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**INDEPENDENT CONTRACTOR OR EMPLOYEE?
MINIMIZING EXPOSURE FROM THE GRAY AREAS OF THE
FRANCHISE RELATIONSHIP**

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INDEPENDENT CONTRACTOR OR EMPLOYEE? MINIMIZING EXPOSURE FROM THE GRAY AREAS OF THE FRANCHISE RELATIONSHIP

I. INTRODUCTION

The issue whether a franchisee may be deemed an employee of its franchisor--with whatever consequences that might bring--may have been lurking for some time. The issue came resoundingly to the forefront in March 2010 when a federal district judge in Boston ruled that franchisees of Coverall, a janitorial franchise, were to be deemed employees pursuant to Massachusetts law, rather than "independent contractors," as their franchise agreements provide. Subsequently, the Supreme Judicial Court of Massachusetts, on certification from the district court in that litigation, held that those employees are entitled to a refund of their franchise fees by virtue of the misclassification of them as franchisees.¹ Another district judge in the same district, more recently, has also held that franchisees of Jani-King, another janitorial franchise, must also be treated as employees pursuant to Massachusetts law.

Two courts, applying different state law, one in California, the other in Kentucky, have recently reached different conclusions than the Massachusetts courts regarding the status of franchisees, respectively, of Jani-King and Subway. Although the decisions of those courts may be distinguished from the Massachusetts decisions because of their application of different state laws, their reasoning is at least arguably contrary to the reasoning of the Massachusetts courts. Adding to the mix, another court, in Georgia, interpreting Massachusetts law, has ruled that franchisees were not employees of the ultimate franchisor in a "three-tiered" franchise system.

Nevertheless, there is now "blood in the water." Other cases have been filed, in which franchisees allege that they are the employees of their franchisor. Although some franchisors may believe that the Massachusetts decisions are not a cause of concern and that the decision should be limited to janitorial franchises in that state, it should surprise nobody that franchisee and employee advocates are considering whether they may successfully claim that their franchisee clients were, in reality, employees, entitled to new remedies beyond those normally available in franchise disputes.

The Massachusetts test for whether an "independent contractor" is an employee is not typical. In Massachusetts, a franchisor or other party seeking to avoid employer status must satisfy three criteria. Most other definitions of the employment relationship apply a multi-factor test, in which the decision-maker engages in a balancing analysis. A key factor in virtually every test is the extent to which the alleged employer "controls" the activity of the party asserting that it is, in reality, an employee.

Franchisors must, as a matter of law, exert a certain amount of control of a trademark licensee to protect their marks. As a business matter, moreover, franchisors need to exercise control over the manner in which their franchisees operate and provide goods and services. A critical component of the success of franchising is uniformity, and that cannot be achieved without establishing standards and enforcing them. Thus, any time an unhappy franchisee, or its counsel, consider whether the franchisee should be deemed an employee, there is at least a

¹ Mr. Dienelt was one of the counsel for Coverall, along with others in the firm of which he was a partner, until March 2012, when he joined another firm.

theoretical argument that the key factor in any analysis of the issue--control--weighs in favor of the conclusion that the franchisee/independent contractor is, in reality, an employee.

Although the Massachusetts decision in the Coverall litigation took the franchise bar at least somewhat by surprise, there have been other situations in which franchisors have been argued or deemed to be employers, based principally on control issues. There is precedent for franchisors to be held to be joint employers, with their franchisees, of the employees of the franchisees. "Vicarious liability" cases, in which third parties assert that a franchisor is responsible for acts of its franchisee, provide perhaps a more comparable situation to the claim by a franchisee that it is the employee of the franchisor. It is not necessary, in such cases, to argue or establish that the franchisee is an employee, but only that the franchisee was the franchisor's agent. However, the factual determination of that issue usually turns on the extent of control exercised by the franchisor over the franchisee--the same, or at least a similar, control issue that is considered in determining the employment issue.

No franchisor intends for its franchisees to be its employees. A premise of franchising, after all, is that the franchisee will, indeed, be an independent businessperson, with the opportunity to succeed in making profits, as any entrepreneur may, as well as the risk of suffering losses. Franchise agreements typically, if not universally, state plainly that the franchisee is an independent contractor and that the franchisor does not guarantee success or any level of revenue or income. Franchising is separately regulated. Among other regulatory requirements, franchisors must provide disclosure documents to prospective franchisees. These disclosure documents also invariably emphasize that there is no guarantee of success and warn of risks.

If a franchisor is deemed an employer of its franchisees, the ramifications can be breath-taking. Presumably, employees will be entitled to assurance of minimum wage, as well as other benefits employees are guaranteed by employment law, notwithstanding disclaimers of profitability or revenue that franchise regulations permit or require. But, the potential ramifications extend well beyond that. The franchisor will face issues with respect to what disclosures it must make and what changes, if any, it can make in its system to avoid, prospectively, being deemed an employer. As the Massachusetts Supreme Judicial Court has ruled, interpreting the law of that state, the franchisor may be required to disgorge franchise fees it has been paid. It might even be true that, if the franchisor were deemed an employer, pursuant to the standard of the National Labor Relations Act, its franchisee/employees would be entitled to form a union and engage in collective bargaining.

The problem caused by the Massachusetts decision may be confined to janitorial franchises in that state. For that matter, the underlying ruling that franchisors are employers may be overturned on appeal to the First Circuit or by a further ruling by the Massachusetts Supreme Judicial Court. But, there is by no means a guarantee that the problem will be so confined, or become a footnote to history. There is no reason, at least in theory, why any franchisor in any state, or nationally, will be immune from litigation alleging that it is an employer of its franchisees, or judicial rulings to that effect. The issue may turn on "control." And, that issue is likely to be fact-intensive, making the prospect of resolution prior to trial at least uncertain.

This paper will consider the problem in more detail. After separate discussion of the franchise and employment relationships, we address recent decisions and controversy about whether and when franchisees may be deemed to be employees and the significant potential

consequences of such decisions. Finally, we express views regarding the scope of the problems arising from such decisions and begin a discussion of potential solutions.

II DEFINITION OF THE FRANCHISE RELATIONSHIP

A. The Legal Description

Regulators began considering business format franchises in the 1960s, following widespread stories of fraud and abuse by franchisors. A wide variety of business arrangements were potentially subject to regulation--franchises as we now know them; business opportunities as we now know them; direct-selling arrangements; dealerships and distributorships; and pyramid schemes. Accordingly, lawmakers were faced with a dizzying array of business arrangements, some of which provided fertile grounds for abuse and others that were established and legitimate. One of the main sources of dispute and vexation was how to define a "franchise."

For several decades, some states had regulated the relationship aspects of certain branded-product franchises, such as automobile dealerships and beer distributorships.² The definition of those franchises, however, generally turned on the tangible product: an "automobile dealer" was one with a contract to purchase automobiles from the manufacturer or distributor.³ But business-format franchising did not necessarily, and indeed most frequently did not, involve the sale of a product from a supplier to a reseller; rather, the franchisee sold products it purchased from third parties, according to the franchisor's specifications, or it performed services, again pursuant to the franchisor's directions.

Two elements of the business-format relationship seemed to fall into place relatively easily: first, the franchisee had to pay a fee for the right to do business using the franchisor's trademark and system; and, second, the franchisor had to grant a trademark license, or at least the right, de facto, to use the franchisor's distinctive identifying characteristics. But these two elements alone reflected little more, if anything, than a trademark license. A definition based upon only those two elements could potentially sweep within the regulation any garden variety trademark license, such as a trademark owner's license to a manufacturer to produce a branded product.

The FTC and the states struggled to define the third element which, combined with the first two, would capture the intent behind the regulation: to insure full disclosure to franchisees who were making a "sunk investment" in the franchise that might otherwise be unrecoverable; and in some states, to protect franchisees from termination without cause and other incidents of overreaching by franchisors in the relationship.

As legislation and regulation was enacted, the third element took one of three basic forms. The first, embodied in the FTC Rule, provides that the franchisor "will exert, or has authority to exert, a significant degree of control over or provide significant assistance in the franchise's method of operation."⁴ The second form, reflected in the California statute, provides that the franchisee "is granted the right to engage in the business of offering, selling, or

² The first legislation regulating the automobile industry was in Wisconsin in 1937. See 1937 Wis. Laws. Ch. 377, 378.

³ See, e.g., Fla. Stat. Ann. § 320.60 ("Agreement' or 'franchise agreement' means a contract, franchise . . . or dealer agreement . . . pursuant to which the motor vehicle dealer is authorized to transact business pertaining to motor vehicles of a particular line-make.")

⁴ 16 C.F.R. § 436.1(h)(2)

distributing goods or services under a marketing plan or system prescribed in substantial part by franchisor.”⁵ The third form defines the last element as one “in which the franchisor and franchisee have a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.”⁶

Thus, putting the three elements together, a franchise is defined, for example, in Wisconsin as:

[A] contract or agreement, either express or implied, whether oral or written, between 2 or more persons by which:

1. A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed or suggested in substantial part by a franchisor; and
2. The operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s business and trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and
3. The franchisee is required to pay, directly or indirectly, a franchise fee.⁷

In addition to the three variants in the definition of a business format franchise, other states have defined a “franchise” in still other terms – sometimes similar, sometimes different – for relationship purposes, such as termination or transfer of the franchise, with the result that there are wide variations and inconsistencies.⁸

Nothing in the definitions of a franchise suggests that the drafters had in mind anything remotely approximating an employment relationship. Indeed, both the FTC and the states included various exemptions from the definition of “franchise” or “franchise fee” for, among other things “fractional” franchises;⁹ leased departments and department stores,¹⁰ purchases or sales of goods at a bona fide wholesale price¹¹ or amounts paid to a trading stamp company.¹² In fact, the emphasis in the exemptions upon various types of wholesale and retail transactions (for, example, a commission-sale arrangement) supports the view that the legislators and regulators were not at all concerned that franchise relationships were employment relationships.¹³

It is, therefore, reasonably safe to say that there is nothing inherent in the definition of a franchise that makes it more or less susceptible to being an employment relationship than the

⁵ Cal. Corp. Code § 31005(a)(1)

⁶ Minn. Stat. § 80C.01 Subd. 4(a)(1)(ii)

⁷ Wis. Stat. § 553.03(4)(a).

⁸ See, e.g., Ark. Code Ann. § 4-72-202 (“written or oral agreement ...in which a person grants to another person a license to use a trade name...or related characteristic within an exclusive or nonexclusive territory or to sell or distribute goods or services ...”); N.J. Stat. Ann. §56:10-3 (“written arrangement...in which a person grants to another person a license to use a trade name . . . and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement or otherwise.”).

⁹ 16 C.F.R. § 436.8(a)(2).

¹⁰ 16 C.F.R. § 436.8(a)(3).

¹¹ See, e.g., Md. Code Ann, Bus. Reg. § 14-201(g)(3)(i).

¹² N.Y. Gen Bus. Law § 681.7(c).

¹³ Wis. Stat. Ann. § 135.07(2).

facts would support; indeed, the exemptions support the view that an employment relationship was not even contemplated by the regulators. And in the cases that preceded the current misclassification cases, the only discussions that approached treating franchisees as employees or agents arose in the vicarious liability area, where third parties sought to hold the franchisor liable for injuries sustained on franchisees' premises and in the joint employer area, where a franchisee's employee sought to hold the franchisor and the franchisee jointly liable for a wrong incurred in the franchisee's workplace. Some of those cases held that while the franchise agreement gave the franchisor control over the franchisee's operations, such control was sufficient only to protect the franchisor's trademarks; it did not necessarily give the franchisor control over the franchisee's day-to-day operations.¹⁴ In other cases, where the courts found more control than necessary to police the trademark, the analysis ended with a finding of principal and agent between the franchisor and franchisee.¹⁵ Thus, for example, even though the issue whether the franchisee was an employee was considered in one case, the court held that there was insufficient control to support such a finding.¹⁶

On the other hand, there is nothing in the various definitions of a franchise that insulates the franchise relationship from being treated as one of employment. And, in fact, there is little in the definitional elements that tends to lean one way or another in evaluating the relationship.

It would appear that the argument can be made, at least in states with franchise statutes, that a finding that a franchise has been misclassified as an employment relationship would frustrate franchise regulation as a matter of policy. However, courts, at least implicitly, have rejected the suggestion that franchisors should be exempted from application of employment laws.¹⁷

Given the absence of any inherent incidents of an employment relationship in the definition of a franchise, the question then arises whether, in structuring the relationship, franchisors have crossed a line that puts them into the category of an employer. While generalities are dangerous, some observations on the nature of the franchises that have been subjected to misclassification claims can be made:

- In most of them, payment by the customer goes to the franchisor, which, after deduction of fees and expenses, forwards the balance to the franchisee. This change in form from the typical model of the franchisee taking the customer's money and forwarding royalties onto the franchisor

¹⁴ *Kerl v. Dennis Rasmussen, Inc.*, 273 Wis. 2d 106, 682 N.W.2d 328, 341-42 (2004); *Hunter v. Ramada World Wide Inc.*, 2005 WL 1490053 (E.D. Mo. 2005). For recent examples of the continuing tension in franchise vicarious liability cases, depending on the perception of the facts, compare *Patterson v. Domino's Pizza, LLC*, No. B235099, 2012 Cal. App. LEXIS 753 (Cal. Ct. App. June 27, 2012) (summary judgment for franchisor of Domino's denied), with *Gray v. McDonald's USA, LLC*, No. 2:10-cv-2779-JPM-tmp, 2012 U.S. Dist. LEXIS 96103 (W.D. Tenn. May 29, 2012) (summary judgment for franchisor of McDonald's granted).

¹⁵ See, e.g., *Greil v. Travelodge Int'l., Inc.*, 186 Ill. App. 3d 1061, 541 N.E.2d 1288 (1st Dist. 1989).

¹⁶ *Viado v. Domino's Pizza, LLC*, 230 Or. App. 531, 217 P.3d 199 (Or. Ct. 2009), review denied, 347 Or. 608, 226 P.3d 43 (Or. 2010).

¹⁷ See, e.g., *Employment Dep't. v. Nat'l Maint. Contractors of Oregon, Inc.*, 226 Or.App. 473, 204 P.3d 151 (Or. Ct. App. 2009) ("We appreciate that franchises are unique business arrangements that can differ in many important ways from a traditional employment relationship. That said, we are not persuaded that franchise relationships demand a modified definition of service remuneration for purposes of ORS 657.030. Rather, the question whether a particular franchise relationship satisfies that statute must be answered on a case-by-case basis, by determining whether services for remuneration have been provided and, if so, whether some exclusion to the definition of employment nevertheless applies.") (citations omitted).

may be perceived as in fact a change in substance, in that it gives the franchisor immediate and complete control over the money.

- In some cases involving retail outlets the franchisor retains control over the purchasing and management of inventory in addition to requiring the franchisee to hand over all revenue, out of which costs and fees are deducted.
- In some of the cases, the franchisor retains control over selecting customers (as in designating accounts for the franchisee to handle), which again maybe seen as giving it the added aspect of control necessary to create an employment relationship.

As shown by the employment misclassification cases, the issue whether an arrangement is a franchise or an employment relationship appears to be driven largely by the facts.

B. The Business Realities

It is not necessary to burden this paper with a detailed description of how franchising works. Nonetheless, it may be useful briefly to emphasize that franchising is designed to provide a business opportunity to franchisees that traditionally has been considered different from employment opportunities that might be provided to a prospective manager or other employee at an outlet of a chain.

The International Franchise Association (IFA) submitted an amicus brief in the Coverall litigation. The brief summarizes the traditional view.

Franchising is a way that budding entrepreneurs can capitalize on the success, brand power, and goodwill of an existing business without the costs and risks typically associated with starting a business.

* * *

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. 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."). Along with that equity interest, the franchise owner is given the immediate right to capitalize upon and benefit from the franchise's established goodwill and brand power.

Unlike an employee, a franchise owner has the power to delegate duties to his own employees, select customers, and adapt techniques for his business apart from the franchising model. These distinctions allow a franchise owner to build and subsequently sell his equity in that business . . . [A] franchise owner does not "buy" a "job"; rather, for consideration, he receives an equity stake in his own business through the use of another's pre-established business model. By contrast, an employee enters an employment arrangement often for no consideration, and in turn, often departs the employment arrangement without equity.

Another distinguishing feature of a franchise relationship is the franchise owner's independence, his right to operate the franchise business. A franchise owner typically purchases that right by paying a "franchise fee." [footnote omitted]. While the owner enjoys independence, his success depends, in part, upon the method of operation developed by the franchisor and, in part, upon the preeminence and popularity of the commercial identity embodied in the franchisor's proprietary marks. These features are the hallmarks of a franchise. [citation omitted].

* * *

Like other retailers or distributors, a franchise owner operates a business in which he invests money and labor, enjoys the right to profit, and bears the risk of loss. Bus. Franchise Guide (CCH), Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, P 6347, 2010 WL 2144637, *2 (C.C.H.) (1979). The franchisor performs the function of a traditional producer or wholesaler by supplying the franchise owner with goods to be distributed (in the case of product franchising) or service opportunities (in the case of business opportunity franchising).

Of course, a franchisor benefits from the expansion of its business when a franchise owner joins the franchisor's system and shoulders the cost of opening his own outlet . . . But unlike in the employment model, in the franchise model, the benefits of expansion run in favor of both the franchisor and the franchise owner. [footnote omitted]. The franchise owner benefits from training and other franchisor-provided services because they allow him to maintain quality and save time. The owner benefits from the brand loyalty of the franchisor's customers, who seek out the qualities associated with the franchise system's goods or services. The owner's success depends on those qualities.¹⁸

Simply put, the franchising "model" differs fundamentally from the employment "model."

III. DEFINITION OF THE EMPLOYMENT RELATIONSHIP

A. General Principles

In the employment law arena, it is not uncommon for the status of an individual performing services to be questioned; an agreement by the parties purporting to determine status is not dispositive.¹⁹ Rather, the analysis is fact specific, based on how the relationship actually works, not only what the parties may have committed to paper.

Courts and agencies generally use one of three tests to determine whether an individual is an employee or an independent contractor: 1) "right to control" test; 2) "economic realities" test; or 3) the "ABC" test. Elements of the three tests overlap.

¹⁸ Brief for International Franchise Association, et al. as Amici Curiae supporting Appellee at 8-14, *Awuah v. Coverall, Inc.*, 460 Mass. 484, 952 N.E.2d 890 (Mass. 2011) (No. SJC-10829).

¹⁹ *Hayes v. Enmon Enterprises, LLC*, 2011 WL 2491375 (S.D. Miss. 2011).

The “right to control” test is the most common and tracks the Restatement of Agency (Second) §220(2). The essential question under this model is who controls the manner and means by which the result is achieved. Ten factors are relevant in this analysis:²⁰

- The extent of control exercised over the details of the work;
- Whether or not the one performing services is engaged in a distinct occupation or business;
- 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;
- The skill required in the particular occupation;
- Who supplies the instrumentalities, tools and place of work for the person doing the work;
- The length of time for which the individual is engaged;
- The method of payment, whether by time or by the job;
- Whether the work is part of the principal’s regular business;
- Whether the parties intend to create a master/servant relationship; and
- Whether the principal is or is not a business.

The “economic realities” test is used by some courts and agencies under some statutory analyses. That test focuses more on the financial opportunities available to the individual than on the means and manner of performing the work. If the individual has significant entrepreneurial opportunity for gain or loss, (s)he is more likely to be considered an independent contractor. Among the factors considered under this model are:

- Investment in tools or equipment;
- Reimbursement of business expenses;
- Services are available to the market, not just one entity;
- Method of payment; and
- Authority to hire assistants without consent of entity for which work is being performed.²¹

The “ABC” test is another variation on theme. Under that iteration, an individual is considered an independent contractor if:

- A. The worker is free from control or direction in the performance of the work;
- B. The work is done outside the usual course of the principal’s business or is done off the premises of the business; and
- C. The worker is customarily engaged in an independent trade, occupation, profession or business.

Within these general parameters, the determination of whether an individual is an independent contractor or an employee may depend on what statute is being applied, which agency or court is making the determination and/or in which state the issue is being considered. For example, the Internal Revenue Service has used a version of the “right to control” test, with twenty factors when it determines whether payroll taxes are due for an individual:²²

²⁰ *FedEx Home Delivery v. NLRB*, 563 F.3d 492 (D.C. Cir. 2009).

²¹ *U.S. v. Silk*, 331 U.S. 704 (1947).

²² Rev. Rul. 87-41, 1987-1 C.B. 296.

1. **Instructions:** Whether the employer/contractor has the right to require the worker to comply with instructions about when, where, and how he or she is to work.
2. **Training:** Whether the worker is required to work with an experienced employee, to attend meetings, or otherwise is trained to perform the services in a particular method or manner.
3. **Integration:** Whether the worker's services are integrated into the business operations generally, in that the success or continuation of a business depends to an appreciable degree upon the performance of the services.
4. **Services rendered personally:** If the services must be rendered personally, whether the worker determines the methods used to do the work.
5. **Hiring, supervising, and paying assistants:** Whether the employer/contractor or the worker hires, supervises, and pays any assistants.
6. **Continuing relationship:** Whether there is a continuing relationship between the worker and employer/contractor.
7. **Set hours of work:** Whether the employer/contractor establishes set hours of work.
8. **Full time required:** Whether the worker must devote substantially full time to the employer's/contractor's business.
9. **Doing work on employer's/contractor's premises:** Whether the work may be done away from the employer's/contractor's premises.
10. **Order or sequence set:** Whether the worker must perform services according to established routines and schedules set by the employer/contractor.
11. **Oral or written reports:** Whether the worker is required to submit regular or written reports of the work performed.
12. **Payment by hour, week, month:** Whether payment is by the job or on straight commission as opposed to payment by the hour, week, or month.
13. **Payment of business and/or traveling expenses:** Whether business expenses are paid by the employer/contractor.
14. **Furnishing of tools and materials:** Whether tools, materials, and other equipment are supplied by the employer/contractor.
15. **Significant investment:** Whether the worker invests in facilities that are not typically maintained by employees.
16. **Realization of profit or loss:** Whether the worker can realize a profit or suffer a loss as a result of his or her services (due to significant investment or liability for expenses).
17. **Working for more than one firm at a time:** Whether the worker performs services for multiple employers at the same time.
18. **Making services available to general public:** Whether the worker regularly makes his or her services available to the general public.
19. **Right to discharge:** Whether the employer/contractor has the right to discharge a worker.
20. **Right to terminate:** Whether the worker has the right to quit at any time without liability.

Responding to criticism that these factors are too complicated, the IRS now groups these factors in three evidentiary categories when it analyzes the issue: behavioral control, financial control, and the relationship of the parties.²³

²³ IRS Publication 1779 (Rev. 8-2008).

The Supreme Court has adopted a common law definition of “employee” for use when the statutory definition is unclear or absent:

In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party’s right to control the manner and means by which the product is accomplished. Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party’s discretion over when and how long to work; the method of payment; the hired party’s role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.²⁴

As is set forth elsewhere, statutes sometimes define the term “employee” in a broad way for purposes of revenue enhancement²⁵ or workplace safety. For example, the Fair Labor Standards Act protects employees, but not contractors, on issues such as minimum wage and overtime pay. It defines “employee” in a less than helpful way as “any individual employed by an employer.” However, the FLSA defines “employ” in a way that should cause concern for franchisors--“to suffer or permit to work”--making this arguably the broadest definition in the employment laws. Even with that broad definition, however, there are limits on the circumstances under which an entity will be considered an “employer” under the FLSA.²⁶

The EEOC uses a 16-factor test similar to the “right to control” test for determining whether an individual is an employee (protected under Title VII and other discrimination laws) or an independent contractor (generally not protected).²⁷

Finally, the National Labor Relations Act, which governs workers’ right to organize and bargain collectively, does not define the term “employee” at all in the statute, although it does specifically exclude independent contractors from its protection. In the case law under the NLRA, the National Labor Relations Board uses essentially the common law test articulated by the Supreme Court in *Darden* but adds emphasis on whether the individual has entrepreneurial opportunities for gain or loss.²⁸

The complexity of these analyses is evident in the recent decision of the Seventh Circuit in *Craig, et al v. FedEx Ground Package Sys., Inc.*²⁹ There, the Seventh Circuit reviewed a decision of the Northern District of Indiana granting summary judgment to FedEx in a consolidated ERISA class action dealing with whether FedEx pickup and delivery drivers are independent contractors or employees. The Seventh Circuit stayed the proceeding, deciding:

²⁴ *Nationwide Mut. Ins. Co., et al. v. Darden*, 503 U.S. 318 (1992), quoting *Comty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-52 (1989) (footnotes omitted).

²⁵ In fact, federal and state governments believe they are losing billions in tax revenue due to misclassification and have stepped up and coordinated efforts to enhance enforcement.

²⁶ See *In re Enter. Rent-A-Car Wage & Hour Employment Practices Litig.*, 683 F.3d 462 (3d Cir. 2012) (holding that the sole stockholder of 38 domestic subsidiaries was not a joint employer with its subsidiaries because it had no authority to hire or fire assistant managers, no authority to promulgate work rules or assignments and no authority to set compensation, benefits or schedules).

²⁷ EEOC Compliance Manual Section 2: Threshold Issues (2000), § 2-III(A)(1); *Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440 (2003).

²⁸ *Corporate Express Delivery Sys. v. NLRB*, 292 F.3d 777 (D.C. Cir. 2002).

²⁹ 2012 WL 2862030 (7th Cir. July 12, 2012).

(1) that employment status was outcome determinative; (2) that state law defined employment status; and (3) that the question should be certified to the Kansas Supreme Court.³⁰ The court noted the conflicting decisions of at least four other courts on the question of the status of FedEx drivers--two held them to be independent contractors, one held they were employees and one said the question presented a genuine issue of fact so as to prevent summary judgment.³¹

B. “Employer” Defined by Statute

Some jurisdictions define whether an individual is an employee or an independent contractor by statute. Furthermore, some jurisdictions define “employer” for all areas of law, while other jurisdictions only define who is an employer for specific areas of the law³². When “employer” is statutorily defined for only limited areas of the law, the possibility exists that a franchisor will be considered an employer of its franchisee for some purposes but not others.

Statutes defining “employer,” regardless of whether it is for a specific area of law or generally, often focus on whether the service performed was outside the potential employer’s usual course of business.³³ As applied to the franchisor-franchisee context, if the work is outside the franchisor’s normal business practices, then the franchisee is generally considered an independent contractor of the franchisor.³⁴ Alternatively, if the services completed are within the franchisor’s routine business operations, then the franchisee may be deemed an employee of the franchisor.³⁵

One of the most recent analyses of the “franchisor as employer” issue was in *Jan-Pro Franchising Int’l, Inc. v. Depianti*.³⁶ The court applied Massachusetts’ statutory definition of “employer” to determine if Jan-Pro Franchising International, Inc. (hereinafter “JPI”) was the employer of Depianti. JPI created a three-tier cleaning franchise in which JPI was the “top tier,” BradleyMktg Enterprises, Inc. (hereinafter “BME”), was the “middle tier,” and Depianti was the “bottom tier.” BME was a regional franchisee of JPI, created by persons unaffiliated with JPI. *Id.* Depianti was a unit franchisee of BME.³⁷ Applying Massachusetts’ three-prong “ABC test,” the court reached a markedly different conclusion from the *Coverall* and *Jani-King* courts, discussed more fully in the next section, and determined that Depianti could not be considered an employee of JPI.³⁸

The first prong of Massachusetts’ law provides that a franchisee must be free from control in performing his service, both under its contract and in fact, to be considered an independent contractor of its franchisor.³⁹ The court concluded that JPI did not have the

³⁰ See *id.* at *2, *6-7.

³¹ See *id.* at *5.

³² See Mich. Comp. Laws Ann. § 141.606 (West) (defining “employer” for tax purposes only); *Awuah v. Coverall N. Am., Inc.*, 707 F. Supp. 2d 80, 82 (D. Mass. 2010) (defining “employer” by statute for all areas of the Massachusetts law using the three prong analysis discussed below); *Doctors’ Associates, Inc. v. Uninsured Emp’rs’ Fund*, 364 S.W.3d 88 (Ky. 2011) (defining “employer” for workers compensation purposes only).

³³ See *Awuah*, 707 F. Supp. 2d at 82; *Doctors’ Assocs., Inc.*, 2011 WL 5878145.

³⁴ See *Doctors’ Assocs., Inc.*, 2011 WL 5878145 (holding that the Subway franchisor was not the employer of its franchisee because the franchisor was in the business of franchising, not making sandwiches).

³⁵ *Awuah*, 707 F. Supp. 2d at 84 (rejecting the idea that the franchisor could be in the business of franchising and holding that the franchisor was the employer of its franchisee because both the franchisee and franchisor were in the cleaning business).

³⁶ 310 Ga. App. 265, 268 (2011), reconsideration denied (Feb. 6, 2012).

³⁷ *Id.*

³⁸ See *id.* at 270.

³⁹ See Mass. Gen. Laws ch. 149, § 148(B)(1).

contractual right to control Depianti's performance of his service, nor did it actually control Depianti.⁴⁰ As a unit franchisee of BME, Depianti implemented a business model established by JPI but was only under contract with BME; JPI was not a party to BME's and Depianti's contract.⁴¹ Although JPI was a third-party beneficiary to the contract between BME and Depianti and had the right to enforce the contract, the court held that this was not sufficient to establish the control required under Massachusetts' law.⁴²

The second prong of Massachusetts' law requires that the service performed be outside the franchisor's usual course of business in order for the franchisee to be considered an independent contractor.⁴³ In this vein, the court noted that JPI lacked contacts with Depianti's customers and that JPI did not compete with Depianti for cleaning contracts.⁴⁴ The court held that these facts established that JPI was not in the cleaning business, but rather in the franchising business.⁴⁵ Thus, the work Depianti performed as a cleaner was outside the scope of JPI's normal operations.⁴⁶

Finally, JPI had to establish that Depianti was customarily engaged in an independently established business, trade, occupation, or profession.⁴⁷ The operative question was whether Depianti could perform his service for anyone, or whether the nature of the business required him to depend on JPI in order for him to continue providing services.⁴⁸ After noting that BME, not JPI, controlled Depianti's customer accounts, the court concluded that the "nature of the three-layer franchise arrangement necessarily means that JPI and Depianti are engaged in operating independent businesses."⁴⁹

There are other employment-related statutes under which franchisors are sometimes sued by the employees of the franchisee. Liability in such instances does not depend on the franchisee being considered an employee of the franchisor but, rather, that the franchisor and franchisee are considered "single or joint employers."⁵⁰ Recently, a class action was filed in the Eastern District of New York, on behalf of a putative class of employees of a franchise of Arthur Murray against the franchisee and the franchisor, alleging that they are joint employers and that they have violated the federal Fair Labor Standards Act, as well as the New York Labor Law, by failing to pay overtime and committing other wage violations.⁵¹

C. Common Law Employer-Independent Contractor

⁴⁰ *Jan-Pro*, 310 Ga. App. at 268.

⁴¹ *Id.*

⁴² *Id.*

⁴³ See Mass. Gen. Laws ch. 149, § 148(B)(2).

⁴⁴ *Jan-Pro*, 310 Ga. App. at 268-69.

⁴⁵ *Id.* at 269.

⁴⁶ *Id.*

⁴⁷ Mass. Gen. Laws ch. 149, § 148(B)(3).

⁴⁸ *Jan-Pro*, 310 Ga. App. at 269.

⁴⁹ *Id.* at 269.

⁵⁰ *Lockard v. Pizza Hut*, 162 F.3d 1062 (10th Cir. 1998) (Title VII); *Kearney v. Kessler Family LLC*, __2011 WL 2693892 (W.D.N.Y. July 11, 2011) (Title VII, ADA); see also, *EEOC v. Papin Enters., Inc.*, 2009 WL 961108 (M.D. Fla. Apr. 7, 2009) (Title VII) ("DAI's reliance on its franchise agreements to avoid "joint employer" liability as a matter of law is unavailing"); *Hickton, et al. v. Enter. Holdings, Inc.*, *supra* (FLSA).

⁵¹ See Amended Complaint, *Ziscand v. Arthur Murray Int'l, Inc.*, No. 12-cv-01841-LDW-ARL (E.D.N.Y. June 29, 2012), ECF No. 15.

Several courts have considered whether a franchisor is an employer of its franchisees under a common law employer-independent contractor analysis.⁵² The key to an employee-employer relationship under the common law is that the employer has the right to control the means and manner in which work is performed.⁵³ Alternatively, the hallmark of an independent contractor relationship is that the contractor has the right to control the means and manner in which the job is completed.⁵⁴ Thus, under an employer-independent contractor analysis, the primary question that courts ask to determine if a franchisor is the employer of its franchisee is whether the franchisor controlled the “means and manner of accomplishing the desired result”.⁵⁵

Some courts consider the *right* to control the means and manner in which franchisees conduct their businesses to be dispositive of whether an employer-employee relationship exists.⁵⁶ In *Hayes v. Enmon Enterprises, LLC*,⁵⁷ an employee of Comcast slipped and fell in a bathroom cleaned by Enmon Enterprises, LLC (hereinafter “Enmon”). Enmon was a franchisee of Jani-King Franchising (hereinafter “Jani-King”).⁵⁸ The court analyzed several provisions of the franchise agreement which purportedly gave either Enmon or Jani-King control over Enmon’s business.⁵⁹ The court ultimately decided that due to the numerous contractual controls placed on Enmon, it could not be considered an independent contractor as a matter of law.⁶⁰ Thus, the court’s analysis suggests that some courts may view run-of-the-mill franchisee contractual controls as creating an employee-employer relationship between franchisees and franchisors (citing the Mississippi Supreme Court’s acknowledgement of the difficulties of these issues: “The line separating servant from independent contractor... ‘is not a line at all but a twilight zone filled with shades of gray’ . . .”).⁶¹

Alternatively, some courts view whether the franchisor *actually* controls the means and manner in which its franchisee conducts its business to be dispositive of whether the franchisor is the employer of its franchisee. In *Hoffnagle*, an employee of McDonalds sued the franchisor after she was assaulted by customers of the restaurant. The franchise agreement at issue contained similar provisions to those listed in *Hayes* and *Drexel*, including a provision that the franchisor had a right to inspect the restaurant at any reasonable time to ensure that the franchisee was acting in compliance with all standards and policies set by the franchisor.⁶² Unlike in *Hayes* and *Drexel*, the court in *Hoffnagle* held that the franchisor did not control the means and manner in which the franchisee operated its business. The court provided that the franchisor would only be considered to control the means and manner in which the franchisee performed its work if it controlled the day-to-day operations of the restaurant.⁶³ However, in a

⁵² *Wise v. KFC Corp.*, 555 F. Supp. 991 (D.N.H. 1983); *Coty v. U. S. Slicing Mach. Co., Inc.*, 58 Ill. App. 3d 237, 373 N.E.2d 1371 (Ill. App. Ct. 1978); *Hoffnagle v. McDonald’s Corp.*, 522 N.W.2d 808 (Iowa 1994).

⁵³ *Drexel v. Union Prescription Centers, Inc.*, 582 F.2d 781, 785 (3d Cir. 1978); *Kerl v. Rasmussen*, 267 Wis. 2d 827 (Wis. Ct. App. 2003)..

⁵⁴ *Id.*

⁵⁵ *Juarez v. Jani-King of California, Inc.*, 273 F.R.D. 571, 581 (N.D. Cal. 2011).

⁵⁶ *Font v. Stanley Steamer Int’l, Inc.*, 849 So. 2d 1214, 1216 (Fla. Dist. Ct. App. 2003) (holding that when the franchisor’s right to control the franchisee’s activities extends to the manner in which a task is completed, the franchisee is an employee of the franchisor under Florida law).

⁵⁷ No. 3:10-CV-00382-CWR, 2011 WL 2491375 (S.D. Miss. June 22, 2011).

⁵⁸ *Id.* at *1.

⁵⁹ *Id.*

⁶⁰ *Id.* at *6.

⁶¹ *Id.* at *2 quoting *Fruchter v. Lynchal Co.*, 522 So.2d 195, 199 (Miss. 1988)). See also *Drexel*, 582 F.2d at 788 (holding that a franchisor’s contractual right to control the manner in which its franchisee performed its work is determinative of whether an employee-employer relationship exists).

⁶² See *Hoffnagle*, 522 N.W. 2d at 810-11.

⁶³ See *id.* at 813. See also *Juarez*, 273 F.R.D. 571 (holding that numerous contractual controls, including the exclusive right to draft contracts for services to be provided by the franchisee to customers, did not amount to

very recent decision, the California appeals court held that California law requires that courts look at the “totality of the circumstances to determine who actually exercises the ultimate control.”⁶⁴ The court held that there was sufficient evidence that the franchisor exercised sufficient control over the franchisee to warrant denial of the franchisor’s motion for summary judgment in this case, which involved alleged sexual harassment of a 16-year-old employee of the franchise.⁶⁵ These cases suggest that, except in cases with very bad facts, courts inquiring into actual control may be less likely to find franchisors to be the employers of their franchisees than courts providing that the stated right to control the means and manner of operation is determinative.

IV THE RECENT CONTROVERSY

A. The Coverall Litigation

The *Awuah* action, on behalf of a putative class of Coverall franchisees was filed against the franchisor in 2007.⁶⁶ In addition to claims that are familiar in franchise litigation, for alleged fraud and other unfair conduct, plaintiffs alleged that they had been misclassified as independent contractors and should instead be deemed to be employees.⁶⁷ The case was assigned to Judge William Young.

Plaintiffs filed a motion for partial summary judgment on the misclassification issue, pursuant to Massachusetts laws. Judge Young granted the motion.⁶⁸

Judge Young recited that:

Under Massachusetts General Laws Chapter 149, section 148B, an individual performing a service is considered an employee unless:

- (1) the individual is free from control and direction and in connection with the performance of the service, both under his contract for the performance of service and in fact; and
- (2) the service is performed outside the usual course of the business of the employer; and,
- (3) 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.

Mass. Gen. Laws ch. 149, § 148B. The burden is on Coverall to establish these three elements, and it must establish each element. *De Giovanni v. Jani-King Int'l, Inc.*, 262 F.R.D. 71, 84 (D. Mass. 2009).⁶⁹

controlling the means and manner in which the franchisee conducted its business, and thus did not create an employee-employer relationship under California law).

⁶⁴ *Patterson v. Domino’s Pizza, LLC*, No. B235099, 2012 Cal. App. LEXIS 753, at *11 (Cal. Ct. App. June 27, 2012).

⁶⁵ *Id.* at *16.

⁶⁶ *Awuah v. Coverall N. Am, Inc.*, Civil Action No. 07-10287-WGY, United States District Court for the District of Massachusetts.

⁶⁷ *See Awuah*, 707 F.Supp.2d at 81.

⁶⁸ *Id.* at 85.

⁶⁹ *Id.* at 82.

Judge Young focused on the second prong of the test, rejecting Coverall's argument that it was "not in the commercial cleaning business, but rather . . . in the franchising business."⁷⁰ Judge Young suggested that "[d]escribing franchising as a business in itself, as Coverall seeks to do, sounds vaguely like a description for a modified Ponzi scheme - a company that does not earn money from the sale of goods and services, but from taking in more money from unwitting franchisees to make payments to previous franchisees".⁷¹ He then immediately stated that "[s]uch a description is not applicable to Coverall," and noted various aspects of the Coverall system that "establish that Coverall sells cleaning services, the same services provided by these plaintiffs."⁷²

In his opinion, Judge Young noted that the Supreme Judicial Court had previously affirmed a decision against Coverall in the context of unemployment benefits, in which that court affirmed an administrative decision that a former Coverall franchisee should be deemed an employee.⁷³ As Judge Young noted, the Supreme Judicial Court, in that context "focused its decision on the third prong," although the agency had ruled that Coverall could not satisfy any of the three prongs.⁷⁴

Thus, Judge Young did not address the first prong, relating to "control and direction" by the franchisor of the franchisee. In his opinion, however, he cited two cases, one from Massachusetts⁷⁵ and one from Wisconsin,⁷⁶ dealing with "respondeat superior" in the context of franchisor vicarious liability, in his discussion of the issue pursuant to the second prong.

There is language in the standard Coverall agreement, in which the franchisee acknowledged that it would be deemed an "independent contractor" (language similar to that found in virtually every franchise agreement). Judge Young did not mention this provision in his opinion, obviously concluding that the statutory definition controlled, regardless of what the franchise agreement provided.

B. The Supreme Judicial Court Decision

The Coverall litigation has a complex, and contentious, history. At the time of his ruling, granting partial summary judgment on the misclassification issue, Judge Young declined to certify a class. Instead, he proceeded to a jury trial in which other claims of the named plaintiffs were addressed. Coverall won a jury verdict in that trial.⁷⁷ Among other rulings in connection with that trial, Judge Young concluded that the Coverall franchise agreement was not unconscionable.

During the course of the litigation, plaintiffs were permitted to add an additional named plaintiff, Graffeo. Subsequently, the parties filed cross-motions for summary judgment with respect to Graffeo's alleged damages on the misclassification issue.⁷⁸ In ruling on these motions, Judge Young decided that certain damages were due Graffeo, but "that Coverall properly could deduct from payments to Graffeo certain amounts related to 'franchise fees,'

⁷⁰ *Id.*

⁷¹ *Id.* at 84.

⁷² *Id.*

⁷³ *Id.* at 82.

⁷⁴ *Id.*

⁷⁵ *Coworx Staffing Servs., LLC v. Coleman*, No. 2005436F, 2007 WL 738913 (Mass. Super. Ct. Feb 7, 2007).

⁷⁶ *Kerl v. Dennis Rasmussen, Inc.*, 273 Wis.2d 106, 682 N.W.2d 328 (Wis. 2004).

⁷⁷ See Jury Verdict, *Awuah v. Coverall N. Am, Inc.*, No. 07-cv-10287-WGY, (D. Mass. May 26, 2010), ECF No. 296.

⁷⁸ See *Awuah v. Coverall N. Am, Inc.*, 740 F.Supp. 2d 240, 241 (D. Mass 2010).

[footnote omitted] royalty and management fees, and the cost of supplies and equipment, so long as Graffeo was paid at least the minimum wage."⁷⁹ Judge Young also concluded, however, that "the resolution of Graffeo's misclassification claims presented issues of Massachusetts statutory law," as a result of which he intended to certify certain questions to the Supreme Judicial Court.⁸⁰

Judge Young certified four questions, all of which dealt with the specific manner in which the Coverall system operated. He added, however, that he "welcome[d] the advice of the Supreme Judicial Court of Massachusetts on any other questions of Massachusetts law deemed material to this case."⁸¹

Various amici participated in the certification proceedings. On behalf of Coverall, the International Franchise Association and others submitted an amicus brief. IFA's position was simply stated: interpreting the law "to prohibit the charging of any fee by any franchisor likely would eliminate franchising in the Commonwealth."⁸²

The Supreme Judicial Court resolved the certified questions largely in favor of Graffeo.⁸³ In addition, that court, responding to Judge Young's invitation, addressed whether Coverall could retain "franchise fees," again ruling for Graffeo and effectively reversing Judge Young's decision. The Supreme Judicial Court reasoned as follows:

In light of the judge's statement that he welcomed other advice about Massachusetts law that is relevant to this case, we address "franchise fees," *i.e.*, the initial and additional fees that Graffeo agreed to pay Coverall in order to enter into what the judge has determined to be a direct employment relationship with Coverall. Our view is that fees such as these constitute "special contracts," not usual between employers and employees. In substance, they operate to require employees to buy their jobs from employers, and in that respect we think they violate public policy. See *Adams v. Tanner*, 244 U.S. 590, 604, 37 S.Ct. 662, 61 L.Ed. 1336 (1917) (Brandeis, J., dissenting), quoting United States Bureau of Labor Bu... No. 109, at 36 (Oct. 1912)("paying for the privilege of going to work, and paying more the more urgently the job is needed, not only keeps people unnecessarily unemployed, but seems foreign to the spirit of American freedom and opportunity"). Cf. 29 C.F.R. § 531.35 (2010) ("wage requirements of the [Federal Fair Labor Standards Act of 1938 (FLSA), 29 U.S.C. §§ 201-219,] will not be met where the employee 'kicks-back' directly or indirectly to the employer or to another person for the employer's benefit the whole or part of the wage delivered to the employee").⁸⁴

Apparently aware of the potential impact on franchising in Massachusetts, the court added the following Delphic footnote:

⁷⁹ *Awuah v. Coverall N. Am., Inc.*, 460 Mass. 484, 952 N.E.2d 890, 893 (Mass. 2011).

⁸⁰ *Awuah*, 740 F. Supp. 2d at 245.

⁸¹ See Order of Certification at 10-11, *Awuah v. Coverall N. Am., Inc.*, No. 07-cv-10287-WG4 (D. Mass. October 26, 2010), ECF No. 347; *Awuah*, 460 Mass. 484, 952 N.E. 2d at 893, n.7.

⁸² Amicus Brief for International Franchise Association, et al, *supra*, at 20.

⁸³ *Awuah*, 460 Mass. 484, 952 N.E. 2d at 901.

⁸⁴ *Id.* at 900.

We emphasize that our concerns over "franchise fees" relate to the potentially exploitative nature of payments by an employee to an employer for the purpose of securing employment. We expressly do not conclude that franchise fees violate public policy when they are agreed to by parties who are not in an employer-employee relationship.⁸⁵

The Court did not expand on this obscure comment by suggesting means for deciding what franchise relationships might be deemed not to be "exploitative" and thus not employment relationships.

C. Other Proceedings in Massachusetts

Judge Young subsequently certified a class of Coverall franchisees. At this writing, the case is still pending. In the absence of any settlement, Coverall is expected to appeal from various rulings by Judge Young, including the underlying ruling that its franchisees must be deemed employees, pursuant to Massachusetts law.

Coverall is not the only franchisor that has been sued in Massachusetts on a "misclassification" claim. However, it appears that, so far, it is only janitorial franchises that have been sued. Recently, in the district court, Chief Judge Mark Wolf, in an action against Jani-King, reached the same conclusion Judge Young reached in the Coverall case, granting plaintiffs summary judgment on the issue whether they had been misclassified as independent contractors, ruling that, as a matter of Massachusetts law, they were employees.⁸⁶ As noted above, a Georgia court, interpreting Massachusetts law, has ruled that franchisees are not employees in a case involving a three-tiered franchise system

D. The Kentucky Decision

In November 2011, the Supreme Court of Kentucky ruled that Subway was not liable for workmen's compensation owed by one of its franchisees, pursuant to applicable Kentucky law.⁸⁷ An employee of the Subway franchisee obtained workmen's compensation, but the franchisee did not have insurance, so the state's uninsured employers' fund sought reimbursement from Subway. An administrative law judge denied the claim on the ground that the governing Kentucky statute "does not encompass a franchisor-franchisee relationship" as it does the relationship between a contractor and a subcontractor.⁸⁸ A court of appeals reversed and remanded for "further consideration of whether the work the uninsured franchisee performed was a regular or recurrent part of [Subway's] business," the applicable test pursuant to the statute.⁸⁹

The Supreme Court reversed the court of appeals. The Supreme Court rejected the administrative determination that, as a matter of law, the franchise relationship was exempt from

⁸⁵ *Id.* at 900, n. 23.

⁸⁶ *See Order, De Giovanni, et al. v. Jani-King Int'l, Inc., et al.*, No. 07-10066-MLW (D. Mass. June 8, 2012), ECF No. 208. There is also an action pending in state court in Massachusetts. *Edson Teles Marchado, et al. v. System4 LLC, et al.*, Case No. SJ-11175 (Mass. Filed April 5, 2012). Nor is Massachusetts the only state that employs an "ABC" test where franchisees have been deemed to be employees. *See Jason Roberts, Inc. v. Adm'r Unemployment Comp.*, No. CV08403233S, 2009 WL 2230754 (Conn. Super. Ct. June 17, 2009) *aff'd sub nom. Jason Roberts, Inc. v. Adm'r*, 127 Conn. App. 780, 2011 WL 1275801 (2011).

⁸⁷ *See Doctors' Assoc's, Inc. v. Uninsured Emp's' Fund*, 364 S.W.3d 88 (Kent. 2011).

⁸⁸ *Id.* at 89.

⁸⁹ *Id.* at 89.

the governing statute, noting that "nothing. . . prevents a franchisor who contracts with another for the performance of work that is a 'regular and recurrent part of the work of the [franchisor's] trade, business, occupation, or profession' from being considered a 'contractor' simply because the other party to the contract is its franchisee."⁹⁰ However, the Court ruled that the administrative law judge had "properly analyzed the facts of the case under the statute," and concluded, on those facts, that Subway was not liable.⁹¹ In particular, the Court affirmed the finding that Subway "was in the business of franchising, not the business of selling sandwiches," as a result of which "the franchisee did not perform a regular or recurrent part of [Subway's] business."⁹²

The International Franchise Association also participated as amicus in the Kentucky case. The Court noted IFA's argument that "to permit a franchisor to be considered a contractor under any set of facts will 'hobble the very aspect of franchising that has allowed it to contribute 176,000 jobs and billions of dollars to the Kentucky economy.'"⁹³ Rejecting this argument, the Court reasoned that franchisors should not be adversely affected by its ruling because "[n]othing prevents a franchisor from including in a franchise agreement a provision that requires the franchisee to maintain workmen's compensation insurance" and to take measures to ensure compliance with the requirement.⁹⁴

The Kentucky decision can obviously be distinguished, at one level, from the Coverall and other Massachusetts decisions simply because it dealt with a different statute. However, the underlying reasoning of the Kentucky decision--that the franchisor is in the business of franchising, not providing the goods or services that its franchisee provides--appears squarely contrary to Judge Young's determination that franchising is not a distinct business, but that the franchisor and franchisee are in the same business. In addition, the Kentucky Supreme Court's comment about a franchisor's right to require its franchisees to maintain workmen's compensation insurance is at odds with the Massachusetts Supreme Judicial Court's opinion that, at least in the Coverall context, a franchisor may not impose that requirement.

E. The California Decision

Jani-King, which now has been determined by a Massachusetts federal district court judge to be an employer there, was successful in obtaining summary judgment from another federal district court judge against the claim that it must be deemed an employer pursuant to California law.⁹⁵ Jani-King franchisees brought a putative class action, claiming in essence that, pursuant to California's labor code, "Jani-King's common policies and practices so tightly controlled the franchisees' actions as to create an employer-employee relationship between Jani-King and Plaintiffs."⁹⁶ Judge Samuel Conti, of the federal district court in San Francisco, rejected this assertion.⁹⁷

Judge Conti, in his opinion, noted that, in California, "the principal test of an employment relationship is whether the person to whom service is rendered has the right to control the

⁹⁰ *Id.* at 92.

⁹¹ *Id.*

⁹² *Id.* at 93.

⁹³ *Id.* at 93.

⁹⁴ *Id.*

⁹⁵ See *Juarez v. Jani-King of California, Inc.*, 2012 WL 177564 (N.D.Cal. Jan 23, 2012).

⁹⁶ *Id.* at 4.

⁹⁷ *Id.*

manner and means of accomplishing the result desired."⁹⁸ Judge Conti recognized that a number of other factors were also pertinent.⁹⁹ He focused, however, on the issue of control and found, as an indisputable fact, that "Jani-King did not exercise sufficient control over Plaintiffs to render them employees."¹⁰⁰ He explained:

Plaintiffs had the discretion to hire, fire, and supervise their employees, as well as determine the amount and manner of their pay. Plaintiffs had the contractual right to decline accounts and, in practice, they did so . . . Jani-King could not terminate Plaintiffs' franchise without cause. See Cal. Bus. & Prof. Code. § 20020. Plaintiffs purchased their own cleaning supplies and equipment. Plaintiffs could bid their own accounts and sell their businesses. Plaintiffs decided when to service certain accounts, subject to timeframes set forth by their clients. Instead of an hourly wage, Plaintiffs' compensation came in the form of gross revenues, less fees paid to Jani-King. Finally, Plaintiffs' franchise agreements expressly state that franchisees are independent contractors

As Plaintiffs point out, Jani-King imposed a number of controls on franchisees However, these controls were no more than necessary to protect Jani-King's trademark, trade name, and good will and, accordingly, did not create an employer-employee relationship between Jani-King and Plaintiffs. For example, to protect its customer relationships, Jani-King retains sole ownership of all contracts with cleaning clients While all contracts for provision of services are drafted by Jani-King franchise owners may "freely set [their] own prices for services and products . . . provided such actions do not affect the business of the franchisor" Jani-King also protects its goodwill by retaining the power to terminate a franchisee's right to service a particular client when the franchisee fails to comply with Jani-King's policies and procedures Jani-King performs billing and accounting for franchisees' cleaning services to maintain consistency across the franchise There is no evidence that this practice limited the business opportunities available to franchisees. Jani-King also communicated directly with some of Plaintiffs' clients to address complaints and ensure customer satisfaction

Plaintiffs make much of the fact that Jani-King collected payments directly from customers and then remitted "what resembles a paycheck to workers." Regardless of how payments were collected and distributed, it remains undisputed that Plaintiffs were entitled to the revenues generated by their franchises, less franchise fees.¹⁰¹

The Jani-King system, at least as described by Judge Conti, is very similar to the Coverall system, as described by Judge Young. The tests for determining whether an employment relationship exists are different, or at least differently stated, in those two, and other jurisdictions. The "control" issue on which Judge Conti focused has not been addressed in the Massachusetts litigation. Thus, one can arguably distinguish the cases and reconcile their results. However, it is surely disconcerting for a national franchisor, like Jani-King, to be deemed an employer in one jurisdiction and not in another, and to be at hazard of varying rulings, on varying bases, in other jurisdictions. Nor may it be comforting to franchisors,

⁹⁸ *Id.* (citation omitted).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at *4-5 (internal citations and footnote omitted).

operating in Massachusetts, if not elsewhere, to see varying results or to believe that any differences between the manner in which they operate, and control (or do not control) their franchisees, will allow them necessarily to avoid being found to be employers, or at least to be embroiled in class action litigation on that issue.

V. HOW FAR CAN THE EMPLOYER/EMPLOYEE ANALYSIS GO?

While the cases that have attacked the franchise structure as an employment relationship have been aimed at the core of the relationship, there are at least two other areas where the type of analysis that is employed in those cases may have a bearing on the outcome of franchise relationships: covenants not to compete and vicarious liability.

Covenants not to compete traditionally were categorized by the courts as falling into two classifications: covenants ancillary to employment agreements and covenants ancillary to sales of business. Most jurisdictions have followed the rules that covenants that are ancillary to the sale of a business are treated much more leniently than covenants ancillary to an employment relationship. This distinction in treatment has been driven largely by policy considerations and the disincentive to put people out of work.

As franchising developed and adopted restrictive covenants as part of the franchise agreements, courts were confronted with the question whether franchise agreements should be treated more like employment agreements or more like sales of businesses. The results have been anything but uniform, with some courts taking a strict view of franchise relationships, similar to employment relationships,¹⁰² while others have taken the view that the sale of a franchise is very much like the sale of a business and covenants should be presumed to be enforceable.¹⁰³ Yet other courts have taken a middle ground and treated franchise agreements as sui generis.¹⁰⁴

While we have not undertaken a comprehensive survey, a simple review of cases that have treated franchise covenants like employment agreements suggests that the courts have not engaged in a particularly rigorous analysis, nor have they applied the factors that are invoked in alleged misclassification cases. Certainly, the argument can be made, in jurisdictions where there are no precedents, that the misclassification factors can be used in determining whether a franchise agreement is more like an employment relationship or like a sale of a business. But, to date, no court appears to have done so.

Cases in which third parties injured on franchisee premises seek to hold the franchisor liable—vicarious liability cases—typically are decided upon theories of actual agency, apparent agency, or premises liability. Many cases that have considered vicarious liability have approached this issue as an agency matter, and have relied upon the actual terms of the franchise agreement, and, in particular, the specific provision referring to independent contractor status, to conclude that the franchisor is not liable. These cases focus upon the terms of the

¹⁰² See, e.g., *Atlanta Bread Co. Int'l, Inc. v. Lupton-Smith*, 285 Ga. 587, 589 (Ga. 2009); *O.V. Mktg. Assoc's, Inc. v. Carter*, 766 F. Supp. 960, 965 (D. Kan. 1991)).

¹⁰³ See, e.g., *Jiffy Lube Intern., Inc. v. Weiss Bros., Inc.*, 834 F. Supp. 683, 691 (D. N.J. 1993); *McCart v. H & R Block, Inc.*, 470 N.E.2d 756, 763-764 (Ind. Ct. App. 1984).

¹⁰⁴ See *Budget Rent-A-Car Corp. of Am. v. Fein*, 342 F.2d 509, 515-518 (5th Cir. 1965) (holding that cases regarding non-competes largely fall into one of two categories: (1) ancillary to the sale of a business; or (2) ancillary to an employment contract, but applying a standard that addresses elements of both relationships).

franchise agreement and often conclude that the franchisor has not exercised sufficient control over the franchise to constitute the franchisee an agent. Rather, the conclusion that those courts have reached is that the franchisor exercises only sufficient control to maintain control over its trademarks, and does not exercise the “day-to-day” control over the franchisee that would make the franchisee an agent for purposes of vicarious liability.¹⁰⁵

Recently, however, the impact of cases challenging the employment status of franchisees has found its way into the vicarious liability arena. In *Hayes v. Enmon Enterprises, LLC*,¹⁰⁶ a third party claimed that a janitorial services franchisee was the employee of the franchisor and that the franchisor was therefore liable for the franchisee’s acts. The court applied the Mississippi analysis for determining an employment relationship, which looks to ten separate factors.¹⁰⁷ It found that five of the factors suggested that the franchisee was an independent contractor, and five suggested that it was an employee.¹⁰⁸ Among the latter were provisions of the franchise agreement requiring the franchisee to follow the franchisor’s established policies, practices, procedures and standards; the franchisor’s right to review the franchisee’s books and records; and the franchisor’s right to change company policies from time to time. The franchisor’s motion for summary judgment was therefore denied.¹⁰⁹

VI. CONSEQUENCES OF MISCLASSIFICATION

If a franchisor’s franchisees are found to have been misclassified as independent contractors, the franchisor faces a panoply of consequences on both the franchise side and the employment side. The consequences will differ by state. Generally, on the franchise side, there are disclosure and registration issues; breach of contract issues; and collateral issues as well. On the employment side, the franchisor may be found liable for minimum wage violations; overtime wage violations; unemployment benefits, workers compensation; failure to indemnify employees for expenses; unlawful deductions from wages, violations of laws against requiring an employee to purchase goods from the employer, employment discrimination and labor law violations.

A. Franchise Law Consequences

1. Repayment of Franchise Fees

The most striking, and potentially devastating, consequence of misclassification of “employees” as franchisees is the remedy: repayment of all fees paid by the franchisee to the franchisor. There are a number of both common law and statutory grounds on which this remedy can be predicated.

a. Common Law

¹⁰⁵ See, e.g., *Hunter v. Ramada Worldwide, Inc.*, 2005 WL 1490053 at *6-*8 (E.D. Mo. June 23, 2005).

¹⁰⁶ 2011 WL 2491375, Bus. Franchise Guide (CCH) ¶ 14,647 (S.D. Miss. 2011).

¹⁰⁷ *Id.* at * 3.

¹⁰⁸ *Id.* at *6.

¹⁰⁹ *Id.* at *7; See also, *Patterson v. Domino’s Pizza, LLC*, *supra*.

If a franchisor is found to have collected franchise fees from persons who properly should have been treated as employees, the employees may claim a right to repayment of their fees on at least two common law bases: that the fees were against public policy; or that the franchisor defrauded them.

The Supreme Judicial Court's decision in *Awuah* held that franchise fees were "special contracts" that required the employee to purchase the job from the employer and that were therefore contrary to public policy. Accordingly, the court held that both initial and "additional" fees were subject to being refunded. This conclusion can potentially bankrupt the franchisor, since, taken literally, it would have to refund *all* fees to *all* franchisees subject to the ruling. The court did not define "additional" fees, nor did it distinguish the different types of additional fees that franchisees might pay: royalties, national marketing fees, local advertising fees or co-op fees, and potentially a myriad of others. Nor did the Court distinguish fees that were for "purchasing" the "job" from fees, such as local co-op fees, that were paid in exchange for goods or services.

The Massachusetts decision was based on common law and the observation that a requirement that an employee purchase a job was against public policy. The court relied upon a dissenting opinion by Justice Brandeis in a 1917 United States Supreme Court decision striking down a prohibition upon employment agencies to which employees paid for the agency's services. Apparently, the *Awuah* decision is unique in this regard, but its holding potentially refreshes, if not resuscitates, a common-law basis for holding that franchise fees, if paid by persons who are lawfully employees, are void as against public policy. While it remains to be seen whether *Awuah's* holding will be followed by other states, its common law ramifications – and the potential applicability of them in other jurisdictions – loom large.

Fraud or negligent misrepresentation claims may also form the basis of rescission and return of franchise fees.¹¹⁰ A fraud case would have to be based on the contention that the franchisor knew, or should have known that its arrangement was one of employment, and that it knowingly deceived the franchisee into "buying a job" instead of "buying a franchise." To be sure, this theory is going to be difficult to prove in the face of evidence that the franchisor "knew" that it was in fact an employer. But with franchise misclassification cases becoming more numerous, and in light of the wide attention they have received, the potential viability of a fraud claim based on the theory that the franchisor "should have known" that it was an employer is enhanced.¹¹¹

For the franchisor, the lesson for now is to audit the files and determine if there has been any past consideration of employment status; it may be helpful or harmful. Second, franchisors should review their structures and, if appropriate, change them in order to attempt to meet a challenge that they were employment relationships.

¹¹⁰ See, e.g., *Motor City Bagels, L.L.C. v. Am. Bagel Co.*, 50 F. Supp. 2d 460, 481 (D. Md. 1999) ("To the extent that the plaintiffs are successful in prosecuting their fraud claim, they likewise could opt to void the contracts and seek restitution for amounts paid to American Bagel under the various franchise and development agreements.")

¹¹¹ *Bissett v. Ply-Gem Indus., Inc.*, 533 F.2d 142, 145 (5th Cir. 1976) ("The Court properly instructed the jury that an alleged misrepresentation must relate to a material fact, and that a misrepresentation is actionable only if the defendant knew or should have known that the statements were false, or if the statements were made without knowledge of their truth or falsity."); *Sklar v. Rowe Furniture Corp.*, Bus. Franchise Guide (CCH) ¶ 10,188 (D. Minn. 1993) (holding that scienter required to plead a claim for fraud included the allegation that defendant knew or should have known representations were false).

b. Franchise Statutes

Franchisees that are found to have been misclassified as such may have claims for violation of the anti-fraud provisions of state franchise laws, and repayment of franchise fees may be part of the remedy. Depending on the jurisdiction, the basis for these claims can arise from any number of facts:

- Failure to disclose that an employment relationship was being sold when the franchisor knew or should have known of it;
- Failure to disclose the incidents of the employment relationship, such as entitlement to workers' compensation of overtime pay;
- Misrepresentation of fees;
- Misrepresentation of the nature and extent of the franchise system itself; or
- Misrepresentation of insurance obligations and costs.

Again, as with fraud, liability in a case like this may well turn on whether the defendant/franchisor knew that it could be classified as an employer. But many franchise disclosure statutes provide for liability based upon “any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,”¹¹² a broad net that is borrowed from the securities acts. Under those acts, the language has been held to place the burden of showing an absence of knowledge on the defendant;¹¹³ or it has been held to equate to “severe recklessness” or disregard of a fact “so obvious that the defendant must have been aware of it.”¹¹⁴ Indeed, some states have construed their franchise statutes as not requiring scienter or reasonable reliance.¹¹⁵ Further, the burden of proof may be less than the clear and convincing evidence typically required for fraud.¹¹⁶ Thus, if a franchise relationship is found to have been misclassified in a state with antifraud provisions in a franchise statute, establishing a violation of that statute for failure to disclose the true nature of the relationship, and its attendant incidents, may be considerably easier than for common law fraud.

A finding of liability can result in rescission under many state statutes. Typically, rescission is going to mean a return of franchise fees, less perhaps the value of what the franchisee has retained. But the statutory recitations of remedies are broader than rescission only: they include: “damages sustained by the grant of the franchise.”¹¹⁷ Court readings of these rather broad statements vary: Washington courts have held that “rescission” does not include losses sustained by the franchisee’s operations.¹¹⁸ Michigan has held that a franchisee must elect between “rescission” and “damages.”¹¹⁹ Minnesota has held that “rescission” may

¹¹² See, e.g., N.Y. Gen. Bus. L. §687(2)(c).

¹¹³ See *Papic v. Burke*, 113 Conn. App. 198, 965 A.2d 633 (Conn. App. Ct. 2009).

¹¹⁴ See *State v. Sterling*, 396 S.C. 599, 615 (S.C. 2012).

¹¹⁵ *Randall v. Lady of Am. Franchise Corp.*, 532 F. Supp.2d 1071 (D. Minn. 2007); *Enservco., Inc. v. Indiana Secs. Div.*, 623, N.E.2d 416 (Ind. 1993)(“fault is not an element . . . of franchise fraud”).

¹¹⁶ See *Kirkham v. Smith*, 106 Wash. App. 177, 23 P.3d 10 (Wash. Ct. App. 2001) (also stating in dicta that the Washington’s act did not require scienter).

¹¹⁷ Md. Code Ann., Bus. Reg. § 14-227(b); for “damages and, if such violation is willful and material, for rescission, with interest at six percent...” N.Y. Gen. Bus. Law § 690(1); for “damages...rescission, or other relief” Minn. Stat. §80C.17; or for “damages cause thereby for rescission or other relief.” Wash. Rev. Code § 19.100.190, among others.

¹¹⁸ *Brader v. Minute Muffler Installation, Ltd.*, 81 Wash. App. 532, 914 P.2d 1220 (Wash. Ct. App. 1996), amended, 922 P.2d 825 (Wash. Ct. App. 1996).

¹¹⁹ *Interstate Auto. Transmissions v. Harvey and Leidi*, 350 N.W.2d 907 (Mich. Ct. App. 1984).

include all amounts incurred by the franchisee in setting up the business, which presumably includes more than simply fees, but also investments and potentially business losses.¹²⁰

Significantly, most of these statutes, if not all, also provide for recovery of attorneys fees.¹²¹ Punitive damages may also be available for franchise disclosure violations, depending on the jurisdiction.¹²²

2. Registration and Disclosure Issues

A finding of misclassification poses disclosure and registration issues to the franchisor. First, there is a serious question of whether the franchisor can continue selling franchises, at least in the jurisdiction where it has been affected by a ruling. The “franchise” is no longer a franchise; it is an employment relationship.

Outside of the affected jurisdiction, how does the franchisor appropriately make disclosure? Is the fact that the “franchise” may be an unlawful employment relationship disclosed only in Item 3 under the appropriate litigation? Or should the franchisor be more comprehensive: Should there be a risk factor about misclassification, and if so, what should it say? What about the franchisor’s description of the business that it is in, if a court has found it to be an employer, under item 1, that calls for “whether the franchisor operates business of the type being franchised.” Are the Item 5 and 6 disclosures of fees imperiled by laws prohibiting the “employer” from making deductions from the franchisee’s wages without consent? Are there potential problems disclosing required purchases in jurisdictions that prohibit an employer from demanding that employees purchase from it? How does the franchisor now construct its Item 20 tables?

It appears, as of this writing, that regulators have not taken a position on any of these issues, nor does there appear to be parallel or analogous authority on which to rely.

3. Other Consequences

Franchisees may have claims for breach of contract against franchisors who are found to be their employers. The key breach of contract claim would be failure to provide a franchise, as promised. This claim can be amplified by references to the transfer provisions of the agreement, which would be evidence that the business had independent, inherent value.

Most jurisdictions follow a “benefit of the bargain” measure of damages in contract cases.¹²³ Under this measure of damages, the wronged party is entitled to recover the value of what it bargained for. Particularly in industries such as the janitorial services industry where the

¹²⁰ *Martin Distribs. v. Vander Bie*, 269 N.W.2d 868 (Minn. 1978).

¹²¹ See, e.g., Fla. Stat. Ann. § 817.416(3); Mich. Comp. L. Ann. § 445.1531(1); Minn. Stat. Ann. § 80C.17, Subd. 3; Va. Code Ann. § 13.1-571(a).

¹²² See *Cox v. Doctor’s Assocs., Inc.*, 613 N.E.2d 1306, 1329 (Ill. App. Ct. 1993), *appeal denied*, 622 N.E.2d 1202 (Ill. 1993), *cert. denied*, 114 S.Ct. 1069 (1994) (punitive damages upheld for violation of Illinois disclosure act).

¹²³ See, e.g., *Am. Speedy Printing Ctrs., Inc. v. AM Mktg., Inc.*, 69 Fed. Appx. 692, 698 (6th Cir. 2003) (“The goal in awarding damages for breach of contract is to give the innocent party the benefit of his bargain – to place him in a position equivalent to that which he would have attained had the contract been performed.”) (quoting *Tel-Ex Plaza, Inc. v. Hardees Rests., Inc.*, 76 Mich. App. 131, 134 (Mich. Ct. App. 1977)); *Guzman v. Jan-Pro Cleaning Sys., Inc.*, 839 A.2d 504, 508 (R.I. 2003) (“It is well settled that a court may award damages for breach of contract to place the injured party in as good a position as if the parties fully performed the contract.”) (internal quotations omitted).

franchisee “buys” a level of monthly income, the calculation of the benefit of that bargain is fairly straightforward. Thus, if the franchisee bought a franchise that was to give him \$10,000 worth of income for a period of 10 years, the franchisee arguably would be entitled to the present value of that income stream, less projected expenses, for the life of the contract. The introduction of the employment relationship into the calculation means that the franchisee may be entitled to more compensation from the franchisor on a separate basis.

Franchisors also run the risk of claims under state “Little FTC” or unfair trade practice statutes. Such laws are sometimes referred to as “consumer protection laws.” These statutes broadly proscribe “unfair and deceptive” acts or practices in commerce and may reach a wide variety of conduct.¹²⁴ It is conceivable that such conduct would include misclassification itself, or some of its incidents. Additionally, some state unfair trade practice laws explicitly or through case law incorporate the rules and rulings of the Federal Trade Commission, thereby making a violation of the FTC Rule a violation of the state unfair trade practice law.¹²⁵ The franchisor thus may face a state-law claim for inadequate or unlawful disclosure, based upon the state’s interpolation of the FTC Act into its unfair trade practice statute.

To be sure, unfair trade practice acts vary widely, and many contain inherent limitations on who can sue for what. For example, franchisees may not qualify as “consumers” under acts that give a private right of action only to “consumers,” as defined in the act.¹²⁶ Others require that the challenged conduct have a significant adverse impact on the public.¹²⁷ But if these challenges can be overcome, an adverse finding could result, in some jurisdictions, in an award of multiple damages and attorneys fees.¹²⁸

B. Employment Law Consequences

The finding that a franchisee is an employee can lead to many forms of liability for the franchisor, including the most obvious--liability for employment tax withholding (FICA, FUTA, income tax, etc.). Claims can be brought by federal and state agencies, as well as by franchisees alleging that they are, in fact, employees. Examples of other potential exposure for franchisors who are deemed to be employers would include but not be limited to:

1. Minimum Wage Laws

The franchisee/employee may have a claim for violation of federal and state minimum wage laws if the economics of the franchise were such that the franchisee had to put in so many hours that he was effectively not receiving the minimum wage. The franchisee in this instance would need to have proof of the hours worked, together with the compensation received that could be counted as gross wages. Federal minimum wage is \$7.25 per hour but many states have higher minimum wage rates, with Washington currently the highest at \$9.04 per hour.

¹²⁴ See, e.g., *Trilogy Props. LLC v. SB Hotel Assocs. LLC*, 2010 WL 7411912 (S.D. Fla. 2010) (holding that Florida Deceptive and Unfair Trade Practices Act claims could proceed against Donald Trump who licensed his name to promote a luxury condominium where the promotions were alleged to have been unfair and deceptive).

¹²⁵ See *Akers v. Bonifasi*, 629 F. Supp. 1212 (M.D. Tenn. 1984).

¹²⁶ See *Triple Z Postal Servs., Inc. v. United Parcel Service, Inc.*, Bus. Franchise Guide (CCH) 13,468 (N.Y. Sup. Ct. 2006).

¹²⁷ See *Evanston Motor Co., Inc. v. Mid-Southern Toyota Distribs., Inc.*, 436 F. Supp. 1370 (N.D. Ill. 1977).

¹²⁸ See, e.g., Tenn. Code Ann. § 47-18-109; Pa. Stat. Ann. § 201-9.2(a).

2. Overtime

Federal law requires that time and a half be paid for hours worked by non-exempt employees in excess of forty in a week. In addition, some states provide that such employees must be paid overtime after a certain number of hours per day or if they work on certain days. A claim that franchisees are entitled to overtime pay is again subject to proof of the actual hours worked and the compensation received for it but the burden of maintaining proof of hours worked is the employer's.

Most wage-related claims are brought as class or collective actions and the FLSA provides for liquidated damages, exposing employees to significant risk. The statute of limitations under the FLSA is two years, unless the violation is willful, in which case it's three years.

Some states provide for additional paid time; e.g., California requires two paid breaks and an unpaid meal period each day, with substantial penalties for failure to provide same.

3. Recordkeeping Requirements

Federal and state employment laws require that employers maintain certain types of records. For example, California provides that employers must provide with each payment of wages a statement of gross wages, total hours worked, all deductions, net wages, dates for which payment is made and the name and address of the employer.¹²⁹ Employees have a right to inspect and copy these records.

The statute goes on to provide that any employee who suffers an injury or an intentional violation of the recordkeeping requirements is entitled to recover the greater of actual damages of \$50 for the initial pay period of the violation and \$100 for each subsequent violation, up to a total of \$400.

Other examples of required recordkeeping for employers may include OSHA logs, EEO-1 reports, applicant flow logs and hiring/termination reports.

4. Purchases and Payments

Most states prohibit an employer from make certain deductions from an employee's pay. For example, California provides it is unlawful for an employer to collect or receive "any part of wages therefore paid by said employer to said employee."¹³⁰ This calls into question royalty payments that the franchisor collects, advertising contributions, as well as required purchases. In addition, California has a "company store" provision that prohibits an employee from being required to purchase job-related equipment from the employer.¹³¹ This prohibition of course, can fly in the face of requirements that franchisees purchase certain items from their franchisor or from approved suppliers. Many states regulate the issue of employee uniforms, requiring the employer to provide and/or clean them at no expense to the employee.

¹²⁹ Cal. Lab. Code § 226.

¹³⁰ Cal. Lab. Code § 221.

¹³¹ Cal. Lab. Code § 450.

5. Unemployment Benefits

Most states provide that employees are entitled to unemployment benefits if they lose their jobs, and that employers must pay for the cost of unemployment insurance.

6. Workers Compensation

Virtually all states provide that employers must provide worker's compensation coverage for injuries suffered on the job either through insurance or contribution to a state fund. Some states (such as New York) also require employers to provide disability insurance for non-work related illnesses or injuries.

7. Health Insurance

Under the Affordable Care Act, most employers will be required to provide health coverage for employees in some way or be penalized for failing to do so.

8. Employment Discrimination

Employers are covered by a panoply of federal and state laws prohibiting discrimination against employees. Many of the laws do not provide similar protection to independent contractors. Depending on the jurisdiction, race, gender, age, disability, national origin, religion, sexual orientation, military status, marital status, parental status, and others can all be protected categories.

9. Government Contractors

If the franchisor is a government contractor or subcontractor, employer status could require that affirmative actions plans be maintained and reports made to the Office of Federal Contract Compliance. Failure to meet the requirements can result in debarment as well as liability for discrimination or pay issues.

10. Collective Bargaining/Labor Law

The National Labor Relations Act protects the right of employees to engage in concerted activity related to the terms and conditions of their employment. If franchisees are deemed to be employees, query whether they could band together and seek collective bargaining rights from their franchisors.

In virtually all employment related statutes, attorneys' fees are available for the prevailing employees and many statutes impose fines or penalties on the employer in addition to the damages payable to the successful plaintiff-employees.

VII. HOW BIG IS THE PROBLEM? AND ARE THERE SOLUTIONS?

A. The Scope of the Problem

The recent spate of litigation in which plaintiff franchisees allege that they are employees of their franchisor and, consequently, entitled to remedies available to employees pursuant to governing employment laws unquestionably creates a problem for franchisors and, ultimately

perhaps, for franchising as a means of distribution. The question is not whether there is a problem, but its extent and possible solutions.

Some may react that the problem is not significant, that is really only applies, narrowly, to janitorial franchises that operate in a certain manner in the Commonwealth of Massachusetts. If that is so, then there is no real threat to franchising, only to those companies, who may ultimately have to abandon franchising in that state if they cannot alter the manner in which they operate to avoid being deemed employers, persuade the courts, that they should not be deemed employers, or persuade the Massachusetts legislature to change the law.

The authors do not subscribe to this narrow view, any more than does the International Franchise Association. We believe that franchise systems in Massachusetts are threatened by the applicable statute, as interpreted thus far by the courts there. We also believe that all franchisors are subject to the risk of being deemed employers pursuant to various applicable state or federal statutes, or at common law, and that the ensuing uncertainty threatens the stability of franchisors, and franchising as a method of distribution.

There is no principled distinction between janitorial and other franchises in Massachusetts that would justify the conclusion that the former are, and the latter are not, employers. Certainly, if Judge Young's rationale in the Coverall litigation is followed, there is no reason to believe that any franchisor will satisfy the second prong of that state's law, such that it will not be deemed to be in the same business as its franchisees. The Supreme Judicial Court of Massachusetts significantly compounded the problem, and the risk, by ruling that franchisee/employees are entitled to a refund of fees they paid the franchisor/employer. We suggest it is foolish for franchisors to take comfort in the Supreme Judicial Court's "saving" footnote, which somehow suggests that "good" franchisors need not worry because the ruling only applies to "bad" ones. That way lies the potential of endless litigation on the subjective issue of "goodness," with the risk that an annoyed judge, jury or arbitrator will punish a franchisor deemed to be "bad" by declaring it to be an employer and forcing disgorgement of fees.

We also believe, given the recent cases in other jurisdictions, that some plaintiffs' counsel will continue to assert misclassification allegations against franchisors elsewhere than in Massachusetts. To the extent the focus of those cases is the amount of control the alleged employer exercises over the activities of the alleged employee, that test is highly fact-dependent, as demonstrated by the "vicarious liability" cases. That is not a pleasant prospect for franchisors who legitimately want to have certainty that they will not have to give back fees they earn by licensing a system to the franchisee and providing the controls necessary not merely to protect their trademark, but also to ensure the uniformity in product or service that is the essence of franchising. In our view, any franchisor, in any state, is at hazard for at least having to defend a claim, perhaps on a classwide or multi-party basis, that the franchise relationship is really an employment relationship and that the employees, as held in Massachusetts, may reclaim the fees they have paid.

B. Potential Solutions

If we are right that the problem is not just a problem for janitorial franchises in Massachusetts, but one that at least creates undesirable risk and uncertainty for all franchises, everywhere, and thus for franchising itself, there needs to be a solution to the problem. That solution can be driven by legal precedent, legislative action, operational changes, or all of the above.

We believe it may be true that some franchises systems may be able to make structural changes that will make it less likely that the franchisor will be deemed an employer. Franchisors may want to evaluate whether the controls they place on their franchisees reach beyond those necessary to protect the trademarks and goodwill. They may also look to minimize the interdependence between the franchisor and franchisee as it relates to the services or product provided to the end user. They may want to have their franchisees contract with or have the direct relationship with the end user, as opposed to the franchisors. Similarly, franchisors may want the franchisees to collect the funds from the customer, as opposed to the franchisors' collecting them, deducting their fees, and then paying the franchisee the balance. Franchisors might also consider requiring their franchisees to incorporate, on the theory that courts and administrative agencies may be less inclined to find a corporation to be an employee.¹³² There may be other structural changes that particular franchise systems might be able to effect that would make their franchisees seem less like employees.

Apart from whether structural changes are feasible, however--and while structural changes may make it less likely that a court's visceral reaction would be that the relationship is an employment relationship--there is nothing in structural changes that will entirely eliminate the risk that the franchisor's exercise of control will be deemed sufficient under one test or another, to require the conclusion that it is an employer, let alone make certain that the franchisor will satisfy the second prong of the Massachusetts, or any similar, test by establishing that it is in a different business from its franchisee. Thus, we do not believe that franchisors can necessarily solve this problem by "tweaking" the structural relationship with their franchisees. If they are particularly vulnerable, because of the nature of the system they operate, to being deemed to be employers, or particularly risk-averse with respect to that prospect, they may choose to revise their system to include only company-operated locations.¹³³

A simple solution to the problem may be legislation (or judicial rulings) that franchisees are not employees, similar to the recent legislation passed in Georgia. The Georgia statute was revised to provide that "[i]ndividuals who are parties to a franchise agreement as set out by the Federal Trade Commission franchise disclosure rule . . . shall not be deemed employees."¹³⁴ An alternative legislative (or judicial) approach would be to limit the remedy available to a franchisee who is deemed an employee to assuring that the franchisee has received minimum wage, and perhaps other traditional employment law remedies, but not to permit disgorgement

¹³² This approach may meet with limited success, at least in Massachusetts. Although the pertinent statute there refers to employees as individuals, the Attorney General has advised that it "will enforce the Law against entities that allow, request or contract with corporate entities such as LLCs or S corporations that exist for the purpose of avoiding the Law." An Advisory from the Attorney General's Fair Labor Division on M.G.L. c. 149, s. 148B, Advisory 2008/1 at 5; see also, *Amero v. Townsend Oil Co.*, No. 07-1080-C, 2009 WL 1574229, at n.4 (Mass. Super. Ct. April 15, 2009) (Massachusetts law); *Lee v. ABC Carpet & Home*, 236 F.R.D. 193, 197-98 (S.D.N.Y. 2006) (FLS A).

¹³³ As it relates to Massachusetts, in any event, it is difficult to envision how any franchisor can escape an employment determination based on the current interpretation of the second prong of the Massachusetts wage statute, so operational changes are likely futile. The path to a solution in Massachusetts--other than to withdraw from the market or convert to only company-operated locations--will likely need to involve advocacy in the legislature, at the Attorney General's Office, and in the court system, either at the First Circuit or Supreme Judicial Court.

¹³⁴ Ga. Code Ann. § 34-9-1 (West). The Virginia Attorney General has issued an opinion that although the pertinent employment law "does not exclude franchises from its terms . . . the application of its test would exclude typical franchises from its scope." Virginia Attorney General Opinion, Opinion No. 10-111, 2011 WL 335173 (Va. A.G. Jan. 25, 2011). Although seeking interpretative opinions from state attorney generals may be a worthwhile approach, it also entails risk. The process can become politicized, perhaps leading to unhelpful language, such as the Virginia Attorney General's unexplained reference to "typical," and may risk waking a sleeping dragon if the Attorney General has not yet considered whether to examine franchisor's under state wage law.

of franchise fees. It is unlikely, however, that 50 state legislatures and countless courts will agree on even a simple solution. Nor, at least for the present, does legislation at the federal level seem possible. Thus, for now, it does not appear there is a universal solution to the problem in prospect.

VIII. CONCLUSION

Franchising is now a global phenomenon. It has a huge economic impact on the economy of the United States and, increasingly, in other countries. Yet, as a separate area of law, franchise law is relatively young and still becoming established. As franchising has grown, and courts have tried to resolve disputes arising from the franchise relationship, a game of legal charades has gone on. An issue in franchising "sounds like" an issue the courts have dealt with in another context, so the courts, by analogy, have applied principles developed elsewhere to franchising. As discussed elsewhere in this paper, that approach was taken with respect to issues of vicarious liability to third parties and covenants against competition. Of course, employment law principles regarding joint employers and, now, whether franchisees are employees, rather than independent contractors, have been applied by the courts.

As franchising has grown, and franchise law as a separate field has begun to come of age, some principles, specifically applicable to franchising, have emerged. For example, in the development of specific principles to covenants against competition in franchising that are variants of those typically used in somewhat analogous areas of sales of business and employment relationships. Similarly, legislation, at both the federal and state levels, specifically relating to franchising has been enacted. But, judicial development of a set of separate principles for franchising has been modest, at best, and legislation, particularly with respect to the franchise relationship (rather than disclosure requirements before the relationship is formed) is fragmentary.

We believe the best solution to the franchisor/employer problem is simple, at least conceptually, but will be difficult, if not impossible, to achieve. The franchise relationship should not be deemed an employment relationship. It should be deemed a franchise relationship. The rules that apply to employment relationships should not be applied to franchising. Rules specifically designed for the franchise relationship should be applied to that relationship. Put another way, the best approach is not "negative" (saying what franchising isn't), but "positive" (saying what it is).

Franchisors, on the whole, and the International Franchise Association, in general, have opposed franchise relationship legislation. Franchisors might well favor legislation, like the Georgia statute, that simply specifies that franchisees are not to be deemed employees. They might be amenable, but probably would be lukewarm, to legislation that, by limiting remedies available to franchisee/employees, implicitly would recognize that a franchisee could be deemed to be an employee. We doubt that franchisors would readily embrace legislative efforts to define franchising as a separate type of relationship and establish separate rules with respect to that relationship. Accordingly, we think it is highly unlikely that there will be a National Franchise Relations Act.

Thus, while we believe the solution should be "positive" legislation, perhaps at a federal level, to define franchising and rules regarding it, we believe that, as a practical matter, the problem will only be addressed by a patchwork of structural changes by certain franchisors, some state "negative" legislation, eliminating the prospect, or reducing the effects of, a

determination that franchisees are employees, and common law development of rules sorting out the definitions and remedies that should apply.

The franchisor/employer problem, for which there is no satisfactory solution at present, may grow, and fester. Certainly, there will be employment lawyers who will, at least for a time, become involved in disputes between franchisors and franchisees. The problem may, in fact, be lessened as franchisors who are the most vulnerable, or most risk-averse, abandon franchising. But, that is certainly not a happy solution for the future of franchising and the opportunities it provides for individual entrepreneurship. We hope, however, that--unlikely as it may seem now--the problem will serve as a "wake-up call" that efforts should begin in earnest to define the franchise relationship in a comprehensive way so that it will be treated as a bona-fide independent contractor relationship, and franchise law will have its own definitions and rules, just as employment law does.

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