTATIVE EXPERIENCE

Carla’s extensive representative experience includes:


PROFESSIONAL HONORS AND AWARDS

- Selected for inclusion in Georgia Super Lawyers® “Rising Stars” (2007)

PROFESSIONAL AND COMMUNITY INVOLVEMENT

- Member, Litigation Section and Forum on Franchising, American Bar Association
- Member, Georgia Asian Pacific American Bar Association (GAPABA)
- Member, National Asian Pacific American Bar Association
- Member, Federal Bar Association
Member, Appellate Practice Section and Franchise and Distribution Law Section, State Bar of Georgia
Barrister, American Inns of Court (Lamar Inn)
Member, Board of Directors, Partnership Against Domestic Violence

RECENT PUBLICATIONS AND SPEAKING ENGAGEMENTS

- Moderator, "How We See It: In-House Counsel Speak," National Asian Pacific American Bar Association, Southeast Regional Conference, Atlanta, Georgia (April 19, 2008)
- Panelist, "Work/Life Balance Issues for Women in the Legal Profession," Second Annual Women's Law Panel, University of Georgia School of Law (April 10, 2008)