WHEN IS CONTROL BY FRANCHISORS OUT OF CONTROL?

Fredric A. Cohen
Cheng Cohen LLC

David J. Meretta
Witmer Karp Warner & Ryan LLP

Sandra J. Wall
McDonald’s Corporation

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WHEN IS CONTROL BY FRANCHISORS OUT OF CONTROL?

I. THE FINE LINE BETWEEN MAXIMIZING CONTROL AND CREATING LIABILITY EXPOSURE

It is a problem that virtually every franchisor – particularly in the foodservice and hospitality fields - has faced: in the wake of personal injuries suffered by a customer or employee of a franchise location, or alleged employment discrimination suffered by a franchisee’s employees, the franchisor is named as a defendant in the resulting lawsuit, on the theory that the franchisor should be directly or vicariously liable for the injuries.

The problem arises out of a fundamental dilemma inherent in franchising: how can a franchisor maximize its ability to manage its brand and enforce system standards without blurring or even eviscerating the status of its franchisees as independent owner/operators? It is through the reservation and exercise of control that franchisors seek to ensure that every customer has substantially the same experience in every franchised and company owned location - whether it be a restaurant, a store, or a service at a home or business. From the viewpoint of franchisors, this uniformity is the essence of franchising.

But this same control forms the heart of the inquiry as to whether a franchisor may be liable for the injuries suffered at a franchise location, or is considered to be an employer of a franchisee’s employees, or is liable for the quality of the products and services offered and sold at franchised locations. Courts focus upon both the form and reality of the franchise relationship. How much control over the operation of the franchisee’s business has the franchisor reserved to itself in the franchise agreement? To what extent has the franchisor exercised actual control over the business and/or the particular instrumentality of the franchisee’s business at issue?

When franchisors cross the line between maintaining system uniformity and policing their trademarks, and in effect are deemed to be running their franchisees’ businesses, the results can prove disastrous. This paper explores the factors pertinent to this tension, explores the latest trends in the case law, and offers some ideas about how franchisors might limit their liability exposure.

II. A FRANCHISOR MAY UNWITTINGLY BECOME AN EMPLOYER OR JOINT EMPLOYER OF ITS FRANCHISEES OR THEIR EMPLOYEES

Franchisors must be vigilant to avoid inadvertently creating an employer-employee or joint employer relationship with its franchisees or its franchisees’ employees and thereby becoming vicariously liable for their acts and omissions.

B. Vicarious Liability Through Control

While a person generally is only liable for his or her own torts, under certain circumstances, the law will impose vicarious liability on a person who did not commit the tortious conduct but who nevertheless is deemed to be responsible for same by virtue of that person’s close relationship with the tortfeasor. A form of strict liability without fault, vicarious liability is imposed upon an innocent party pursuant to the doctrine of respondeat superior (“let the master

answer"), where such imposition is justified by the nature of the agency relationship, most particularly by the element of control or right of control.²

The fundamental requirement of control or the right to control that underlies the doctrine of respondeat superior derives from the earliest manifestations of the doctrine. Although the rationale for vicarious liability has expanded and the circumstances of its application have become more diverse, the basic formula for respondeat superior has remained the same: only a “master” who has the requisite degree of control over a servant’s physical performance will be held vicariously liable; to hold otherwise would not serve the justification for the rule.³ Simply stated: liability without fault should not be imposed upon a principal that does not control or have the right to control the day-to-day physical conduct of an agent, as the principal neither has the ability nor the incentive to prevent harm.⁴

Conversely, a principal generally is not liable for the acts of an “independent contractor” who contracts to perform services for the principal, but who is neither controlled by the principal nor subject to the principal’s right to control with respect to his physical conduct in the performance of the undertaking.⁵

The imposition of vicarious liability thus is determined by evaluating the relationship between the tortfeasor and the principal.⁶ A principal’s vicarious liability generally depends upon the existence of either an agency or employment relationship, through which the principal controls or has the right to control the tortfeasor.⁷

1. Agency Relationship

An agency relationship arises when parties manifest consent that one shall act on behalf of the other and subject to his or her control. The critical element of an agency relationship is the right of control. For an agency relationship to exist, the principal must have the right to control both the means and the details of the process by which the agent is to accomplish his task in order for an agency relationship to exist. This principle is embodied in Section 220 of the Restatement of Agency, created in 1958, pursuant to which the existence of a master-servant relationship - and the resulting imposition of vicarious liability – turns on the extent of control reserved by the master over the details of the work.

³ Kerl, 682 N.W.2d at 336.
⁴ Id. at 336-337.
⁵ Id. at 335; Restatement (Second) of Agency, §2(3). See also Page Keeton, Prosser & Keeton on the Law of Torts § 71 (5th ed.1984) (the fundamental difference between an employee and an independent contractor is that one who hires an independent contractor "has no right of control over the manner in which the work is to be done, it is to be regarded as the contractor's own enterprise, and he, rather than the employer is the proper party to be charged with the responsibility for preventing the risk, and administering and distributing it").
Section 220(2) of the Restatement (Second) of Agency, which numerous courts continue to apply in the franchise context, identifies the following factors as relevant to the determination of whether a master maintains the right of control over another sufficient to create an agency relationship:

(a) the extent of control which, by the agreement, the master may exercise over the details of the work;
(b) whether or not the one employed is engaged in a distinct occupation or business;
(c) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;
(d) the skill required in the particular occupation;
(e) whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;
(f) the length of time for which the person is employed;
(g) the method of payment, whether by the time or by the job;
(h) whether or not the work is a part of the regular business of the employer; and
(i) whether or not the parties believe they are creating the relation of master and servant.

Absent proof of the principal’s right to control, the relationship is that of an independent contractor. There are two types of agency: actual agency and apparent or ostensible agency, also known as agency by estoppel.9

a. Actual Agency

In order to establish the existence of actual agency, the franchisor must have actually consented to the franchisee acting as an agent on the franchisor’s behalf. An actual agency exists “when the agent is really employed by the principal.” In the franchise setting, an actual agency relationship “is determined by the nature and extent of control and supervision retained and exercised by the franchisor over the methods or details of conducting the day-to-day operation.”10

b. Apparent Agency

Conversely, under a theory of apparent or ostensible agency, the franchisor - by words or conduct - must represent or permit it to be represented that the franchisee is the franchisor’s agent, in which case the franchisor will be estopped to deny the agency. This principle rests on the essential elements of doctrine of estoppel, to wit: representations by the principal, justifiable and reasonable reliance thereon by a third party, and a change of position or injury resulting from such reliance.11

2. Employment Relationship

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8 See e.g., Leach v. Kaykov, 2011 WL 1240022 (E.D.N.Y., 2011), discussed at length, infra.

9 See e.g., Broock v. Nutri/System, Inc., 654 F.Supp. 7, 10 (S.D.Ohio 1986) (”[u]nder Ohio law a franchisor may be vicariously liable for a franchisee’s tortious conduct under a theory of apparent agency or agency by estoppel . . . “).

10 Hayman, 86 N.C.App. at 277, 357 S.E.2d at 397.

In the tort context, in order to hold a party vicariously liable for the torts of another, a court’s first inquiry is whether the relationship is that of an employer-employee or a principal-independent contractor.12 Where the relationship is that of an employer-employee, then liability will be imposed on the employer if the employee was acting within the scope of his employment, under the theory that “one who expects to derive a benefit or advantage from an act performed on his behalf by another must answer for any injury that a third person may sustain from it.”13

In the labor relations or civil rights context, although the issue of which entity is the direct employer of an employee is rarely in dispute, courts have fashioned various doctrines by which a separate entity that does not directly employ the employee may still be considered his or her employer, the most prevalent of which are the “single employer” and “joint employer” doctrines.14 Although analytically distinct, the single and joint employer doctrines occasionally are mixed or combined by the courts.15

The “single employer” doctrine focuses on the interrelatedness of separate corporate entities. For example, a four-part test adopted by the Sixth Circuit treats two entities as a single employer where the following circumstances are found to exist: (1) interrelation of operations, (2) common management, (3) centralized control over labor relations, and (4) common ownership or financial control.16

By comparison, the “joint employer” doctrine applies where separate entities jointly control each other’s employees, such as through “the supervision of the employees’ day to day activities, authority to hire or fire employees, promulgation of work rules and conditions of employment, work assignments, and issuance of operating instructions.”17 The joint employer theory typically is a better fit than the single employer theory in the franchise context (for example, it would rarely, if ever, be the case that a franchisor and franchisee have common management or ownership), and thus has been advanced more often in franchisor vicarious liability matters.

B. Application of Agency/Employment Principles to the Franchise Relationship

Most courts that have addressed the issue of a franchisor’s vicarious liability have presumed that respondeat superior applies in the franchising context and have applied some form of the traditional master/servant “control or right of control” test to determine whether the franchisor-franchisee relationship should give rise to vicarious liability.18 This approach has increasingly come under criticism, however, and has evolved somewhat over time. Courts today

12 Carter, 175 N.J. at 409.
13 Id., at 408–09.
15 Id., at 993-994.
18 Kerl, 682 N.W.2d at 337.
continue to differ as to if and to the extent to which the nature of franchising, and particularly its Lanham Act underpinnings, should be taken into account in this analysis. As a result, franchisors must carefully consider the potential consequences of its retention or exercise of control over its franchisees.

5. The Gradual Erosion Of The Traditional “Control” Test

With near uniformity, courts apply some version of the “right to control” test in determining whether the imposition of vicarious liability on a franchisor is appropriate. An increasing number of courts have recognized, however, that as a general matter, the control test and the typical rationale for finding vicarious liability are not easily transferrable to the franchise relationship. Recently, one court reluctantly applied the general vicarious liability in the franchise context in the absence of a clear alternative analytic framework, having observed that application of the traditional employee-independent contractor analytical framework does not fit squarely in the context of franchising. As described by one commentator, most courts imprudently continue to attempt to “shoehorn” the Restatement test into modern franchise vicarious liability cases.

6. The Unique Nature of Franchising

Although some courts have been slow to grasp the concept, there are material differences between a typical franchising arrangement and pure employment relationships. These differences make respondeat superior an imperfect analytical framework in the unique context of franchising.

a. Differences From an Employment Relationship

Under federal law, a “franchisee” is distinguishable from a typical “employee” in that the franchisee owns equity in a business, and thereby accepts the risks, rewards, and responsibilities of business ownership. Antithetical to traditional employment arrangements, a franchise arrangement proceeds on the premise that a franchisee can earn and retain the profits of his venture, and create a business with an identifiable value that the franchise owner can sell for a profit. Unlike employees, most franchisees have the power to delegate duties to their own employees, select customers, and adapt techniques for their businesses apart from the franchising model. These distinctions allow franchisees to build and subsequently sell their equity in the business. Along with that equity interest, the franchise owner is given the right to

\[19\] See e.g., Bricker, supra (under Ohio law, “[t]he determinative factor in deciding whether an agency relationship exists between a franchisor and a franchisee is the degree of control the franchisor has over the operations of the franchisee's business”) (internal citation omitted); Cislaw v. Southland Corp., 4 Cal.App.4th 1284, 1288. (1992) (a franchisor may be vicariously liable if it has “complete or substantial control over the franchisee”) (internal citation omitted).

\[20\] Kerl, 682 N.W.2d at 337.


\[23\] See 16 C.F.R. § 436.2(d) (“The term ‘franchisee’ means any person: (1) who participates in a franchise relationship as a franchisee...or (2) to whom an interest in a franchise is sold.”).
capitalize upon and benefit from the established goodwill and brand power of the franchise system, while operating the franchised business independently. Whereas most employees enter into an employment arrangement for no consideration and depart without equity, franchisees furnish consideration and receive an equity stake in their own business through the use of another’s pre-established business model. These features are the hallmarks of a franchise.

b. Lanham Act Underpinnings

A primary reason that respondeat superior is an imperfect analytical framework in the franchise context is the franchisor’s obligation to protect its trade or service mark under the Lanham Act. The franchisor-franchisee relationship is heavily influenced by rules of trademark law, primarily as set forth in the Lanham Act. At its core, franchising involves a franchisor’s licensing of intellectual property, usually in the form of the franchisor’s trademark. “Generally, franchising is a method of expanding a business by licensing independent businessmen to sell the franchisor’s product or service or to follow a format and trade style created by the franchisor using the franchisor’s trademarks and trade names.” Because the vast majority of franchise relationships include a license for the franchisee to use the franchisor’s trade or service mark, the detailed quality and operational 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.

Among other requirements, “the Lanham Act places an affirmative duty upon a licensor of a registered trademark to take reasonable measures to detect and prevent misleading uses of his mark by his licensees or suffer cancellation of his federal registration.” This duty “derives from the Lanham Act's abandonment provisions, which specify that a registrant's mark may be canceled if the registrant fails to control its licensees' use of the licensed mark.” Accordingly, a trademark licensor is obligated to maintain adequate control over the use of its mark in order to avoid non-compliance with the Lanham Act.


25 See also Leach v. Kaykov, supra, citing John Hanks, Franchisor Liability for the Torts of Its Franchisees: The Case for Substituting Liability as a Guarantor for the Current Vicarious Liability, 24 OKLA. CITY U.L.REV. 1, 3 (1999) (“The franchisor-franchisee relationship is neither that of an employer-employee nor of an employer and independent contractor ... [I]t is not surprising then that judicial attempts to apply the employee-independent contractor dichotomy in the franchising context often appear arbitrary.”); see also Deanna Conn, When Contract Should Preempt Tort Remedies: Limits on Vicarious Liability for Acts of Independent Contractors, 15 FORDHAM J. CORP. & FIN. L. 179, 214 (2009) (“The current law of vicarious liability is inconsistent in the franchise area.”); King, Limiting the Vicarious Liability of Franchisors for the Torts of Their Franchisees, 62 WASH. & LEE L.REV. 417, 468–69 (2005) (noting that a franchisor is often “caught in a quandary, trying to protect the goodwill and reputation of his trademark while at the same time avoiding so much control or appearance of control [of franchisees] that it is deemed to have crossed the actual or apparent agency line” for purposes of vicarious liability).


28 Kerl, 682 N.W.2d at 338.


A second, no less important reason explaining the imperfect intersection between the traditional control analysis and franchising is that successful franchising is “all about controls.” The quality assurance model that guides all successful franchise systems today is a central organization that develops standards of operation, trains licensees, and enforces compliance with its standards through supplier relationships and through field inspections. Many franchisors believe that the key to their success lies in rendering each of its franchise locations indistinguishable from all others, a goal that is unattainable in the absence of control.

A franchisor thus is faced with the dilemma of balancing its goals of achieving system success through the exercise of control over its franchisees and protecting its trade or service marks, national identity and professional reputation, while at the same time stopping short of such a degree of control that would make it vicariously liable for the acts of the franchisee and its employees.

c. Regulatory Background

i. The Franchise Rule

The controls that a franchisor asserts over the conduct and operations of its franchisees are required to be disclosed in its franchise disclosure document (“FDD”) under the Federal Trade Commission’s Franchise Rule, 16 CFR Part 436 (2007), as well as pursuant to state franchise laws. The most pertinent such controls from a vicarious liability standpoint are the following:

a. Item 8 – Restrictions On Sources Of Products and Services

The first of these areas of mandated disclosure is set forth in Item 8 of the FDD, entitled “Restrictions on Sources of Products and Services”. In this Item, the franchisor must disclose any obligations it imposes on its franchisees to purchase or lease goods, services, supplies, fixtures, hardware and software, real estate, or comparable items related to establishing or operating the franchised business, either from the franchisor, its designee, or suppliers approved by the franchisor or under the franchisor’s specifications.

From the franchisor’s perspective, such requirements are central to ensuring that customers have comparable experiences at every location in the franchise system. For example, if fast food franchisees were allowed to use hamburger meat of their choosing and offer additional products and services to customers outside of the standard menu, this would lead to significant variations in food quality and product selection from one location to the next.

31 See 2 Gilson on Trademarks § 6.04 (“Control over the nature and quality of the licensee’s goods or services is the touchstone of a valid trademark license”).


33 Id.

This, in turn, would have the likely effect of creating customer confusion and causing damage to the franchisor’s brand.

With an eye toward controlling the brand and minimizing product variation, as well as increasing bottom line profitability, more franchisors are becoming involved in the manufacture, branding and distribution of the goods and services that are sold to customers. While such involvement can better ensure uniformity in the supply of goods and services to customers, it may also have significant unintended negative consequences, to wit: as discussed, infra, a franchisor’s involvement in the manufacture, branding and distribution of products may create potential additional liability exposure. Franchisors thus must carefully weigh the benefits of such involvement against the risk.

b. **Items 9, 12, 15 & 16 – Franchisee’s Obligations, Territory, Operation Of The Business And Selling Restrictions**

In Item 9 of its FDD, entitled “Franchisee’s Obligations”, the franchisor must disclose a list of specifically identified principal obligations on the part of its franchisees, including compliance with the franchisor’s standards, policies and/or operating manual, restrictions on products and services that may be offered, and requirements pertaining to maintenance, appearance and remodeling, among other obligations.

Items 12, 15 and 16 of the FDD require the disclosure of such items as (i) the territory granted to the franchisee, if any; (ii) the franchisee’s obligation to participate in the actual operation of the franchise business; and (iii) any restrictions on what the franchisee may sell.

On their face, many such obligations reserve control to the franchisor over the franchisee’s business. Franchisors argue, however, that these controls are merely hallmarks of any franchise system and do not create vicarious liability for the acts of franchisees or franchisees’ employees. See infra.

c. **Item 11 – Franchisor’s Assistance, Advertising, Computer Systems & Training**

In Item 11 of the FDD (“Franchisor’s Assistance, Advertising, Computer Systems, and Training”) the franchisor must disclose, among other things, (i) whether the franchisor directly provides equipment, signs, fixtures, opening inventory and supplies, or provides only the names of approved suppliers; (ii) whether the franchisor provides written specifications for these items; and (iii) whether the franchisor is involved in hiring and training of employees and establishing prices.

The franchisor must also disclose in Item 11 the table of contents of its operating manual that it provides to franchisees, along with the number of pages devoted to each subject and the total number of pages in the manual, unless the franchisor offers prospective franchisees the opportunity to view the manual before investing in a franchise.

In many franchise systems, the most critical language governing the franchise relationship appears in the franchisor’s operating manual. As can be seen in cases such as *Leach v. Kaykov*, 2011 WL 1240022 (E.D.N.Y., 2011), discussed *infra*, the rights reserved by a franchisor in its operating manual can prevent an award of summary judgment in favor of the franchisor in vicarious liability cases. Moreover, the extent to which the franchisor furnishes
equipment or is involved in hiring and training of the franchisee’s employees are factors commonly considered by courts in determining whether a franchisor is liable for the acts and omissions of its franchisees or their employees. See *infra.*

d. **Items 13 & 14 - Trademarks, Patents, Copyrights And Proprietary Information**

Items 13 and 14 of the FDD require the disclosure of (i) the trademarks licensed to the franchisee and restrictions on the franchisee’s rights to use those trademarks; (ii) the franchisor’s patents, copyrights and proprietary information that the franchisee may use.

These items reflect the Lanham Act underpinnings of franchising, discussed *infra,* including the duty of a licensor of a registered trademark to take reasonable measures to detect and prevent misleading uses of its mark by licensees or suffer cancellation of the federal trademark registration. Although some early decisions found to the contrary, the prevailing view of courts today is that a franchisor may fulfill its Lanham Act obligations without exposing itself to vicarious liability. See *infra.*

e. **State Franchise Disclosure Laws**

Many state franchise disclosure laws have franchise disclosure requirements comparable to the Franchise Rule. Some state franchise relationship laws impact franchisors’ ability to enforce certain controls and restrictions upon franchisees. For example, the Iowa franchise relationship law restricts a franchisor’s ability to require that franchisees purchase goods, supplies, inventories or services exclusively from a franchisor, where items of comparable quality are available from third party vendors. Compliance with these provisions serves to limit a franchisor’s potential exposure to liabilities arising out of the offer and sale of these products and services.

7. **Control In The Context Of The Franchise Relationship**

Fortunately for those franchisors that are mindful of the foregoing considerations, an increasing number of courts have held that the existence of quality and operational standards and the reservation of inspection rights do not establish a franchisor’s control or right of control over the franchisee sufficient to ground a claim for vicarious liability.

In this regard, it has been observed that the Lanham Act was not intended to “saddle [a] licensor with the responsibilities under state law of a principal for his agent”, and that a franchisor must be permitted to retain such control as is necessary to protect and maintain its trademark, trade name and good will, without the risk of creating an agency relationship with its franchisees. In *Cislaw v. Southland Corp.*, the court remarked that a “franchisor’s interest in

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36 See Kerl, 682 N.W.2d at 338, and cases cited therein.
the reputation of its entire system allows it to exercise certain controls over the enterprise without running the risk of transforming its independent contractor franchisee into an agent”, and for that reason, “California courts have consistently held that a principal-agent relationship exists only when the franchisor retains complete or substantial control over the daily activities of the franchisee's business.”

Although vicarious liability and Lanham Act analyses both involve an element of “control,” the inquiries are distinct. To protect its trademark, a franchisor must retain sufficient control over the licensees’ dealings in the end product to ensure that they will apply the mark to either the same product or to one of substantially the same quality with which the public in the past has associated the product. Conversely, the vicarious liability “right to control” test focuses on a franchisor's control over a franchisee's performance of its day-to-day operations.

The distinction between the right to control and direct the details of the work, rather than the right to control the result to be obtained, is embodied within the Franchise Rule itself, which defines a “franchise” as a continuing commercial relationship or arrangement in which the contract terms specify that the franchisor “will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation.”

8. **Common Hallmarks Of A Franchise**

Courts generally have held that facts that merely show the “common hallmarks of a franchise” do not establish vicarious liability. In evaluating the requisite level of control necessary to create vicarious liability for a franchisor, courts commonly distinguish between control over a franchisee’s day-to-day operations and controls designed primarily to ensure “uniformity and the standardization of products and services.” For example, it was recently observed in *Juarez v. Jani-King of California, Inc.* that in order to establish a prima facie case of an employer-employee relationship under California law, it likely must be shown that a franchisor exercised control over its franchisee “beyond that necessary to protect and maintain its interest in its trademark, trade name and goodwill”. By extension, the court continued, courts can safely exclude from the employee-employer relationship analysis facts that merely show the common hallmarks of a franchise, such as those that constitute a “marketing plan or system” under which the franchisee's operation is “substantially associated with the franchisor's trademark, service mark, trade name,” or goodwill.

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39 *Cislaw*, 4 Cal.App.4th at 1292.


41 1 Gladys Glickman, *Franchising* § 3A.02[4][a] (emphasis added).

42 *Rainey v. Langen*, 998 A.2d 342 (Me. 2010).

43 16 CFR §436.1(h)(2).


Another court has held that a franchisor’s implementation of detailed and specific standards regarding how a franchisee manufactures, packages, prepares, or serves the franchisor’s product, its monitoring of compliance, and its termination of franchisees for noncompliance “is not the equivalent of retaining day-to-day supervisory control of the franchisee’s business operations.”

An example of a distributor that successfully walked the line by enforcing its system standards without creating vicarious liability for itself is in the case of McKee Foods Corp. v. Lawrence et al. In McKee, the Court of Appeals of Georgia found that a distribution company addressed its interest in protecting the reputation and viability of its products and sales network by, among other things, regulating distributors’ storage facilities and sanitation efforts, establishing requirements for product freshness and trademark usage, and limiting the types of entities it wanted in its distribution chain. The court found that none of these requirements dealt with the day-to-day operations of the distributors, who were free to make business decisions regarding sales efforts and growth, customer calls, delivery times and routes, delivery methods, pricing, product placement, and other day-to-day matters.

The McKee court concluded that although the distribution company imposed certain overarching guidelines and regulations through the distributorship agreement, those provisions simply served as a means of ensuring conformance with a certain level of quality and protecting its professional reputation. The court ruled that the distribution company did not have the right to control the time, manner, and method of the distributors’ daily activities, and thus could not be held vicariously liable as the distributor’s employer or principal.

Recognizing the distinction between the “power to control and direct the details of the work,” rather than the “result to be obtained”, a number of courts have adopted a modified, more narrow version of the vicarious liability “right to control” test, which is often referred to as the “instrumentality rule.” Under the “instrumentality rule”, a franchisor may be subject to vicarious liability for the tortious conduct of its franchisee only if the franchisor had control or a right of control over the daily operation of the specific aspect of the franchisee’s business that is alleged to have caused the harm.

Representative of this approach is the 2004 decision of the Wisconsin Supreme Court in Kerl v. Dennis Rasmussen, Inc. Reasoning that the Lanham Act-related obligations incumbent upon franchisors weighed in favor of narrowing the focus of the traditional “right to control” test, Kerl held that “a franchisor may be subject to vicarious liability for the tortious

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46 Jani King, supra, citing Cal. Bus. & Prof.Code § 20001(b).
49 See, e.g., Kerl, supra; Papa John’s Int’l, Inc. v. McCoy, 244 S.W.3d 44, 55 (Ky.2008); VanDeMark v. McDonald’s Corp., 153 N.H. 753, 904 A.2d 627, 634-36 (2006); see also Hong Wu v. Dunkin’ Donuts, Inc., 105 F.Supp.2d 83, 87-88 (E.D.N.Y.2000).
50 One commentator points out that the instrumentality rule represents a merging of vicarious and direct liability, because a necessary corollary to a franchisor having “control of the instrumentality” is that the franchisor also assumed a duty with respect to that instrumentality. Killion, supra.
51 273 Wis.2d 106, 682 N.W.2d 328, 333 (2004).
conduct of its franchisee only if the franchisor had control or a right of control over the daily operation of the specific aspect of the franchisee’s business that is alleged to have caused the harm.\footnote{Kerl, 682 N.W.2d at 342.} The court in Kerl went so far as to note that the detailed requirements typically imposed upon a franchisee’s operations through franchise agreements actually suggest that the franchisor does not intervene in the daily operation and management of the franchisee’s business.\footnote{Id., at 338.}

Notwithstanding its imperfect fit in the franchising context, other courts have continued to apply the traditional “right to control” test in analyzing franchisor vicarious liability.\footnote{See e.g., Bricker, supra (to determine whether a principal-agent relationship exists, courts consider the same factors as ‘in the absence of a franchisor-franchisee relationship’); Drexel v. Union Prescription Ctrs., Inc., 582 F.2d 781, 785-90 (3d Cir.1978); Butler v. McDonald’s Corp., 110 F.Supp.2d 62, 66-68 (D.R.I.2000); Font v. Stanley Steemer Intl, Inc., 849 So.2d 1214, 1216-19 (Fla.Dist.Ct.App.2003); Viado v. Domino’s Pizza, LLC, 230 Or.App. 531, 217 P.3d 199, 208-09 (2009).}

As a result, it is necessary to evaluate the franchise relationship in light of the franchisor’s duty to police its trademark. A franchisor may regulate the uniformity and the standardization of its products and services without risking the imposition of vicarious liability. If a franchisor takes further measures to reserve and/or exercise control over a franchisee’s performance of its day-to-day operations, however, it is no longer merely protecting its mark, and the imposition of vicarious liability may be appropriate.

In summary, while the mere existence of a franchise relationship does not necessarily trigger a master-servant relationship, it also does not automatically insulate the parties from such a relationship. Stated differently, while the existence of a franchisor-franchisee relationship does not in itself preclude the existence of a principal-agent relationship, neither does the mere licensing of a franchisor’s trade or service mark create an agency relationship, either actual or ostensible.\footnote{Taylor v. Checkrite, Ltd., 627 F.Supp. 415, 416 (S.D.Ohio 1986); Cislaw v. Southland Corp., 4 Cal.App.4th 1284, 1288 (1992).}

C. How Much Control Is Too Much Control?

Under a control analysis, when do a franchisor’s words and deeds cross the line - however imperfectly drawn - such that vicarious liability may be appropriate? A court’s review of the control exercised by the franchisor over the franchisee’s business invariably begins with an evaluation of the franchise agreement that the franchisor requires its franchisees to sign. What does the agreement say about the franchisor’s operations manuals and system standards? Are the manuals and standards incorporated by reference into the franchise agreement? Does the franchise agreement recite that the manuals and standards may be modified by the franchisor from time to time? If so, are there any contractual limitations on the right to modify the franchisee’s obligations? Are the controls that the franchisor seeks to impose through its standards and manuals necessary to protect the integrity of the brand, or do these controls really dictate every detail of the franchisee’s business such that the franchisee is really just implementing the franchisor’s standards rather than running his or her own business? Although a franchisor generally is not considered to be the employer of its franchisees’ employees,\footnote{Taylor v. Checkrite, Ltd., 627 F.Supp. 415, 416 (S.D.Ohio 1986); Cislaw v. Southland Corp., 4 Cal.App.4th 1284, 1288 (1992).}
evaluation of this issue requires examination of both the degree of control retained by the franchisor, as well as the totality of the facts surrounding the relationship.

2. Recent Application Of The Restatement Factors: Leach v. Kaykov

Applying the Restatement (Second) of Agency factors and New Jersey law, a federal district court in New York this March engaged in an extensive analysis of whether a livery car dispatch service franchisor was vicariously liable for the torts of one of its franchisee drivers. In that case, Leach v. Kaykov, the plaintiffs sued to recover for injuries sustained in an automobile accident in which one plaintiff was a passenger of a livery car dispatched by Royal Dispatch Service, Inc. (“Royal”). The car was independently owned, insured, licensed and driven by a franchisee of Royal named Kaykov. The accident involved a construction vehicle owned by J. Fletcher Creamer & Son, Inc. (“Fletcher”). Although the plaintiffs and Kaykov entered into a stipulation dismissing with prejudice their respective claims against Royal, Fletcher filed cross-claims for contribution and/or indemnification against Royal and Kaykov. Royal then moved for summary judgment regarding Fletcher’s cross claims, arguing that Royal was not vicariously liable for Kaykov’s torts, and thus could not be liable to Fletcher for contribution or indemnification as a matter of law.

The Leach court noted preliminarily that although application of the traditional analytical framework of employee-independent contractor and the independent contractor exception to determine whether a principal should be held vicariously liable for the torts of another does not fit squarely in franchisor-franchisee relationships, the court nevertheless would rely on these principles in the absence of a clear alternative legal framework.

The Leach court proceeded to engage in a detailed analysis of the Restatement factors to determine whether Royal maintained sufficient control over its franchisees so as to create an employer-employee relationship in the context of the totality of the circumstances. Although the court found that the relationship between Royal and Kaykov was that of principal-independent contractor, the court nevertheless concluded that summary judgment with respect to Fletcher’s cross-claim for contribution was inappropriate, due to the factual disputes that existed concerning the control that Royal actually exercises over its franchisees. This included whether Royal requires franchisees to work certain early morning shifts, whether Royal receives and responds to customer complaints concerning the franchisees, whether Royal inspects the vehicles, and whether Royal has a hand in enforcing the rules set forth in a “Rulebook” corresponding to the franchise agreement.

The painstaking detail which the court afforded each of the Restatement factors offers a useful roadmap to franchisors looking to avoid Royal’s pitfalls. The decision also illustrates the imperfect application of traditional vicarious liability principles in the franchising context.

a. The Royal Vehicle-For-Hire Dispatch Franchise Relationship

Royal operates a vehicle-for-hire dispatch service and establishes accounts to provide car services to business entities upon demand. To service its customers, Royal enters into


franchise agreements with its drivers. Royal refers each customer call to one of its drivers through a computer system required and installed by Royal in the driver's car at the driver's expense. The driver has the option to ignore, reject, or accept each call offered by Royal. The driver, who is identified in the franchise agreement as “an independent businessman” who is “not deemed to be an employee or agent of [Royal],” is also free to contract with other franchisors and serve their own private clients and may hire its own drivers or employees upon Royal's written approval. If the driver elects to accept Royal's call, the driver is free to determine the route that he or she will take to reach the passenger's destination, although Royal requires that its drivers' vehicles be equipped with a GPS device. Upon arrival at the destination, the driver collects a voucher from the passenger and then forwards the voucher to Royal, which Royal uses to collect the specified voucher amount from the account-holding company. After collecting the money, Royal disburses payment to the drivers, withholding a commission for itself ranging from 18–24% of the total fare collected, depending on how quickly the driver chooses to be paid. The driver also pays weekly dues to Royal.

Under the Royal franchise agreement, the franchisee, which has the right to divest, sell, transfer, or assign its franchise (subject to Royal's written consent, which may not unreasonably be withheld), "shall at all times be free from the control or direction" of Royal in operating the vehicle, and that Royal shall not supervise or direct the franchisee's services, “except as specifically set forth herein or in the Franchisor's [R]ulebook, which supervision or direction is set forth primarily for the benefit of all Franchisees.” Perhaps not surprisingly, both Royal and Fletcher claimed that the quoted provision supported their respective positions.

Through the operation of the franchise agreement and the corresponding Rulebook, Royal requires that each franchisee own his or her own four-door Lincoln Town Car or Cadillac that is not more than three years old, carry his or her own liability and worker's compensation insurance, and maintain his or her own licensing. Although drivers generally may set their own schedule and hours, the Rulebook requires them to work at least one shift per week between 4:00 and 9:00 a.m. – a requirement that Royal claims not to have enforced. The Rulebook also lays out detailed aesthetic and operational rules with which the franchisees are required to comply, such as requirements concerning drivers' attire, conduct, attitude toward passengers and other drivers, vehicle cleanliness and inspections, and shift requirements.

The Royal franchise agreement contains a broad list of actions constituting a material breach by the franchisee and authorizing “for cause” termination, including violating the law and failing to "maintain Franchisee's vehicle in excellent condition and offer professional courteous and efficient service”, and for a “serious breach” of the Rulebook. A catchall provision in the

59 Id., at 2.

60 For example, Royal requires that drivers wear dress pants, a white shirt, a tie, a "black, dark gray, navy blue, or a dark suit," dark shoes and no hat and must be “clean, groomed and smell fresh every single day.” Drivers must assist passengers with luggage and, when dropping off passengers at night, must wait until the passenger is safely inside the destination dwelling before departing. The driver's car must be clean and include a GPS, a telephone, a rate book, at least one voucher pack, a pen, and small clip board, among other items. A company magnetic sign with the driver's car number must be on the back panel of the vehicle's trunk when the driver is working. There was also evidence (although disputed) that Royal requires its franchisees to attend and satisfactorily pass a training course on how to properly use and operate the computer system, and that Royal retains the ability to compel the drivers to attend further training sessions if the driver “needs further training in [Royal’s] sole but reasonable judgment.”

61 Id., at 5.
agreement allows Royal to terminate the agreement for cause due to the franchisee’s breach of “any other term or condition” of the Agreement.  

Uniquely, Royal delegates the enforcement of its franchise agreement and Rulebook to a committee formed and comprised of elected franchisees. This includes conducting hearings and imposing sanctions, random inspections of drivers’ attire and vehicles. The franchise agreement specifically requires that franchisees “abide by all the rules and regulations presently set forth in the Rulebook ... or any reasonable rules and regulations which may hereinafter be promulgated and enforced by the Franchisees’ Committee”. The parties disputed whether the franchisees performing such functions were controlled by Royal.

b. The Restatement Of Agency Factors

1. The Extent And Retention Of Contractual Control

The first of the Restatement of Agency factors, “the extent of control which, by the agreement, the master may exercise over the details of the work”, focuses on the agreement between the parties and the right to control retained by the principal, and not the degree of control actually exercised. The latter factor is separately analyzed by New Jersey courts within the control exception section of the independent contractor analysis, which focuses on both the right to control retained by agreement and the day-to-day control actually exercised by the principal. Under this Restatement factor, the more control that the principal reserves in the agreement between the parties, the more likely courts are to find that an employer-employee relationship has been created. A principal’s right of control can be achieved through specific provisions in the agreement, or through the reservation of broad discretionary authority within the agreement.

The Leach court remarked that the parties’ contractual recitations are not conclusive as to whether not an employer-employee relationship exists; instead, the relevant inquiry is the level of control exercised or retained by the principal, as well as “the totality of the facts surrounding the relationship.” Considering the disputed facts concerning the Rulebook and franchise agreement in a light most favorable to Fletcher, the court found that this factor tipped in favor of finding the existence of an employer-employee relationship between Royal and

62 The Leach court noted that, conversely, the range of possible material breaches by Royal was far more constrained, and there was no corresponding catchall provision applicable to such breaches.

63 Id., at 6.

64 See Drexel v. Union Prescription Ctrs., Inc., 582 F.2d 781, 789 (3d Cir.1978) (applying the Restatement factors under Pennsylvania law and concluding that summary judgment for the franchisor was inappropriate, where the franchise agreement included provisions “so nebulously and generally phrased as to suggest that [the franchisor] retained a broad discretionary power to impose upon the franchisee virtually any control, restriction, or regulation it deemed appropriate or warranted”).

65 The Leach court observed that when evaluating respondeat superior liability in the worker’s compensation context, New Jersey courts utilize an additional “nature of the work” test that is not generally applicable in the tort context. This test focuses on the worker-plaintiff’s economic dependence on the principal and on the relationship between the worker-plaintiff’s and principal’s work. The court further noted that courts broadly construe the term “employee” within the worker’s compensation act so as to “bring as many cases as possible” within the scope the act, thus further distinguishing such cases from tort matters.

Kaykov, where Royal’s power to create and/or enforce rules governing such intricate details of the day-to-day means and methods of the franchisees’ work far exceeded general supervisory powers that merely sought uniformity and standardization of services among its franchisees.67

The court likewise found that the language of the franchise agreement itself could be interpreted as retaining broad and general control for Royal over Kaykov; the agreement includes a list of material breaches that, if committed by the franchisee, would give Royal the right to terminate the franchise agreement and further contains broad discretionary authority for Royal to terminate the agreement for cause “due to breach by Franchisee of any other term or condition of this Agreement.”68 The court found that the breadth and discretion Royal retains under the franchise agreement in determining what constitutes a material breach of the contract suggests at least minimal retention of control. Toward this end, the court found that the provision that franchisees “shall at all times be free from the control or direction of the franchisor in the operation of franchisee’s vehicle,” was not dispositive as to whether Royal controlled Kaykov, particularly when considering the franchise agreement as a whole.

The court was not persuaded either that the enforcement of the Rulebook was carried out by committees of franchisees, rather than by Royal, or that this arrangement would insulate Royal from liability. To the contrary, the court found that Royal endorsed, supported and/or created this system to protect itself from being held liable for the torts of its franchisees, while at the same time benefiting from the control exerted by a franchisee committee that operates under Royal’s auspices, noting that the enforcement of strict standards of conduct for drivers in order to maintain the goodwill and reputation of a first-rate car service redounded to Royal’s benefit.

Irrespective of whether Royal itself enforced the Rulebook, the court found that under the plain language of the franchise agreement, adherence to the Rulebook is a material obligation of the franchisee, and its failure to do so is a basis for termination of the franchise relationship. The court thus concluded that the explicit incorporation of the Rulebook by reference in the franchise agreement, in and of itself, raised issues of fact as to whether Royal controlled the details of the franchisees’ work by and through the Rulebook and supplied evidence upon which a jury could find that Royal retained and/or exercised control over Kaykov.

2. **Distinct Occupation And Regular Business**

Considering “whether or not the one employed is engaged in a distinct occupation or business,” and “whether or not the work is a part of the regular business of the employer,” 69 although the *Leach* court found that Kaykov’s activity was an integral part of Royal’s overall

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67 In this regard, *Leach* found on one hand that the contractual requirements that franchisees (i) own a certain make and model of car, (ii) maintain insurance listing Royal as the party to be notified in the event of cancellation, and (iii) undergo drug and alcohol testing, were “the types of arrangements endemic to the proper, legal, and safe administration of a franchise,” and, without more, did not suggest that Royal retained or exercised more than general supervisory authority over its franchisees. *Id.*, at 17-18. The court nevertheless rejected Royal’s argument that its Rulebook powers were merely “akin to basic supervisory power”, noting that the Rulebook explicitly set forth detailed rules governing the drivers’ attire, conduct, handling of customers and their luggage, attitude toward passengers and other drivers, vehicle inspections, and shift requirements, and allows for spot inspections to ensure compliance with the rules, and a comprehensive adjudication system to evaluate and punish transgressors. *Id.*

68 *Id.*, at 17.

business model (Royal’s reliance on the franchisees to pick up and drive passengers was central to Royal’s operation), it concluded that this factor tipped toward an independent contractor relationship, because Royal was in the regular business of dispatching and Kaykov was engaged in “a distinct, but inter-related, occupation”. The court observed that “[a]lthough the functioning of the dispatch service ultimately relies on the availability of drivers to be dispatched, each franchisee is engaged in a separate business of driving his or her own vehicle, which is owned, insured and maintained by the franchisee.”

3. **Expertise Of The Individual**

With respect to the third Restatement factor - the skill or expertise required in the particular occupation – the *Leach* court found that Kaykov has a distinct skill, relied upon by Royal, which is characteristic of an independent contractor. Kaykov maintained his own driver’s and livery licenses, operated his motor vehicle, and navigated between points of pick-up and delivery by taking routes of his choosing. The court remarked that “[a]lthough operating a vehicle and navigating it from point to point may not be considered a highly skilled trade, the skill set is certainly different from that of a dispatcher, and Royal relied on Kaykov’s ability to operate his car, navigate to destinations, and maintain his licenses.”

4. **Instrumentalities And Tools For The Job**

The *Leach* court found that the “tools and instrumentalities” factor weighed in favor of an independent contractor relationship, as Kaykov owned and supplied all of the items necessary for the job - such as his licenses, insurance, the vehicle itself, and the GPS – with the exceptions of the computer dispatch system necessary to receive dispatch calls from Royal, and the company magnetic sign displaying his car number on his vehicle while he is working on a Royal job. The court further noted that Kaykov was responsible for servicing and repairing his vehicle at a location of his choosing.

5. **Duration Of Employment**

Although the term of the parties’ franchise agreement was indefinite (which would tend to reflect an employment relationship), the *Leach* court found that each job was separately contracted, suggesting the existence of an independent contractor relationship. Rather than the seven-year term during which Kaykov had owned his franchise with Royal, the court found that the appropriate measure of the “job” term was the length of each job assigned to and completed by Kaykov, which could range from a short trip of a few blocks to an interstate ride.

6. **Method Of Payment**

The *Leach* court found that the “method of payment” factor strongly favored the existence of an independent contractor relationship, given that Kaykov was paid by the job,

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70 Id., at 18.

71 The court found significant in this regard the facts that Kaykov is the owner and operator of a vehicle who may accept or reject any call dispatched by Royal, that he may employ his own drivers to operate his cars as a part of his franchise, and that he may contract with other franchisors and/or private clients.

72 Id., at 19.
received a 1099 tax form, and had no tax withholdings made by Royal. The court noted that the fact that Royal collected the money from the business client and then disbursed that payment to Kaykov after deducting the requisite commission nevertheless was consistent with an independent contractor relationship, since Kaykov was paid on a per-job basis.

7. Understanding Of The Parties

In Leach, the court determined that the parties had clearly intended to form an independent contractor relationship, where the franchise agreement recited that the franchisee “is, and shall remain, an independent businessman, and shall not be deemed to be an employee or agent of the Franchisor”, where the agreement allows franchisees to take jobs as they please, to take on their own clients, and to enter into other franchise agreements, and where there was no evidence that Kaykov expected to receive unemployment benefits if the agreement were terminated, or expected to receive workers’ compensation or similar benefits of traditional employment. To the contrary, Kaykov carried his own worker’s compensation and liability insurance.

c. Royal Conclusion: Franchisors May Still Be Liable For The Torts Of An Independent Contractor

Viewing all of the factors together, the Leach court found as a matter of law that an independent contractor relationship existed between Royal and Kaykov. While the court acknowledged the existence of material issues of fact regarding whether Royal actually exercised or retained contractual control over the manner and means of Kaykov’s work, even if Royal did actually exercise or retain such control, the record was clear that neither party believed they were creating an employment relationship, and entered into an agreement that clearly contemplated an independent contractor relationship.74

The court thus proceeded to consider whether the relationship between Royal and Kaykov fell under New Jersey’s control exception causing a principal to be liable for the torts of an independent contractor, to wit: whether Royal retained control of the “manner and means” of the performance of the work.75 This may be expressed through control “over the equipment to be used, the manner or method of doing the work, or direction of the employees of the independent contractor”. This type of control, which focuses on the principal’s level of control in the day-to-day relationship, is distinguished from “supervisory acts” performed by the principal which relate only “to the result to be accomplished, not to the means of accomplishing it.”

Notably, the court observed that although New Jersey courts look to similar factors and apply a similar analysis when determining whether an employer-employee relationship exists as when determining whether the control exception applies to a principal-independent contractor

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73 Under this factor, courts consider “the method of payment, whether by the time or by the job” to determine if an employer relationship exists. An individual who is paid by the job or receives a 1099 tax form is more likely to be considered an independent contractor, whereas an individual who receives an annual or hourly salary and is subject to the principal’s W-2 withholdings is more likely to be considered an employee because this creates a strong economic reliance on the employer and reduces the employee’s autonomy.

74 The court noted that the fact that Kaykov owned his own vehicle and other instrumentalities necessary for the business and was under no obligation to follow certain routes, including on the day of the accident, lent further support to this conclusion.

75 The other two exceptions are where the principal engages an incompetent contractor, or where the activity contracted for constitutes a nuisance per se.” Mavrikidis, 153 N.J. at 133, 707 A.2d 977 (citing Majestic, 30 N.J. at 431, 153 A.2d 321).
relationship, once it has been determined that an independent contractor relationship exists, New Jersey courts utilize a lower threshold for the level of control exercised by the principal in order to find that the exception to principal immunity applies.

The court determined that significant issues of material fact remained as to whether or not Royal exceeded the scope of general supervisory powers and retained or actually exercised sufficient control over Kaykov to expose it to liability for Kaykov's acts through the control exception. The court concluded that the existence of issues of disputed fact relative to the first Restatement factor (control retained by agreement) were compounded by factual disputes over Royal's actual practices, including whether franchisees were required to work specific shifts, and whether Royal receives and responds to complaints by customers, actually inspects the franchisees' vehicles, and has a hand in enforcing the Rulebook and/or imposing sanctions on franchisees. The court further determined that there were questions of material fact as to whether, in practice, there is sufficient separation between Royal and the franchisees' committee to dispel the suggestion, induced by the Rulebook's incorporation into the franchise agreement, that Royal retains sufficient control to render the relationship within the control exception. The court thus denied Royal's motion for summary judgment on Fletcher's cross-claim of contribution.

D. Janitorial Services Industry

The franchised dispatch service analyzed in Leach offers some intriguing parallels with the janitorial services industry, which has been the subject of several noteworthy decisions in recent years.

6. The Coverall System

In the Coverall North America, Inc. (“Coverall”) system, franchisees only clean at locations provided by Coverall. Franchisees are provided with a plan of action and directed to follow it by Coverall. The franchisees are required to allow Coverall to negotiate contracts and pricing directly with clients, bill clients, and provide a daily cleaning plan to which the franchisees are required to adhere, under the supervision of a Coverall field consultant. Any expansion of the franchisee’s business concurrently expands Coverall's clientele base, as each new customer became a Coverall client. Any complaints regarding the quality of the franchisee’s services are channeled directly through Coverall and resolved by a Coverall field consultant.

7. The Jani-King System

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76 The Leach court noted that the fact that the plaintiffs and Kaykov have dismissed their respective claims against Royal did not preclude Fletcher from seeking contribution and/or indemnification from Royal if Royal were to be found vicariously liable for Kaykov's acts, because "the cause of action owned by the plaintiff is distinct from the cause of action arising out of the duty of additional defendant to indemnify [or contribute to] the defendant." Cooper v. Phila. Dairy Prods., 34 N.J.Super. 301, 304, 112 A.2d 308 (1955).

77 The court concluded that Fletcher had no cause of action against Royal for indemnification or common law negligence, because Royal did not owe any legal duty to Fletcher.

By comparison, under the Jani-King International business model, Jani–King provides cleaning and janitorial services to large commercial clients and sells franchises to individuals or entities that perform the janitorial work for Jani–King’s clients. Franchisees pay an initial franchise fee and finder’s fee, paid in installments over the life of the agreement, with a down payment due on purchase. In return, franchisees receive a specific non-exclusive geographic territory, and during an initial period, Jani–King offers each franchisee a certain amount of centrally generated business, based on the size of the fee paid by the franchisee. In addition to centralized bidding, Jani–King centrally performs accounting, data management, and franchise training. In addition to the above fees, franchisees must pay Jani–King a number of other fees, including an accounting fee and an advertising fee. Franchisees agree to clean, interact with clients, and perform other business tasks according to Jani–King’s standardized procedures. For example, franchisees must purchase specific cleaning equipment, carry insurance, and report customer complaints to Jani–King. Franchisees also solicit clients directly, although they must comply with Jani–King’s procedures in doing so.

8. The Coverall Decisions (Massachusetts)

Having separately analyzed the Coverall arrangement, both the U.S. District Court for the District of Massachusetts and the Massachusetts Supreme Judicial Court concluded that Coverall franchisees do not constitute independent contractors. Both opinions analyzed the Coverall franchise arrangement under the three-part “ABC” test that is part of both the Massachusetts Independent Contractor statute, G.L. c. 149, §148B and the Massachusetts Unemployment Insurance law, G.L. c. 151A, §2. Under that test, an individual performing a service is considered an employee unless the franchisor (or principal) satisfies the burden of establishing the following three factors:

(a) the individual is free from control and direction in connection with the performance of the service, both under his contract for the performance of service and in fact;

(b) the service is performed outside the usual course of the business of the employer; and

(c) 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.

It is significant to note that subsection (a) of the ABC test is a combination of §220(2)(a) of the Restatement (Second) of Agency (the extent of control which, by the agreement, the master may exercise over the details of the work) and the control “exception” applied in Leach (which examines whether the principal “retains control of the manner and means of the doing of the work which is the subject of the contract”); subsection (b) is substantially similar to §220(2)(h) of the Restatement (whether or not the work is a part of the regular business of the employer); and subsection (c) roughly correlates to §220(2)(b) of the Restatement (whether or not the one employed is engaged in a distinct occupation or business).

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Thus, unlike *Leach*, which engaged in a balancing and totality of the circumstances analysis of each of the above factors in addition to considering the other Restatement factors in reaching a determination as to the nature of the Royal franchise relationship, the Massachusetts courts were (and are) statutorily required to rigidly deem the Coverall franchise relationship to be that of an employer-employee if *any* of the three ABC prongs were unsatisfied.

Consistent with the foregoing, both *Coverall* decisions turned on a single prong of the ABC test. Remarkably, neither decision addressed the first (control) prong of the test or otherwise determined whether the franchisees were free from Coverall’s control and direction in performing cleaning services, either contractually or in fact.

The *Coverall* federal court decision focused on the second ABC prong in the context of an unfair or deceptive trade practices claim filed by seven Coverall franchisees. The court allowed the franchisees’ motion for partial summary judgment on the basis that Coverall had misclassified the franchisees as independent contractors, finding that the services performed by the franchisees were not outside Coverall’s usual course of business. The court concluded that Coverall sells cleaning services, the same services provided by the franchisees. In so holding, the court rejected Coverall’s arguments that it is in the franchising business and not the commercial cleaning business, that it sells franchises and trains and supports the franchises but it does not clean any establishments nor employs anyone who performs the cleaning services.

The *Coverall* state court decision, issued four years earlier, turned on the third prong of the ABC test in the context of a franchisee’s claim for unemployment benefits. Under that prong, the court considered “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.”[^82] Stated differently, it is for the court to determine “whether the worker is wearing the hat of an employee of the employing company, or is wearing the hat of his own independent enterprise.”[^83] The court concluded that Coverall had failed to satisfy its burden of establishing that the claimant’s business was independent of Coverall, finding that the claimant was compelled to rely heavily on Coverall.

### 9. The Jani-King Decision (California)

A very different conclusion was reached during 2011 by a California federal district court, which analyzed the Jani-King franchise arrangement in *Juarez v. Jani-King of California, Inc.*[^84] In *Juarez*, four individuals who purchased Jani-King International franchises and performed janitorial work under the Jani–King franchise agreement sought class certification of their claims, which included six alleged violations of the California Labor Code, against the franchisor. The plaintiffs’ Labor Code claims presented a singular theory of liability: that Jani–King’s franchise system is a “scheme to evade responsibility for janitorial workers’ wages and job benefits by purporting to hire them indirectly (through the ‘franchises’) as ‘independent


contractors' while, in fact, retaining control over the work that Plaintiffs and other janitorial workers perform. The plaintiffs also argued that Jani–King so tightly controls and oversees the janitorial work done by its franchisees so as to create an employer-employee relationship, triggering the numerous employee protections provided by California’s Labor Code, such as payment of overtime wages, payment of California’s minimum wage, and itemized wage statements.

The Juarez court denied the motion for class certification, finding that there was very little - if any - common evidence among the plaintiffs tending to prove an employer-employee relationship between Jani–King and its franchisees, leaving aside the policies required to protect Jani–King’s service mark and goodwill.

The court proceeded to apply the California test – which is far less rigid than the Massachusetts ABC test – to determine the nature of the Jani-King franchise relationship. Under California law, which is primarily based upon the Restatement factors, “the principal test of an employment relationship is whether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired.” California courts also consider a number of additional factors in this inquiry, including:

a. the right of the principal to discharge at will, without cause;
b. whether the one performing services is engaged in a distinct occupation or business;
c. whether the work is usually done under the direction of the principal;
d. whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;
e. the length of time for which the services are to be performed;
f. the method of payment;
g. whether the work is a part of the regular business of the principal; and
h. whether the parties believe they are creating an employer-employee relationship.

The court found that the indicia of control presented by the plaintiffs merely reflected policies which Jani–King was required to abide by under California’s franchise law, and that such control “shows nothing more than that which makes the owners franchisees.” Such indicia of control included: (1) that through the franchise manuals and other documents, Jani–King directs the franchisees’ method of cleaning, their cleaning schedule, their contact with customers, and their manner of dress; (2) that franchisees must be reachable within four hours of contact and must notify Jani–King before going on vacation; (3) that franchisees are not permitted to handle customer complaints without notifying Jani–King and following specific procedures; (4) that franchisees must obtain Jani–King’s approval before they establish an office location, use a trade or business name, or create a vehicle display; and (5) that franchisees must “always use Jani–King’s name and Jani–King’s phone number with clients.”

85 Id., at 575.
87 Id., citing S.G. Borello & Sons, 48 Cal.3d at 351.
88 Id., at 582.
89 Id., at 581.
The court concluded that such requirements merely reflected Jani-King’s efforts to substantially associate the system with its service mark.

The court observed that the substantial public policy reasons for shifting to employers (upon the establishment of a prima facie case that the plaintiff provided services for the employer) the burden of disproving an employment relationship – such as countering an employer’s strong motive to circumvent the costs of compliance with the California Labor Code by creatively classifying its workers as independent contractors90 - do not weigh as heavily in the franchise context. The court noted that this is so because franchisors are subject to a considerable amount of regulation that does not apply to independent contractors or employees, such as the Franchise Rule.

10. **Impact Of The Coverall And Jani-King Decisions**

   Notwithstanding the unique nature of the narrow and rigid ABC test at issue in Coverall, of particular concern for franchisors and franchisees alike is the notion advanced by the Coverall federal court that franchisees act in the same “usual course of business” as their franchisors.91 In this regard, the court rejected the argument that franchising is a business in itself – which the court remarked “sounds vaguely like a description for a modified Ponzi scheme” - rather than a company that is in the business of selling goods or services, which uses the franchise model as a means of distributing the goods or services to the final end user without acquiring significant distribution costs.92 As support for its ruling, the court pointed out that Coverall developed the system used by the franchisees "as the result of the expenditure of time, skill, effort, and money", it trains its franchisees and provides them with uniforms and identification badges, it contracts with and bills virtually all customers and retains a percentage of the revenue earned on every cleaning service.93

   The ruling that franchisees act in the same “usual course of business” as their franchisors could have vast potential implications for franchising.94 If the term “usual course of business” were construed to include any function related to distributing a product or service, the multiple levels of virtually every distribution system would be deemed to be in the “same business”. In other words, each senior distribution layer would be deemed to be the “employer” of the next junior layer. As has previously been observed at the ABA Forum on Franchising, labeling one’s business a “franchise” has “wide ranging effects on parties’ rights and responsibilities,” effects that are not assumed lightly.95

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90 See *Narayan v. EGL, Inc.*, 616 F.3d, 895, 900 (9th Cir.2010).

91 *Awuah*, 707 F.Supp.2d at 84.

92 *Id.*

93 *Id.*


It has been argued that upholding the federal court’s classification ruling may have disastrous consequences for franchising, particularly in Massachusetts. For example, the ruling could force all franchise owners into unwanted employment relationships and deny franchise owners the opportunity to invest in and build their own businesses. Four certified questions in Coverall (concerning wages, damages and worker’s compensation issues under Massachusetts law in the context of that case) are currently being considered by the Massachusetts Supreme Judicial Court.

E. An Inconvenient Truth: Control in the Convenience Store Industry

The strict controls imposed by convenience store franchisors such as 7-Eleven upon franchisees naturally have attracted claims of vicarious liability. For example, in Singh v. 7-Eleven, Inc., two employees of a 7-Eleven, Inc. franchise location sought to recover unpaid overtime and meal break compensation from the franchisor under the Fair Labor Standards Act and the California Labor Code. The court granted 7-Eleven’s motion for summary judgment on all claims, finding no evidence to indicate that 7-Eleven controlled the daily activities of the franchise store.

To determine whether 7-Eleven was the plaintiffs’ joint employer under a “vertical” relationship (in which a company has contracted-for workers who are directly employed by an intermediary company), the Singh court applied the “economic reality test”. Under that test, the court considers “the totality of the circumstances of the relationship, including whether the alleged employer has the power to hire and fire the employees, supervises and controls employee work schedules or conditions of employment, determines the rate and method of payment, and maintains employment records.”

The court found no evidence to support the plaintiffs’ argument that the franchisee’s right to run the operation was illusory and that, in reality, the franchise agreement allowed 7-Eleven to control the essential terms and conditions of employment. To the contrary, the court found that 7-Eleven neither reserved nor exercised control over any terms of the employment or employee training, nor influenced the franchisee’s hiring decisions. The franchise agreement contained explicit disclaimers of 7-Eleven’s non-control over the franchisee’s employees, reciting that (i) the franchisee agreed “to exercise complete control over and responsibility for all labor relations and the conduct of [its] agents and employees, including the day-to-day operations of the Store and all Store employees”, (ii) the franchisee and its agents and employees “may not be considered or held out to be [7-Eleven’s] agents or employees”, (iii) that 7-Eleven will not exercise “any discretion or control” over the franchisee’s employment policies or decisions, and (iv) all store employees are solely [the franchisee’s] employees.”

The court likewise found that the franchisee had exclusive control over the plaintiffs’ work schedules. In this regard, the court did not find it significant that 7-Eleven set the store

96 Mr. Meretta’s firm, Witmer, Karp, Warner & Ryan LLP, has filed an Amicus brief on behalf of the International Franchise Association in the Awuah matter and is engaged in efforts to revise the laws governing the definition of independent contractors in Massachusetts.


98 2007 WL 715488, at 3 (quoting Hale v. State of Arizona, 993 F.2d 1387, 1394 (9th Cir. 1993).

99 Id., at 3.
hours to be 24 hours a day, or retained control over the delivery of service by the plaintiffs, or inspected the plaintiffs’ uniforms and equipment, or instructed the plaintiffs to check IDs when selling alcohol and cigarettes. The court observed that 7-Eleven’s enforcement of these terms and conditions was limited, and that its remedies under the franchise agreement – allowing it to terminate the agreement on three days’ notice with the opportunity to cure the violation in most cases – did not permit 7-Eleven to interfere with the day-to-day operations of the store.\(^\text{100}\)

Finally, the court found that 7-Eleven was neither responsible for setting the plaintiffs’ wages, nor for using its own funds to pay the plaintiffs’ compensation, nor for providing any employment benefits. Although 7-Eleven provided payroll functions and generated the plaintiffs’ paychecks, the court determined that these acts were ministerial, done for the franchisee’s convenience, and did not suggest that 7-Eleven controlled labor relations.

Although it avoided vicarious liability in \textit{Singh}, additional indicia of control exercised by 7-Eleven over its franchisees are being revealed through increasingly strict post-Enron financial reporting regulations. In particular, pursuant to the 2007 Financial Accounting Standards Board’s revised interpretation of Accounting Research Bulletin No. 51 (“FIN 46R”, “Consolidation of Variable Interest Entities”), publicly held franchisors must consolidate into their financial statements the assets, liabilities, equity and results of Variable Interest Entities (VIEs), which are entities in which the company has a controlling financial interest.

In the wake of the new financial reporting regulations, 7-Eleven and some other franchisors have identified their franchisees as VIEs. For example, 7-Eleven has explained in its 10-K:

\begin{quote}
We include the franchise stores’ merchandise sales and cost of sales in our financial statements because we believe that we retain a more significant financial and merchandising advisory role in the franchise business than is present in most other franchisor/franchisee relationships. For example, unlike most franchise models, we own or lease the stores and equipment used by the franchisees as well as provide financing, bookkeeping, advertising, business consulting and other services. Due to this level of involvement and our retention of certain business risks associated with the ownership or leasing of franchised locations and the equipment used by franchisees, we believe that our financial statement presentation appropriately reflects the substance of this combined economic relationship.\(^\text{101}\)
\end{quote}

It remains to be seen whether such additional indicia of control will be deemed to tip the scales in favor of imposing vicarious liability on franchisors that identify franchisees as VIEs.

\textbf{F. Security Requirements Vs. Recommendations: Voluntary Assumption of Duty}

A franchisor may also inadvertently create potential liability exposure for itself by imposing mandatory security procedures on its franchisees. In this regard, when deciding whether the terms of a franchise agreement give rise to vicarious liability, “courts typically draw

\(^{100\text{ Id.}, \text{at 5.}}\)

\(^{101\text{ 7-Eleven, Inc. Form 10-K (March 15, 2004)}}\)

[http://markets.financialcontent.com/mi.newsob/action/getedgarwindow?accesscode=119312504042330]
distinctions between recommendations and requirements” and are reluctant to impose liability based on mere suggestions.\(^\text{102}\)

3. **Mandatory Security Policies**

Numerous courts have held that through the imposition of such mandatory procedures, the franchisor has voluntarily assumed a duty of care to the franchisee’s employees and may be held liable in negligence for failing to exercise due care to protect those employees from harm caused by the criminal acts of others.


For example, in *Martin v. McDonald’s Corp.*,\(^\text{103}\) the court rejected McDonald’s contention that it had no duty to protect its franchisee’s employees from criminal acts committed by others during a robbery of the franchise location. The plaintiffs were the parents of an employee who was murdered during the robbery, and two employees who were assaulted. The *Martin* court upheld the judgment entered against McDonald’s following the trial, reasoning that although the law did not impose a duty on McDonald’s to protect its franchisee’s employees from harm, McDonald’s had voluntarily assumed a duty to the victims. The court noted that, recognizing the threat of armed robberies and the importance of security in its restaurants, McDonald’s had formed a department to deal with security problems and prepared a “bible” for restaurant security operations. McDonald’s also employed a regional security manager who served as the franchisee’s security supervisor, and he not only undertook the obligation to check for security problems, he communicated McDonald’s security policies to store management and followed up to ensure that the problems had been corrected and that the “recommended” security procedures were being followed.\(^\text{104}\)


Similarly, a trial verdict against Domino’s Pizza was upheld under a voluntary-undertaking theory of liability in *Decker v. Domino’s Pizza, Inc.*\(^\text{105}\) In *Decker*, an employee of a Domino’s franchisee was seriously injured during a robbery. The court found that Domino’s “undertook to do more than just provide a time-delay safe to its franchisees. Defendant undertook to provide a security program that would deter robbery and protect employees from harm in the event of a robbery by providing the appropriate training and information.”\(^\text{106}\) In particular, Domino’s had formed a committee to study security issues, adopted a mandatory cash management system involving the use of time-delay safes in franchisees’ stores, produced literature regarding robbery prevention, employed a franchise consultant to ensure compliance with the franchisor’s standards (including robbery prevention) and to ensure that management trainees were properly trained in safety and security, maintained a security hotline, and provided


\(^{104}\) *Martin*, 213 Ill.App.3d at 491.


\(^{106}\) *Id.*, at 527.
store safety kits which contained posters warning of a time-delay device on the in-store safe. Under these circumstances, the court found that Domino’s was obligated to perform with reasonable care the robbery-prevention measures that it undertook to provide.


In *Greil v. Travelodge Intern., Inc.*,\(^{107}\) it was held that a question of fact existed as to whether Travelodge International, Inc. was sufficiently involved in the day-to-day operations of a franchised motel location so as to create an actual agency relationship. The plaintiff was a guest of the franchisee motel who was injured when he jumped from his second story room to the sidewalk below to escape an attempted robbery in his motel room.

The Travelodge license agreement, which required that the franchisee operate the motel in a “clean, safe and orderly manner”, also required the franchisor’s written consent to deviate from specific standards and procedures and granted Travelodge the right to supervise the operations, a right that the franchisor frequently and regularly exercised.\(^ {108}\) In particular, among the many items that Travelodge checked, found deficient, and called to the franchisee’s attention for correction were matters involving the safety of guests, including parking area lighting, locks on the premises and latches and locks on windows.

Based on these facts, the *Greil* court found that the criminal’s intrusion into the plaintiff’s motel room created a question of material fact as to whether the break-in could have been prevented, and whether Travelodge, the franchisee or both had failed to provide “clean, safe and orderly” accommodations.


In *Lawson v. Schmitt Boulder Hill, Inc.*,\(^ {109}\) involving injuries sustained by an employee of an McDonald’s franchisee who was attacked in the restaurant parking lot, the court observed that *Martin, Decker* and other cases illustrate that whether a franchisor maintains mandatory security procedures is a crucial factor in determining whether the franchisor has voluntarily undertaken a duty of care toward a franchisee’s employees. The *Lawson* court reversed the trial court’s ruling granting McDonald’s motion to dismiss, finding that McDonald’s had not overcome the plaintiff’s allegations that McDonald’s mandated compliance with security procedures, including required lighting and procedures relating to restaurant parking lots. The court found that McDonald’s had failed to satisfy its initial burden to affirmatively show that it did not undertake a duty of care – specifically, that McDonald’s did not present evidence concerning the *Martin and Decker* factors, e.g. whether McDonald’s produced a security “bible,” whether it maintained any security committees, or whether any McDonald’s employees served as security supervisors for its franchisees’ operations.

4. **Recommended Security Policies**

\(^{107}\) 186 Ill.App.3d 1061, 541 N.E.2d 1288 (Ill.App. 1 Dist.,1989).

\(^{108}\) Id., at 1293.

Conversely, where a franchisor merely makes recommendations with respect to security measures, but does not mandate that such measures be implemented, courts have found that no duty of care exists between the franchisor and its franchisee’s employees. For example, in *Helmchen v. White Hen Pantry, Inc.* 110 the franchisor was held not to be vicariously liable for the death of its franchisee’s employee who was abducted from the store, raped and murdered. Although the *Helmchen* franchisor took steps to heighten awareness and offer suggestions to its franchisees regarding security issues, and employed a “director of loss prevention” who discussed loss prevention strategies with the franchisees, the franchisor did not specifically mandate any security measures.

In *Castro v. Brown's Chicken & Pasta, Inc.*, 111 the court affirmed summary judgment in favor of the franchisor regarding negligence claims filed by the administrators of the estates of two victims of a mass murder that occurred at a franchise restaurant location. The *Castro* court found that the franchisor left security measures to the discretion of individual franchisees; it did not mandate that any security procedures be followed, it did not supply franchisees with any written materials. 112 Moreover, the franchisor’s routine quality inspections were limited to matters of food safety and accident prevention and did not relate to crime prevention. 113 The *Castro* court carefully distinguished *Martin* and *Decker*, noting that unlike McDonald’s and Domino’s, the franchisor in *Castro* “did not implement mandatory security measures to be followed by the franchisee, it did not follow up to make sure that security recommendations were followed, it did not provide security for the Palatine restaurant or engage in routine security checks, and it did not set up a security hotline or a committee to review security measures.” 114

Toward this end, in *Chelkova v. Southland Corp.*, 115 the court affirmed summary judgment in favor of a convenience store franchisor on the basis that it owed no duty to a franchisee’s employee who was sexually assaulted while working alone at the store during a late-night shift. The court found that the franchisor offered the services of field consultants to address security matters, prepared a robbery prevention kit, provided training to franchisees concerning rape and robbery prevention, and paid for a security system provided by an outside vendor. However, the franchisees were not required to follow the defendant’s recommendations and that the security system paid for by the defendant was optional. Whereas Dominos, in *Decker*, “took affirmative action to ensure compliance with its security standards,” the *Chelkova* franchisor permitted the franchisee to run the business as it saw fit. 116 The *Chelkova* court found *Martin* to be distinguishable for similar reasons, noting that “McDonald’s clearly undertook to implement and enforce security measures at the store in question.” 117

G. Training And Inspections

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112 Id., at 550.
113 Id.
114 Id., at 552.
116 Id., at 724.
117 Id., at 725.
Virtually all franchisors provide some form of training to new franchisees and conduct periodic inspections of the franchise location during the term of the franchise agreement. Under certain circumstances, however, such training and inspections may render the franchisor vicariously liable for harm that occurs involving the subject of such training or inspections.

3. **For Informational Purposes Only: Rainey v. Langen (2010)**

Considering franchisor vicarious liability as a case of first impression in Maine, the Supreme Judicial Court of Maine in *Rainey v. Langen*\(^{118}\) affirmed the trial court’s grant of summary judgment in favor of Domino’s Pizza, LLC regarding the negligence claim of a motorcyclist who was injured in a collision with a pizza delivery vehicle driven by an employee of a Domino’s franchisee. The court held that Domino’s did not retain sufficient control over the franchisee so as to subject itself to vicarious liability for the motorcyclist’s injuries.

*Rainey* concluded that the numerous quality control requirements and minimum operational standards in the Domino’s franchise agreement and “Manager’s Reference Guide” fell short of reserving control over the performance of the franchisee’s day-to-day operations.\(^{119}\) The court’s determination that the Domino’s franchisee was an independent contractor turned on an analysis of an eight-factor test which closely corresponds to the Restatement test\(^{120}\) that had been used in Maine for 80 years,\(^{121}\) and particularly on the degree of control reserved by Domino’s, as evidenced by the Agreement and Guide.\(^{122}\)

In reaching its decision, the *Rainey* court found it to be particularly important that the agreement specified that the supervision and operation of the franchise store was the franchisee’s “sole responsibility” and that it was not Domino’s “responsibility or duty” to implement employee training programs.\(^{123}\) The court further noted that, although bound by certain mandated minimum requirements, the franchisee determined the schedule and wages of its employees and made all day-to-day decisions concerning the hiring, firing, training, supervising, and disciplining of its employees.

Although Domino’s retained the right to conduct inspections and terminate the franchise relationship, the court found that those conditions did not constitute sufficient control to impose vicarious liability. The sections of the Guide upon which the plaintiffs based their claim of

\(^{118}\) 998 A.2d 342, 349-351 (Me.,2010).

\(^{119}\) *Id.*, at 350.

\(^{120}\) These factors are: (1) the existence of a contract for the performance by a person of a certain piece or kind of work at a fixed price; (2) the independent nature of the business or his distinct calling; (3) his employment of assistants with the right to supervise their activities; (4) his obligation to furnish necessary tools, supplies, and materials; (5) his right to control the progress of the work except as to final results; (6) the time for which the workman is employed; (7) the method of payment, whether by time or by job; and (8) whether the work is part of the regular business of the employer.

\(^{121}\) This test was originally set forth in *Murray’s Case*, 130 Me. 181, 186, 154 A. 352, 354 (1931).

\(^{122}\) Like numerous other cases, *Rainey* recognized that the declaration in the franchise agreement the parties are “independent contractors” was relevant but not controlling. *Id.*, at 350, citing *Campbell v. Wash. Cnty. Technical Coll.*, 219 F.3d 3, 7 (1st Cir.2000).

\(^{123}\) *Rainey*, supra at 350.
vicarious liability specifically stated that they were for “informational purposes only" and that the franchisee was not required to adopt or use any policy or practice contained in those sections.124 Moreover, the court observed that the few mandatory sections of the Guide, while comprehensive and detailed, do not dictate the precise methods by which the franchisee is required to carry out its daily responsibilities. The Guide further provided that “franchisees are solely responsible for the terms and conditions of employment applicable to their team members.” The court concluded that the quality, marketing, and operational standards present in the Domino’s franchise agreement and Guide did not establish the supervisory control or right of control necessary to impose vicarious liability.

Notably, Rainey identified several other factors that it found to be inconsistent with an employer-employee relationship, to wit: (1) that franchising, by its nature, typically involves the licensing of “independent businessmen” to sell the franchisor's product or service,125 (2) that the franchisee was responsible for purchasing or leasing its own equipment and supplies; and (3) that Domino’s did not compensate the franchisee as its employee; rather, the franchisee was paid by its customers and provided Domino’s with a royalty fee. At first glance, these observations appear to be at odds with the federal court’s findings in the Coverall case that franchisees act in the same “usual course of business” as their franchisors, that franchising is a business in itself.126 The facts of these cases are distinguishable, however, in that the Coverall franchisees received compensation from the franchisor, rather than directly from the customer as the Domino’s franchisee did. In addition, unlike the Coverall arrangement in which the nature of the business compelled the franchisees to depend on the franchisor for the continuation of the cleaning services, the Domino’s franchisee did not depend on Domino’s to provide pizza delivery customers.


In Braucher ex rel. Braucher v. Swagat Group, L.L.C.,127 one plaintiff died and another became ill from an outbreak of Legionnaires Disease in the pool and spa area of a Comfort Inn. As a result, the franchisor, Choice Hotels, International, Inc., faced several negligence-based claims along with the hotel franchisee. The court granted summary judgment to Choice Hotels, finding that neither the franchise agreement nor Choice Hotels’ actions created a duty to the plaintiffs regarding the operation of the hotel pool and spa.

The court noted that although a franchisor may assert sufficient control of a hotel so as to be responsible for the operation of the pool and spa, the steps taken by Choice Hotels in Braucher did not go beyond the limited steps necessary for Choice Hotels to maintain the required level of quality associated with the franchised brand so as to protect its trademarks – such as by setting operational standards, retaining the right of periodic inspections, and retaining the right to terminate the franchisee should it fail to comply with the franchisor’s standards.

124 Id., at 345.
125 Id., citing 1 Gladys Glickman, Franchising § 2.01.
126 Awuah, 707 F.Supp.2d at 84.
127 702 F.Supp.2d 1032 (C.D.Ill., 2010).
The court held that Choice Hotels’ actions in making visual inspections of the pool and spa twice a year and retaining the right to close the pool and spa if the water was cloudy (to prevent drowning) did not establish a duty to the plaintiffs. Choice Hotels also did not impose any requirements for controlling bacteria levels in the pool and spa, and it did not test the water quality. Under these circumstances, the court found that the franchisor was simply maintaining the quality of its brand.

H. Control Over Franchisees’ Employees

The recommendations-versus-requirements distinction is equally applicable in the Title VII context. Courts have been nearly uniform in holding that a franchisor should not be deemed to be an “employer” for purposes of Title VII when the plaintiff works for an independently owned franchise. Those courts that have found a franchisor to be an employer under Title VII generally have reached this conclusion only after determining that the franchisor required the franchisee to adopt specific employment policies.

In McFarland v. Breads of the World, LLC, Panera, LLC (Panera), a wholly owned subsidiary of Panera Bread Company (Company), was sued for discrimination by an employee of a Panera franchisee (Breads). The employee claimed that, by virtue of its franchisor-franchisee relationship with Breads, Panera was his employer for Title VII purposes, either as his single employer, a joint employer with the franchisee, and/or under agency principles. The court rejected all three theories.

Applying the Sixth Circuit’s four-factor “single employer” test - (1) the interrelation of operations between Panera and Breads; (2) whether the two entities shared common management, common directors and boards; (3) whether Panera exercised centralized control over Breads’ labor relations and personnel; and (4) whether Panera and Breads were under common ownership and financial control - the McFarland court concluded that there was no evidence that Panera controlled Breads’ day-to-day labor relations such that the two entities could be considered to be the plaintiff’s single employer.

McFarland held that the type of “limited authority” exercised by Panera to approve Breads’ operations and financial records pursuant to the franchise agreement was insufficient to prove that the two entities were a single employer. In so holding, the court noted the following factors: (a) the franchise agreement provided that Breads was an independent contractor and identified Breads as an independent owner of a Panera franchise location; (b) the agreement prohibited Breads from making any express or implied agreements, warranties, guarantees or representations or incurring any debts in the name of Panera or on its behalf, (c) there were no common officers or directors among Breads and Panera, and (d) neither Panera nor the

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Company played a role in Breads' payroll system or maintained Breads' business records, just as Breads did not fulfill these functions for Panera or the Company; and (e) Panera did not own or maintain Bread's real estate, or any of the fixtures or food products at Bread's locations.

The court likewise found no evidence that Panera played a central role in Breads' labor relations, a factor which is particularly relevant in the Title VII context. Although certain courts have found an agency relationship where a franchisor requires its franchisee to hire, train, and supervise employees in accordance with extensive guidelines and reserves the right to impose discipline upon employees engaging in discriminatory acts,\(^{132}\) *McFarland* held that, at most, Panera exercised only "the type of minimal control over Breads' labor relations that one would expect of a franchisor."

In particular, the court determined that Panera did not exercise any form of control over Breads' employment decisions, where: (i) Panera did not involve itself in in the hiring, firing, disciplinary, or day-to-day decisions with respect to Breads' employees, and it expressly disclaimed any right to do so in the franchise agreement; (ii) the agreement stated that Breads was solely responsible for all employment decisions with respect to its personnel, regardless of whether Breads received advice from Panera; and (iii) neither the plaintiff's job application nor the employee handbook, upon which the plaintiff relied to support his discrimination claims, contained any reference to the franchisor.

Noting that the Sixth Circuit's recognition that the single employer theory and the agency theory are "essentially the same", the court applied the above findings to dispose of the plaintiff's agency claim and rejected his allegation that Breads and Panera were his joint employers.\(^{133}\)

II. **Jurisdictional Application**

The establishment of an agency relationship has additional implications for franchisors beyond vicarious liability and employment issues. For example, agency principles are equally applicable where the issue is personal jurisdiction. A number of courts have employed the concept of actual or apparent authority to exercise jurisdiction over a principal, or alternatively, have declined to exercise jurisdiction where a claimed agency relationship is not proven.

In *Bauer v. Douglas Aquatics, Inc.*,\(^ {134}\) Douglas Aquatics, Inc., a Virginia pool management and construction company franchisor was held to have established minimum contacts sufficient to be subject to jurisdiction in North Carolina under an apparent agency theory, based upon representations on the franchisor's website regarding its Charlotte franchisee, DA Charlotte. In particular, the franchisor's website represented that "[DA Charlotte] is one of five [of] Douglas [Aquatics], Inc.'s locations throughout Virginia and North Carolina," and that "Douglas [Aquatics], Inc. opened its fifth location in Charlotte, North Carolina in 2005 trading as Douglas Aquatics Charlotte". The website further described DA Charlotte as one of Douglas Aquatics, Inc.'s locations that provides pool construction needs in the Charlotte, North Carolina area. The court found that such representations constituted words or conduct representing or permitting it to be represented that DA Charlotte is its agent, notwithstanding the disclaimers of agency found in the franchise agreement (declaring the parties' relationship to be


\(^{133}\) *McFarland*, supra, citing *Satterfield v. Tennessee*, 295 F.3d 611, 618 n. 6 (6th Cir.2002) (collecting cases).

\(^{134}\) 698 S.E.2d 757, 764-767 (N.C.App.,2010).
independent, and that the franchisee is specifically prohibited from representing itself as the franchisor’s agent or engaging in any activity which would purport to bind the franchisor) were of no moment, since the plaintiff consumer who contracted with DA Charlotte was never privy to the franchise agreement.

The lessons of Bauer are particularly apt for franchisors that sometimes fall into the trap of posting website content solely with an eye toward attracting prospective franchisees or customers. A franchisor may create exposure for itself even outside the four corners of its franchise agreement and operating manual.

III. INVOLVEMENT IN THE MANUFACTURE, BRANDING AND DISTRIBUTION OF GOODS AND SERVICES

Many franchisors generally are aware of numerous types of risks that are associated with participation in the product distribution chain, such as potential exposure to claims based upon antitrust, disclosure violations, breach of contract or breach of the covenant of good faith and fair dealing. Such participation in the distribution of products sold at franchised outlets – whether directly or through related entities – also carries significant risks in the product liability area, an issue that has remained largely unaddressed in franchising.

Whether by designating sources of product supply, receiving rebates or other consideration on account of franchisee purchases, developing specifications for the manufacture of products, supervising the manufacturing process for quality control or other purposes, participating in the chain of title of products destined for franchised outlets, or mandating minimum or maximum resale pricing restrictions, a franchisor’s participation in the distribution of products sold at franchised outlets can give rise to potential strict product liability and other tort claims filed by consumers, franchisees and others.

The quiet rise in strict product liability claims against franchisors is not altogether surprising. As one commentator observed many years ago, “[p]roducts liability fits naturally into the franchise system. Franchising’s very purpose is to put products into the ‘stream of commerce’. Thus, depending upon the franchisor’s relation to the product, strict liability can be a significant vehicle of recovery.”

A. Overview Of Key Products Liability Concepts

1. The Nature Of Strict Products Liability

The liability of manufacturers, sellers and distributors of defective products that cause injury to persons or property is governed by state law and varies from jurisdiction to jurisdiction. Under the doctrine of strict products liability, a manufacturer is liable for harm caused by a defective product, despite the manufacturer’s exercise of due care, and even absent contractual privity with the person harmed. The imposition of liability without fault derives from the recognition that a commercial seller of any product having a manufacturing defect should be liable in tort for harm caused by the defect, irrespective of the plaintiff’s ability to maintain a traditional negligence or warranty action. In effect, strict products liability “merges the

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135 Stuart, John F., A Franchisor’s Liability for the Torts of his Franchisee, 5 University of San Francisco Law Review 118 at 134.

136 Restatement of the Law (Third), Torts: Product Liability, § 1 comment a.
concept of implied warranty, in which negligence is not required, with the tort concept of negligence, in which contractual privity is not required."\textsuperscript{137}

2. **What Constitutes A Product?**

In the context of strict products liability analysis, many of the goods that are required to be purchased by franchisees in the operation of their franchised outlets constitute “products”, meaning “tangible personal property distributed commercially for use or consumption.”\textsuperscript{138} Items such as real property and electricity also may be deemed “products” where the context of their distribution and use “is sufficiently analogous to the distribution and use of tangible personal property” that it is appropriate that they be treated as products.\textsuperscript{139} Importantly for franchising, services are not considered products for strict liability purposes, even when those services are provided commercially.\textsuperscript{140} However, the underlying products used to make finished consumer products – such as cheese and dough used to make pizza, or ice cream or frozen yogurt - all constitute products which, if defective, may give rise to strict products liability.

3. **Is It A Product Or A Service?**

Distinguishing between products and services is not always simple and straightforward. Two recent decisions – *Ontiveros v. 24 Hour Fitness USA, Inc.*\textsuperscript{141} and *Nafar v. Hollywood Tanning Systems, Inc.*\textsuperscript{142} – highlight the difficulty in distinguishing between the two as well as the distinction’s potentially case dispositive significance in products liability analysis.

In *Ontiveros*, the plaintiff was injured at a fitness center owned and operated by the defendant, when two steps of the stair-step machine on which she was exercising collapsed. She brought a claim for strict products liability against the defendant. The trial court granted summary judgment for the defendant as a result of the plaintiff’s written acknowledgements in her membership agreement that the defendant could not be held liable for defective exercise equipment and that the defendant provided “recreational services.” A California appellate court affirmed the judgment for the defendant, concluding that the “dominant purpose” of the plaintiff’s membership agreement was for the provision of fitness services, and that the defendant therefore was not strictly liable to the plaintiff under a product liability theory of recovery.\textsuperscript{143}

The principal issue on appeal was whether the dominant purpose of plaintiff’s membership agreement was (a) the provision of fitness services, in which case the defendant could not be strictly liable for defective equipment, or (b) the use of fitness equipment, which

\textsuperscript{137} *Id.*

\textsuperscript{138} Restatement of the Law (Third), Torts: Product Liability, § 19(a).

\textsuperscript{139} *Id.*


would render the defendant strictly liable because the defendant “would, in effect, be in the chain of distribution.”

In concluding that the dominant purpose of the membership agreement involved the provision of fitness services, the *Ontiveros* court observed that in addition to entitling the plaintiff to use exercise equipment, the membership agreement entitled her to take classes and other activities offered at the center, and to take advantage of testing centers where she could check her blood pressure and weight. The court found that the defendant was in “the business of providing fitness services and made exercise machines available to members as an incident to those services.” The court accordingly held that the defendant was entitled to summary judgment on the products liability claim.

In contrast to the *Ontiveros* decision, a district court in New Jersey held in *Nafar v. Hollywood Tanning Systems, Inc.* that tanning services offered at a franchised location of a tanning salon system did not constitute “services” within the meaning of New Jersey’s Product Liability Act. The plaintiff alleged that the defendant franchisor had (i) exaggerated the benefits of tanning and the tanning booths that it manufactured, designed and distributed for use in its franchise locations, and (ii) failed to warn her about certain dangers associated with their use. Arriving at a conclusion that the plaintiff wished to avoid — because she had elected to plead fraud, rather than products liability claims — the court found that the actionable conduct at issue pertained to “goods”, rather than “services.” The court stated:

Defendant’s service itself did not cause the harm, if any, suffered by Plaintiff. The alleged harm results from the purported lack of adequate warning(s) on Defendant’s product. Moreover, this is not an instance where Defendant provided a service and the purportedly defective ‘product’ was simply incidental to that service. [Citation omitted]. Here, instead, Defendant manufactured, designed and distributed the tanning beds used in its franchises. Any injury arising out of the use of the beds is properly characterized as a products liability action.

To truly appreciate the *Nafar* court’s holding, it is important to understand the procedural posture of the case. The complaint asserted claims under New Jersey’s Consumer Fraud Act, and for fraud, unjust enrichment and breach of warranty. Because the plaintiff is statutorily prohibited from pursuing dual claims under the CFA and under New Jersey’s Products Liability Act, and because she had not yet suffered personal injuries as a result of the tanning, she expressly disclaimed any personal injury damages and instead sought treble and punitive

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144 *Id.*, at 810.

145 *Id.*, at 21.

146 The *Ontiveros* court acknowledged that the facts before it were not as compelling as those in *Ferrari v. Grand Canyon Dories*, 32 Cal.App.4th 248, 259; 38 Cal.Rptr.2d 65 (1995), which held that a customer injured by a defective whitewater raft could not prevail on a products liability claim against the tour operator who provided the raft, because the service provided was recreational raft transportation; the provision of the raft was “merely incidental” to the service rendered.


148 *Id.*, at 18.

149 *Id.*, at 20.
damages through her fraud-based claims associated with her purchase of the tanning services, based upon the defendant's failure to inform her of the dangers associated with tanning.

The defendant moved for judgment on the pleadings as to the CFA claims, arguing that those claims were subsumed by the PLA and therefore not separately actionable. The court initially denied the motion, noting that plaintiff was not claiming physical injuries but rather monetary harm (her purchase of defendant's services) caused by defendant's failure to inform her of the dangers associated with tanning. The defendant subsequently moved again for partial judgment on the pleadings, citing new authority in support of its argument that the plaintiff's claim essentially was a products liability claim, and that her CFA claim therefore was subsumed by the PLA. This time, the court granted the motion, recognizing that "any claim within [the PLA's] coverage (i.e., products liability claims) cannot also be brought pursuant to the CFA." 150

The lesson of Ontiveros and Nafar is that it can be difficult to determine whether the instrumentality causing the alleged harm is a product or service, particularly when a customer receives both.

4. **Types Of Defects**

Products may be deemed defective in three distinct respects. 151 A "manufacturing defect" exists when a product was not manufactured in accordance with its intended design, that is, when it "departs from its intended design even though all possible care was exercised in the preparation and marketing of the product." 152 A product suffers a "design defect" when it was manufactured in accordance with its intended design but the design itself was defective, that is, when the foreseeable risks the product poses "could have been reduced or avoided" by "a reasonable alternative design" and the failure to adopt the alternative design "renders the product not reasonably safe." 153 Obviously, manufacturing defects "occur in only a small percentage of units in a product line," whereas a design defect will affect every unit manufactured. 154 Finally, a product may be deemed defective because it is sold without adequate warning or instruction, like the tanning services at issue in Nafar v. Hollywood Tanning Systems. 155 This type of defect will be found where the foreseeable risks posed by the product's use could have been avoided or reduced by providing "reasonable instructions or warning" and the failure to provide such instructions or warnings "renders the product not reasonably safe." 156

B. **Liability Standards** 157

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151 This categorization is reflected in state statutes, see, e.g., N.J.S.A. 2A:58C-2 (defining three type of defects actionable under the New Jersey Products Liability Act), recognized in the case law, see, e.g., Caterpillar Tractor Co. v. Beck, 593 P.2d 871, 881 (Alaska 1979), and adopted by the American Law Institute, see Restatement (Third), § 2.

152 Restatement of the Law (Third), Torts: Product Liability, § 2(a).

153 Id., § 2(b).

154 Restatement of the Law (Third), Torts: Product Liability, § 1 comment a.


156 Restatement of the Law (Third), Torts: Product Liability, § 2(c).
1. **“Seller” Liability**

Section 1 of the Restatement of the Law (Third), Torts: Products Liability (1998), provides simply that “[o]ne engaged in the business of selling or otherwise distributing products who sells or distributes a defective product is subject to liability for harm to persons or property caused by the defect.”

The plain language makes clear that strict products liability is not imposed solely on manufacturers and is not limited to sales. One “sells” a product by “transfer[ring] ownership” of it either for use or consumption or for resale for eventual use or consumption, including manufacturers, wholesalers and retailers. “Sellers” of products sold through a franchised outlet would therefore include manufacturers, distribution centers, others in the chain of title, and franchisees. One “otherwise distributes” a product by “provid[ing] the product to another” either for use or consumption or “as a preliminary step leading to” use or consumption. The term “distributors” would include lessors, bailors, and others who provide products to others “as a means of promoting either the use or consumption of such products or some other commercial activity.” Non-manufacturing sellers and distributors are subject to liability “even when [they] do not themselves render the products defective and regardless of whether they are in a position to prevent defects from occurring.”

2. **Apparent-Manufacturer Liability**

Section 14 of the Restatement (Third) codifies what is sometimes referred to as apparent manufacturer liability. Section 14 provides that “[o]ne engaged in the business of selling or otherwise distributing products who sells or distributes as its own a product manufactured by another is subject to the same liability as though the seller or distributor were the product’s manufacturer.”

The fact that Section 1 of the Restatement covers all sellers and distributors, and not just manufacturers, limits the significance of Section 14. Under certain circumstances, however, it

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157 The discussion of liability standards focuses on those formulations adopted by the American Law Institute in the Restatement (Third), and may vary from any specific state’s products liability statute or common law.

158 Restatement of the Law (Third), Torts: Product Liability, § 1. Section 7 provides a standard of liability specific to food products and ingredients. It provides that one who sells or distributes a defective food product is liable for the harm the defect causes, and that a "harm-causing ingredient" of the food product constitutes a defect "if a reasonable consumer would not expect the food product to contain that ingredient." Restatement of the Law (Third), Torts: Product Liability, § 7.

159 While one must be "engaged in the business of selling or otherwise distributing products" in order to be subject to strict products liability, one need not be engaged exclusively or even primarily in that business. Restatement of the Law (Third), Torts: Product Liability, § 1 comment c.

160 Id. § 20(a).

161 Restatement of the Law (Third), Torts: Product Liability § 20(b).

162 Id.

163 Restatement of the Law (Third), Torts: Product Liability, § 1 comment e.

and its predecessor (Section 400 of the Second Restatement), have been applied to impose liability on parties who were neither sellers nor distributors of the defective products, such as trademark licensors who licensed the use of their mark to the manufacturer of a defective product, as the cases discussed infra show (although comment b to §14 suggests the rule stated in that section “does not generally apply to trademark licensors,” and that such licensors are liable as “sellers” when they “participate in the design, manufacture or distribution of” defective products).  Section 400 has also been used to impose negligence liability on non-manufacturers where, as is often the case, state law limits product liability claims to manufacturers.

3. Trademark Licensor Liability

A franchisor’s mere licensing of a manufacturer’s use of the franchisor’s mark or logo in connection with the manufacture and distribution of products may also give rise to potential strict products liability. While most courts that have addressed the issue of a trademark licensor’s potential liability for injury or harm caused by defective products bearing the licensor’s mark have concluded that liability will attach only where the licensor “substantially participated” in the product’s design, manufacture or distribution, a few courts have imposed liability based solely on the grant of a license to use the licensor’s mark. And at least one state supreme court has suggested that the licensing of a mark that winds up on a defective product might give rise to comparative negligence liability as well. Accordingly, franchisors who license to manufacturers and others involved in the design, manufacture or distribution of products the use of their marks, especially those who participate in the design, manufacture or distribution processes, must consider their potential exposure to strict products liability claims for defective products bearing their marks.

4. Impact Of The Lanham Act’s Policing Requirements

The Lanham Act imposes on trademark holders an obligation to police their marks or face potential cancellation. While this duty to police is occasionally cited as creating a tort duty to purchasers of logoed products or services, there is little precedent or support for such claims. Nevertheless, the more a licensor’s involvement in the design, manufacture or distribution of products bearing its mark approaches the substantial participation that underlies the apparent manufacturer doctrine, the greater the risk to the licensor of strict products liability for injury caused by defective products. In Lou, the court treated the concern dismissively, suggesting that “courts generally have declined to base liability as an apparent manufacturer liability on.”

166 Restatement of the Law (Third), Torts: Product Liability § 14, comment b.
solely on the requirements imposed by the Lanham Act.” But other courts have been less reassuring. For example, in Automobile Ins. Co. v. Murray, Inc., the court suggested that the risk of tort liability associated with the Lanham Act’s policing requirements are the cost of doing business, stating:

While the trademark licensor’s obligation to police its mark for purposes of maintaining the quality of the trademarked product, or to avoid a claim of abandonment, can be seen as in tension with the licensor’s desire to avoid exposure to strict products liability claims based on involvement in the licensee’s manufacturing or distribution activities, because the purchasers, particularly in the case of consumer products, like a lawnmower, rely on the trademark as representing the product to be of good quality, a primary reason for even creating and using a trademark, and given the public’s interest in product safety, it is not unfair to impose liability upon trademark licensors based on such involvement and quality assurance activity. The licensor is thus in no worse a position than if it had retained exclusive control over the quality and safety of the trademarked product by manufacturing and selling the product itself.

Thus, the Lanham Act scarcely provides licensors with any safe harbor from potential tort exposure based on defective products bearing their marks. The more a licensor does to ensure quality and safety, the greater the likelihood of its liability for the harm caused by a defective product that finds its way to market.

IV. THE LIABILITY INSURANCE COMPONENT

Virtually all franchise agreements include a “hold harmless” indemnification clause requiring that franchisees hold harmless and indemnify the franchisor for the acts, errors, omissions or negligence arising out of the franchisee’s operations. Most franchise agreements also contain a requirement that the franchisee include the franchisor as an additional-insured on its commercial general liability insurance. This additional-insured coverage – which typically can be obtained at little to no cost - provides critical protection to franchisees in the event that the indemnification clause is triggered. In the absence of adequate insurance coverage, a franchisee could be held responsible to indemnify the franchisor out-of-pocket.

For example, in Braucher ex rel. Braucher v. Swagat Group, L.L.C., the court held that the franchisee was obligated under the terms of the indemnification clause in the franchise agreement, which required that the franchisee indemnify Choice Hotels for all costs, including attorney fees and the costs of suit, if (1) the franchisor is subject to a claim for damages allegedly arising from the operation of the franchised hotel, (2) the franchisor is not at fault for the alleged damages, and (3) the franchisee is found to be at fault for the alleged injuries.

175 Id., at 437.
V. HOW FAR SHOULD A FRANCHISOR GO TO EFFECT SYSTEM CHANGE?

C. Provisions In The Franchise Agreement, Operations Manual And Standards

A well-crafted franchise agreement incorporates manuals and standards into the franchise agreement and provides the franchisor with the right to make changes from time to time. Given that many franchise agreements have a term of at least 5 to 10 years, the franchisor must retain the flexibility to incorporate changes and innovation into the system during the term of the agreement, changes that may not have been contemplated by the franchisor (or the franchisee) at the outset of the agreement. These changes often are necessary for the continued evolution and success of the franchised system. This helps to explain why the look and feel of products and services offered by franchisors ten years ago generally is quite different from the same products and services offered by those franchisors today.

Franchise systems must be flexible to survive in today’s ever-changing world. When we think about how the internet has affected business generally and franchising specifically, one only needs to look at how information is communicated and products and services are sold today versus five, ten or twenty years ago. No franchise systems could possibly have envisioned the role that the internet would play in business generally and no franchise contract could have been specific enough to capture all of the nuances of the technological environment we live in today.

Irrespective of whether there are contractual limits on a franchisor’s right to make modifications to its system, the franchisor must resist the temptation to implement modifications with impunity. For example, it would not be prudent for a franchisor to try to modify a franchisee’s fundamental rights or status under a franchise agreement through changes in a manual or standards. If a franchise agreement granted a franchisee an exclusive territory, the franchisor could not completely eliminate the territorial exclusivity through a change in systems standards unless the franchise agreement specifically provided the right to do so. However, a franchisor can modify products or services offered through manuals and standards as well as impact the method of operations and look and feel of the franchise through manuals and standards, with the only limitations being contractual ones and notions of reasonableness.

Some franchise contracts impose monetary restrictions on what the franchisee is required to invest in during the term of the franchise (example, franchisee will not be required to spend more than 1.5% of sales from date of opening or refurbishing of unit) or do not require certain modifications if there is not a significant time left on the franchise term (to amortize the

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178 Of course, such changes must be communicated to the franchisees, and the best practice is to incorporate a reasonable phase-in period for new or different standards. For example, due to the evolution of technology, the franchisor may require its franchisee to upgrade its computer systems from time to time but will often give its franchisees a period of time to purchase and install the new systems, with the time allowed related to the significance of the investment and the time necessary to properly implement the new systems.

investment made by franchisees). Even if the franchisor has the legal right to enforce the change, if the franchisees’ implementation will cause the franchisee to be unable to meet other financial obligations to properly run the franchised businesses, such requirements should be carefully managed.

D. **Best Practices – “A Carrot is Better Than A Stick”**

Notwithstanding the right of control over its franchisees’ businesses that a franchisor may have reserved, the franchisor should always take into consideration the potential impact that the exercise of such control may have upon the franchise relationship. Before implementing more significant controls or system changes, franchisors should ensure that the modifications have been sufficiently tested and vetted, if possible, in company owned and in a variety of franchised units. These test results should be shared with the franchise community (with appropriate disclaimers that no franchisee is guaranteed to achieve comparable results).

It is critical that franchisors demonstrate to the franchisee community that the changes will have a direct or even indirect benefit to the franchise system as a whole. It is also important for the franchisor to make a business case for the controls or changes. Are the changes necessary to allow the system to be and remain competitive in the marketplace? Will the franchise system fall behind in the competitive market in the absence of the changes? Will these changes help franchisees grow sales and profitability?

By demonstrating the value of the changes to the franchisees, franchisors can implement changes while minimizing franchisee concern and dissent. In fact, Franchisees can be highly effective advocates for change if they are included in these processes. Commentators have observed that open communication and collaboration between a franchisor and its franchisees is an important ingredient for system success, and can be extremely beneficial for franchisors and franchisees alike. Many franchisors believe that a well-informed franchisee will more readily “buy in” to new and improved programs and policies and will be a more supportive “partner” for the franchisor. A franchisor’s philosophy of open communication also causes it to more thoroughly analyze the impact of any decision on franchisees, and to properly articulate the rationale for the decision. It has been posited that, beyond merely being desirable, a structure that delivers efficient, effective and formal franchisee participation in system governance is essential for franchise-based business organizations to flourish in the long term.

The hallmark of highly successful franchise organizations is a system that combines franchisor leadership with participatory governance, one that has the ability to implement franchisee-driven innovation combined with selective adoption of corporate initiatives. This fusion of leadership and participatory governance promotes system success with “stunning”

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results and is fully consistent with the best practices in organizational design, which are moving strongly toward flat, collaborative, cooperative, and participatory management systems and organizational designs.\footnote{185}{Id., at pp. 26, 28.}

Franchisors are not considered to be guarantors of the viability of system changes. Courts have recognized that a franchisor’s exercise of reasonable business judgment does not make it liable for breach of contract or breach of the implied covenant of good faith and fair dealing, even when the judgment results in financial loss to franchisees.\footnote{186}{Dunham, et al. supra at p. 238.} If franchisors were required to provide assurances that each new product or service or system change would be successful, changes would rarely if ever be implemented. Some changes may negatively affect certain units while positively impacting the majority of the system. A franchisor must continue to make decisions that it deems best for the system as a whole, notwithstanding the impact on individual units.

Finally, the timing and implementation of such changes is critical. Immediate changes or controls are far more likely to result in system dissention. While health or safety concerns may occasionally necessitate an immediate change, whenever possible, it is best for a franchisor to establish a reasonable phase-in period for system changes that allows franchisees sufficient time to adopt and accept these changes. Franchisees are less likely to feel threatened by changes made in an orderly fashion and given time to adjust to the modifications. Once the time frame for phase-in ends, however, the franchisor must be vigilant to enforce the change on non-participating franchisees as failure to do so can undermine trust of the franchise system and also severely inhibit the cooperation of franchisees when future changes or controls are imposed.

VI. CONCLUSION

There is a fine and often elusive line separating franchisors’ enforcement of system standards from control over the day-to-day operations at franchised locations. From the standpoint of franchisors, the uniformity and consistent customer experience that is so vital to franchising requires that franchisors adopt and enforce system-wide standards. Because the same control that enables franchisors to implement system standards also affords them an opportunity to prevent harm at the franchised locations, however, franchisors that reserve and/or exercise that control have been held vicariously liable for such harm to employees and customers of franchisees, as well as to third parties.

The keys to managing this liability risk are selectivity and restraint. Franchisors can limit their exposure to vicarious liability claims by reserving or exercising control over the day-to-day operations of franchised locations only with regard to those aspects of the business that are critical to the brand, while leaving to their franchisees those tasks and responsibilities that are traditionally the preserve of independent businesses. There will be differences of opinion as to which controls are critical to the brand, with franchisees seeking to limit those controls while franchisors seek to expand them. Suffice it to say, however, that no franchisor would knowingly choose to increase its vicarious liability exposure. Franchisors must therefore remain ever vigilant in preventing this risk as they strive to ensure uniformity in brand experience.
FREDRIC A. COHEN

Ric is a litigator and trial lawyer committed to helping keep the world safe for franchising. He helps franchisors manage their relationships with franchisees, franchisee associations, vendors and competitors, anticipate and prevent disputes, and achieve outstanding results in litigation and arbitration. Ric co-founded the Cheng Cohen LLC firm in 2007 after nearly twenty years at DLA Piper US LLP and predecessor firms. When he is not doing what he loves, Ric likes to cook.

DAVID J. MERETTA

Dave represents franchisees and franchisee associations throughout the country. Born in Kalamazoo, Michigan, Dave received his undergraduate and law school education from the University of Michigan. He joined Witmer, Karp, Warner & Ryan LLP in Boston in 2000 after clerking for the Hon. Lawrence M. Glazer of the 30th Judicial Circuit Court of Michigan.

Dave has been published in the American Bar Association’s Franchise Law Journal. He co-authors his firm’s Franchise Law Newsletter and is a contributor on BlueMauMau.org. He was a presenter at the first annual conference of the International Association of Franchisees and Dealers in 2010. He assisted with the creation and development of the American Bar Association’s Forum on Franchising Facebook page in 2010.

SANDRA J. WALL

Sandy has been with McDonald’s Corporation, in Oak Brook, Illinois, since November 2004. She is Managing Counsel of the Franchise Practice Group, which is responsible for preparing all franchise documents for owner/operators and preparing and handling the maintenance and filing of McDonald’s franchise disclosure document. She began her legal career in 1981 with the law firm of DLA Piper US LLP in Chicago and left the firm in December 1996 to become an Associate General Counsel for Sears, Roebuck & Co. There, she managed the team that handled all commercial contracts for Sears and assisted in the structuring of three franchise programs.

Sandy received her undergraduate degree from the University of Illinois and her law degree from Northwestern University. She is a member of the North American Securities Administrators Association’s Franchise Project Group’s Advisory Committee and has been appointed to the Illinois Franchise Advisory Board. She is a member of the Forum Committee on Franchising’s Publications Committee.