Joint Employer Liability for Franchisors After the Obama Era

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New York Law Journal

November 29, 2016

From the perspective of the franchise community, the Nov. 8 election may result in some unexpected but pleasant news.

The hottest issue in franchise law over the last few years has been in the joint employer area. In the franchise context, joint employer liability (JEL) could occur when an employee could claim that he or she had not one, but two, employers—one being the franchisor and the other the franchisee. The argument favoring this result is that often both have the right to control the employee; hence, both should be liable for some if not many of the franchisee's liabilities. These might include state sales and income taxes, tort liability, violations of the labor and employment laws, and so forth.

Until 2015,[1] the test on whether a joint employer situation existed was focused on the issue of actual control—that is, the exercise of control by both franchisor and franchisee over employees. However, the decision in *Browning-Ferris Industries of California, Inc.*[2] changed the test for establishing JEL. As a result of that decision—a non-franchise case—the test became one of right to control, rather than actual control. The fear of the franchise community was that the Browning-Ferris decision would increasingly become applicable to most franchise arrangements. Consequentially, franchisors began to alter their business models in order to avoid JEL.

In agreements addressing employee-related items, such as training, dress, skill sets, and payroll processing, the traditional obligation-imposing "must" language in franchise agreements and operations manuals, was changed by many franchisors from "must" to "may," or the relevant task, restriction or franchisor right may have altogether been dropped from the franchise agreement or operations manual. Many, if not most, franchisor lawyers felt this would be the best way to reduce the risk of a judicial or administrative ruling that a franchisor was the joint employer of its franchisees' employees.

But for franchisors, the strategy of the National Labor Relations Board (NLRB) and the Department of Labor—that is, making JEL the norm—has forced them into making a Sophie's Choice between (1) increasing protection against JEL by loosening controls over its franchisees, or (2) providing previously given up protection for the brand by maintaining or increasing the restrictions placed in franchise agreements or operations manuals. This includes, for example, more financial reporting, more auditing, direct training of employees and managing background checks of employees.

With the recent change in government, members of the franchise community are surmising that the reach of *Browning-Ferris* will not be extended and eventually will be reduced. However, given the structure of elections relating to the NLRB's board membership, changes to the push for JEL will not occur before 2018.

Unless and until changes occur, the question for franchisors is: Which risk would be better for the franchisor to accept: JEL or the consequences of weakening brand control.

Joint Employer Liability

Most franchisor lawyers appear to vote in favor of reducing exposure to JEL and, in essence, place lesser importance on brand protection. However, this decision may not give adequate consideration for strengthening and adding contractual provisions to protect brand, and, instead, finding other ways to limit exposure to JEL.

No doubt, trying to avoid any risk makes sense. However, a franchisor can more easily deal with JEL than the destruction of brand equity. Why? In the context of franchising, the franchisor has layers of protection that would reduce its level of exposure to JEL.

First, franchise agreements almost always require franchisees to indemnify the franchisor for claims arising out of its franchisees' operations. In some cases, this might even be true if the franchisor may have been negligent. This indemnification requirement provides the first level of protection to the franchisor from JEL. Unless the franchisee goes bankrupt, the franchisor should ultimately bear none of the financial risk of a JEL claim asserted against it.

Second, backing up the indemnification is the common requirement that the franchisee must have insurance coverage with respect to JEL. Even if the franchisee might not be in a position to indemnify its franchisor, the franchisee's insurance should reduce or eliminate the JEL risk altogether to franchisors. This assumes that the franchisee does, indeed, have the coverage, that the policy names the franchisor as an additional insured, that the insurance is for an appropriate amount, that the policy stays in effect, and that any exclusions from coverage for the underlying events are for matters not likely to occur.

Unfortunately, in practice, the insurance coverage is sometimes insufficient because (1) there might be a broad exclusion with respect to the terms of the policy; (2) frequently franchisees do not carry out their obligation to purchase appropriate insurance; and (3) franchisees let policies lapse. Thus, following this approach is likely to mean a greater administrative burden on the franchisor. Note that engagement of a competent insurance broker is critical if following this strategy.

Third, franchisors themselves typically carry the necessary insurance coverage. Thus, if the franchisee is insolvent or for other reasons does not purchase an appropriate policy, the franchisor's own insurance policy can protect it from JEL. The franchisor's lawyer needs to suggest that the franchisor investigate the possibility of buying JEL insurance coverage—at which point the franchisor will have to decide whether it should purchase JEL insurance, or it should make sure that it has other adequate means of protecting itself against JEL.

Protection to the Brand

Given the current trend, and with other avenues for protection available, a franchisor might simply assume that its current agreement or operations will result in JEL, in which case it might be better off taking steps to better increase protection to the brand regardless of their effect on a JEL ruling. That is, the franchisor should increase its controls or assistance to the franchisees as well as tighten restrictions. One of the problems of ignoring or reducing brand protection is that some risks of damage to the brand are not insurable, and damages might not be capable of quantification.

But take, for example, the situation where a franchisor becomes subject to a food-borne illness complaint by a customer. The damage suffered by a customer can be, and usually is, covered by insurance. But as Jack in the Box learned in 1993 when some of its restaurants were accused of serving hamburgers that contained the E. Coli bacteria, the damage extends beyond the individual customer. Damage to the goodwill of the brand—an intangible asset might not be completely insurable. In this instance, the sales at Jack in the Box restaurants dropped somewhere in the neighborhood of 30-35 percent at the beginning of the E. Coli crisis, and continued for several months thereafter, before the bleeding stopped.[3] This is a loss few franchisees can afford, and if the franchisees were not adequately insured, there might be a specter of bankruptcy on the horizon for them.

Moreover, the loss incurred by the franchisees will also adversely affect the franchisor's revenue and profits. It should also be noted that the income of the franchisor for the period during and after the time the E. Coli incidents occurred were down almost $30 million. This example shows that stringent quality controls could be crucial, even at the expense of increasing JEL.

It is said that almost everything is insurable, the only questions being the cost of the insurance and whether underwriters will assume this risk. If the JEL insurance is so expensive that it is unaffordable, then softening the brand controls might be the better approach. The right strategy to implement for the franchisor is difficult to predict.

Endnotes:

1. An interesting issue, not discussed in this article, is how would one implement these changes. An even more interesting question, one that is likely to occur with the change in government, is: How can a franchisor take back rights it might have given up at this time, if the fears of *Browning-Ferris*, go away either as a result of judicial decisions or policy changes at the NLRB or Department of Labor.

2. 362 NLRB No. 186 (Aug. 27, 2015).

3. Los Angeles Times (March 11, 1993); United Press International (May 13, 1993).

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