Is the Franchise Model Under Attack?

During the last two years, franchisors have been facing courts and legislatures that appear to be increasingly hostile to franchising, as greater numbers of franchisor-franchisee relationships are being deemed to be franchisor-employee relationships. This column summarizes some of the most serious recent challenges to the franchise business model.

By Marc Lieberstein | September 5, 2019

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Sadly, I submit this column on franchising for the late Rupert Barkoff, my mentor in franchising, and the author of this column for the New York Law Journal for many years. For the last six years I had the privilege to work with and learn franchise law from Rupert, and we periodically debated the merits of franchising, and whether, as the title of this article asks, franchising was the best way for brand owners to do business.

Rupert was a true believer in franchising and its benefits, and indeed before he passed became involved in several restaurant ventures that I am sure he hoped would eventually franchise. But, in Rupert's Nov. 17, 2017 NYLJ article titled "*Joint Employer Liability in the United States and Australia*," Rupert discussed several recent impediments to the franchise model including the unexpected rise of joint employer liability and misclassification actions for franchisors, and new state laws, e.g., CA-AB5 California, that appeared to target franchising and conspire to reduce or eliminate franchise activity. Notably, at the end of Rupert's 2017 article he posed whether "it may be time to reflect on the franchise model and ask if there is a better way to do business." It is now 2019, and I am confident Rupert would deem this inquiry very appropriate in light of the current state of affairs in franchising.

During the last two years, franchisors have been facing courts and legislatures that appear to be increasingly hostile to franchising, as greater numbers of franchisor-franchisee relationships are being deemed to be franchisor-employee relationships. This may subject franchisors to significant financial exposure for joint employer liability and/or wage and hour liability claims, not to mention union threats and increased labor costs. The franchise model was supposed to enable franchisors to avoid these liabilities and costs, and facilitate growth of their branded businesses faster and more cost effectively. Franchisees purportedly did not want to be employees—they wanted a chance to own and operate their own businesses and make money. This column is not large enough to provide a full history of how we got here, and where we are, but below is a summary of some of the most serious recent challenges to the franchise business model.

Direct vs. Indirect Control

Until 2015, the National Labor Relations Board (NLRB) previously required "direct control" over a franchisee's employees for a franchisor to be found a "joint employer," and hence be liable for the acts/omissions of the franchisee's employees. Generally, direct control meant a franchisor was directly involved in day-to-day franchisee operations, e.g., hiring, firing,

setting hours, payroll, etc. Then a 2015 NLRB decision, *Browning-Ferris Industries*, 362 NLRB No. 186, changed that standard to "indirect control," making it easier to find franchisor joint employer liability. This decision was widely viewed as a direct attack on the franchisor-franchisee relationship.

However, in September 2018, the NLRB released a proposal to return to the former standard requiring direct control. Most believe that direct control will be required under the NLRB standard at least under the current administration as it relates to the joint employer issue. Indeed, in a recent NLRB decision, *SuperShuttle DFW*, 367 NLRB No. 75, the NLRB ruled that the franchisees were not statutory employees under the National Labor Relations Act, and seemingly narrowed the federal standard for who may be considered an independent contractor in the context of union employees (the decision did not extend to wage and hours claims). This is a positive sign for franchisors and franchisees who want their independence, yet who like the franchise model for growth and profit as well as maintaining consistent high quality standards associated with the franchise brand across all franchise outlets.

The ABC Test

But, on the flip side, in connection with misclassification actions, we have *Dynamex Operations W. v. Superior Court*, 4 Cal. 5th 903 (2018), where the California Supreme Court made it more difficult for employers (including franchisors) to classify workers (including franchisees) as independent contractors by adopting what has become known as the "ABC test." Under the ABC test, a worker is presumed to be an employee under state wage and hour laws unless the hiring entity can affirmatively show (A) the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact; (B) the worker performs tasks that are outside of the usual course of the hiring entity's business; and (C) the worker is customarily engaged in an independently established trade, occupation or business of the same nature as the work performed for the hiring entity. And in May 2019, the Ninth Circuit ruled in *Vazquez v. Jan-Pro Franchising Int'l*, 923 F.3d 575 (9th Cir. 2019) that the *Dynamex* decision applied *retroactively* to the franchisor-franchisee relationship. The court held Jan-Pro could be the plaintiffs' employer under the ABC test, despite a three-tier franchise structure where (1) Jan-pro acts as franchisor, (2) the master owner acts as franchisee, and (3) the master owner acts as franchisor to the unit franchisee. On July 22, 2019 the Ninth Circuit granted a petition for rehearing, and certified the question of retroactivity to the California Supreme Court. There is also proposed California legislation that would in effect apply *Dynamex* retroactively, if passed. Accordingly, a lot is riding on this issue in California for franchisors operating in that state (and possibly for franchisors in other states where franchise regulators are waiting to see how California handles this matter).

There is no doubt that millions of dollars are at stake in these misclassification cases, not to mention the continued existence of franchising and similar business models such as distributorships that have operated for decades without this threat. Just take a look at some recent misclassification cases that settled before any court rulings: in June 2019, Pepperidge Farms in a Ninth Circuit case agreed to pay $22.5 million to resolve claims that it denied employment benefits to product distributors in California, Massachusetts, and

Illinois by misclassifying them as independent contractors; in April 2019, FedEx, in a New York case, agreed to pay $3.1 million to settle claims that it misclassified drivers as independent contractors and made deductions to their pay that violated New York labor law; in April 2019, TFI International, in another California case, settled for $4.75 million in a class and collective action claims brought by delivery drivers alleging independent contractor misclassification; and in March 2019, Uber and Swift Transportation also agreed to pay millions of dollars to settle their respective misclassification class action claims (Uber: $20 million; Swift: $100 million).

Not all recent decisions on the misclassification issue are bad. A July 2019 decision in the Southern District of New York, *Franze v. Bimbo Foods Bakeries Distrib.,* 2019 WL 2866168 (S.D.N.Y. July 2, 2019) granted summary judgment to Bimbo Foods, finding that it was not liable for the distributor claims for independent contractor misclassification. Notably, regarding the ABC test (although this test was not applied in the New York Bimbo case), the district court found that Bimbo was not in the business of distributing bread despite Bimbo being one of the largest manufacturers and suppliers of bread in the United States. The ABC test has been difficult for franchisors to navigate in those states applying that test (California, New Jersey, Vermont, Massachusetts, Connecticut) despite the separation of franchisor and franchisee, and despite evidence that the franchisor was only in the business of franchising, not providing goods or services like its franchisees. Indeed, Jan-Pro suffered this precise fate in the *Vazquez* case where the court applied the ABC test established in *Dynamex*, and refused to recognize the separation of Jan-Pro from its downstream franchisees.

Finding the Thread

When faced with tough franchise questions like those presented by joint employer liability and misclassification claims, I (we) had Rupert to consult with and get his thoughts about how franchisors could be better protected to avoid liability. I (we) cannot do that anymore, but I know Rupert would tell me to look for the business thread in the court opinions that can provide guidance to our franchise clients, i.e., what are the courts really worried about, what/who are they really protecting? The thread is difficult to find with the application of the ABC test in the misclassification context, whereas it is a little easier to find the thread in the joint employer liability context. But, in both contexts, what the courts do appear concerned with is that franchisors may be exerting too much control over their franchisees, resulting in a lack of independence and perhaps too much power lying in the franchisor's hands with less fair treatment for franchisees when it comes to compensation, profit sharing, royalty obligations, and liability.

The courts seem to be looking for franchise relationships that truly separate the franchisor from the franchisee, where, other than exerting control for purposes of protecting the franchise brand, the franchisor relinquishes control to the franchisee, allows for some leeway for the franchisee to sell or offer competing products or services that do not impact the franchisee's performance of its obligations to the franchisor, and leave staffing and payroll to the franchisees, i.e., really let the franchisee own and operate the franchise business as opposed to having what amounts to a franchisor-employee relationship wrapped up in franchise agreement with contract language for an independent

contractor/franchisee. If franchisors can demonstrate an independent relationship with their franchisees, there is a better chance joint employer and misclassification claims will be avoided, and the answer to Rupert's question could be that one does not require abandonment of the franchise business model, because that model can work and operate successfully within the law.

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