

Can Franchisees Be Recast as Employees?

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (<http://www.woodporter.com>) and is the author of *Taxation of Damage Awards and Settlement Payments* (4th ed. 2009), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (5th ed. 2010), all available at <http://www.taxinstitute.com>. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Although independent contractor versus employee inquiries are inherently factual, they all seem to spring from an independent contractor label. Yet increasingly, the franchisee versus franchiser line is being investigated, too, with at least some cases finding that a franchisee is an employee.

Copyright 2011 Robert W. Wood.
All rights reserved.

The line between independent contractor and employee is an important one. It affects income and employment taxes (federal and state), workers' compensation, unemployment insurance, contract and tort liability, and much more. It governs the applicability of wage and hour and overtime protections, nondiscrimination laws, the provision of health insurance coverage, and the applicability of pension laws. In fact, it is hard to think of any line that has more ramifications.

Given the incentives, many employers push the envelope and err on the side of not treating workers as employees. Yet sometimes the liability for misclassification can be worse than treating workers as employees in the first place. In any event, care and thoroughness are needed in making worker status decisions. Furthermore, if independent contractor status is selected, considerable finesse is needed in drafting and implementing contracts and other aspects of work so that the arrangement is defensible.

Based on my experience, relatively few businesses do a good job of establishing proper relationships in the first place. Even fewer businesses do a good job of monitoring and revisiting the status of

their workers. Facts change, inconsistencies occur, and each business can spell trouble.

Franchise Cases

Traditionally, the characterization question is between independent contractor and employee. Although that point is inherently factual, the duality is well litigated. There are myriad tests and indices applied, but the line between independent contractors and employees generally centers on the concept of control.

The more control exerted by the employer (or the more control the employer *could* exert if it chose to exercise its rights), the more likely it is that employee rather than independent contractor status will be found. These independent contractor versus employee issues are raised in:

- tax cases with various state or federal governmental entities;
- tort cases in which plaintiffs seek to hold employers liable under *respondeat superior* principles despite putative independent contractor relationships;
- unemployment and workers' compensation cases;
- labor and employment cases in which workers seek damages under labor and employment laws that cover them if they are employees but not independent contractors, etc.;
- traditional labor union representation; and
- ERISA and other employee fringe and pension benefit coverage.

Worker status has become one of the more significant distinctions in modern life. It involves considerable factual examination. Today, more sophisticated nomenclature and concepts are in use that may call for even more nuanced analyses into the legal status of companies and their workers.¹

Mindful of the traditional contractor versus employee line, some companies are using a franchise relationship rather than the traditional and more unvarnished independent contractor role. That may be because the franchise concept truly fits their business model. It may also be because a franchise relationship is a step removed from the traditional

¹See Robert W. Wood and Christopher A. Karachale, "Home Workers and the Debate Over 'Who's a Statutory Employee' Under the Internal Revenue Code," 2 *Business Law News* 11 (2010).

employee versus independent contractor distinction. After all, the independent contractor versus employee line is an increasingly sensitive one.

Increasingly, the use of independent contractor terminology and concepts may be seen as practically inviting inquiries into the bona fides of the worker relationship. It is no secret that the independent contractor label is under attack. As but one example, in February 2010 the IRS started a National Research Program to audit 6,000 employers over three years. Part of the IRS focus is on assessing and documenting revenue losses that result from employers misclassifying employees as independent contractors.²

Basics of Franchise Relationships

At first glance, the relationship of franchiser and franchisee may not seem relevant to traditional worker status analysis. Many consumers equate the concept of franchiser and franchisee with fast-food operations or other consumer businesses. We understand in some vague way that the franchiser, be it McDonald's or the UPS Store, allows the franchisee to use its name, logo, and many other items of intellectual property. We understand that franchises promote consistency, pool advertising and sourcing efforts, and much more.

Yet worker status is — by necessity — broached in many franchise agreements. Typically, franchise agreements acknowledge that the franchisee is strictly an independent contractor, not an employee. These agreements typically negate the franchisee holding any *other* sort of relationship with the franchiser. Many franchise agreements include numerous provisions limiting the liability of the franchiser and the control the franchiser holds over the franchisee's day-to-day operations (for example, posting signage at a franchise alerting the public that the business is owned by an "independent contractor" and not the franchiser).

Against the background of typical franchiser-franchisee relationships, it is appropriate to question whether a franchisee might be viewed as an employee. After all, the legal authorities across an array of legal disciplines consistently hold that a worker may be an employee even if he is denominated an independent contractor. That is true in tax law, labor and employment law, pension and benefits law, workers' compensation, and unemployment.

The traditional independent contractor versus employee line seems more opaque with a putative

franchise arrangement. Nevertheless, it seems clear that franchise nomenclature by itself does not immunize a company from having workers re-characterized. In that light, it is appropriate to question when putative franchise relationships may be challenged.

Coverall

An example of the use of a putative franchise arrangement (arguably designed to mask worker status matters) is *Awuah v. Coverall North America Inc.*³ There, a Massachusetts court held that janitorial workers nominally labeled as franchisees were actually employees. Depending on one's perspective, it is possible to see *Coverall* as illustrating the danger of Big Brother upsetting legitimate enterprise or as justice ferreting out the truth of a work relationship.

Either way, the case is an important study in the principles of substance over form. It also raises the need for further exploration and definition. The examination of putative franchise arrangements may turn out to be a new branch of the age-old independent contractor versus employee characterization inquiry.

Coverall created a franchise arrangement under which it was the franchiser and individual janitors were treated as franchisees. The franchise agreement licensed the janitors to use Coverall's methods, procedures, standards, and equipment for cleaning commercial properties. However, a reading of the case and the pertinent documents makes it hard to think of individual janitors as separate businesses.

After all, customers generally contracted with Coverall, not with franchisees. In addition to signing a franchise agreement, each worker was required to wear approved uniforms and identification badges while on customers' premises. Coverall provided equipment and supplies and performed all billing and collection on customers' accounts. Coverall would then deduct its "franchise fees" before remitting payments to the workers.

Coverall provided complete training programs, cleaning techniques, management techniques, and an initial customer base. Furthermore, the court found that Coverall controlled many aspects of the services provided, including negotiating contracts and pricing directly with customers, billing customers, and providing a daily cleaning plan that the franchisee was required to follow. Although the franchisee could solicit additional customers, any prospects who signed up became customers of Coverall directly, not customers of the franchisee.

²See Sam Young, "Official Fleshes Out Details on Payroll Research Project," *Tax Notes*, Jan. 17, 2011, p. 274, *Doc 2011-858*, or *2011 TNT 10-5*.

³707 F. Supp.2d 80 (D. Mass. 2010).

The daily regimen was also strenuous and replete with instructions about how work was to be performed. Each janitor was given a list of cleaning assignments every day and was expected to check in with a Coverall representative when he arrived at work. Each franchise was likewise expected to check out with a Coverall representative on departure.

The legal test applicable in *Coverall* was Massachusetts's three-part ABC test, which applies for purposes of workers' compensation coverage.⁴ Under the ABC test, the company had the burden of showing that the services performed were:

- (a) free from its control or direction;
- (b) outside the usual course of its business, or outside all of its places of business; and
- (c) as part of the worker's independently established trade, occupation, profession, or business.

As with the ABC tests in many states, all three prongs had to be met for Coverall to show that its franchisees were independent contractors. The court found the company actually exercised substantial control over the course and scope of each janitor's work. It was also clear that contract cleaning (the job undertaken by the janitors) was not outside the usual course of Coverall's business.

Coverall failed the first two prongs of Massachusetts's ABC test. However, the court seemed most bothered by the obvious fact that Coverall had not shown that any franchisee was independent. No franchise could perform janitorial services for any customer and thus did not meet the third test. Therefore, the court affirmed the determination of employee status.

Worker status disputes can be quite expensive, and the considerable expense and time involved in *Coverall* is worth noting. The case was initially brought in state court in Massachusetts.⁵ It proceeded to appellate court,⁶ and was then remanded to the trial court.⁷

Other Franchise Cases

Although *Coverall* is generally viewed as a leading case on the issue, there are a few other cases exploring the line between franchisee and employee. For example, *Singh v. 7-Eleven Inc.*⁸ con-

siders the issue in the context of the Fair Labor Standards Act (FLSA). The court's evaluation of the vertical relationships within a franchise model is particularly interesting.

In *Singh*, workers at a convenience store sued both the store owner (the franchisee) and 7-Eleven (the franchiser) under the FLSA, which defines an employer to include "any person acting directly or indirectly in the interest of an employer in relation to an employee."⁹ In evaluating the connection between the workers and 7-Eleven, the court noted the vertical nature of the relationship between the parties due to the franchise structure.

In the Ninth Circuit, where *Singh* was considered, whether an entity is an employer under the FLSA is a question of law that must be determined by applying the economic reality test.¹⁰ Under the economic reality test, a court must consider the totality of the circumstances.¹¹ The test encompasses a number of factors, including the power to hire and fire; supervision and control of work schedules or conditions of employment; the rate and method of payment; and maintenance of employment records.

Regarding hiring and firing, the 7-Eleven franchise agreement stated that the franchiser did not exercise any discretion or control over a franchisee's employment policies. The agreement said that all employees of the franchisee were working under the means of operations of that particular franchisee. Also, the franchisee exclusively set work schedules and conditions. Although 7-Eleven provided payroll service, the court held that "providing a payroll service to a franchisee's employees does not in any manner create an indicia of control over labor relations sufficient to demonstrate that the franchisor is a joint employer."¹² Using that application of the economic reality test, the court did not find an employer-employee relationship between the workers and 7-Eleven.

The court in *Arguello v. Conoco Inc.*¹³ considered whether franchisees were employees for purposes of Title VII of the Civil Rights Act of 1964. In that case, a group of minority customers of Conoco (a gasoline station franchise) sued the franchiser, claiming they were discriminated against while purchasing gasoline and other products at a Conoco gas station. They argued that even if the offending

⁴Massachusetts General Law c. 151A, section 2.

⁵563 F. Supp.2d 312 (D. Mass. 2008).

⁶554 F.3d 7 (2009).

⁷707 F. Supp.2d 80 (D. Mass. 2010). See also *Coverall North America Inc. v. Commissioner*, 447 Mass. 852, 857 N.E.2d 1083 (2006) (finding a worker was an employee of Coverall for purposes of an unemployment benefits claim).

⁸2007 U.S. Dist. LEXIS 16677 (N.D. Cal. 2007).

⁹29 U.S.C. section 203(d). See *Torres-Lopez v. May*, 111 F.3d 633, 638, 639 (9th Cir. 1997); *Real v. Driscoll Strawberry Associates Inc.*, 603 F.2d 748, 754 (9th Cir. 1979).

¹⁰2007 U.S. Dist. Lexis 16677, 8 (N.D. Cal. 2007).

¹¹*Id.*

¹²See U.S. Dist. LEXIS 16677 (N.D. Cal. Mar. 7, 2007), citing *Hatcher v. Augustus*, 956 F. Supp. 387, 392 (E.D. N.Y. 1997).

¹³207 F.3d 803 (2000).

employee was outside the scope of his employment (consequently severing any agency relationship between the offending franchisee and the franchiser), Conoco had a non-delegable duty to prevent racial discrimination.

They also argued that Conoco should be held liable because it ratified the franchisee's conduct. Although there was an employee and *respondeat superior* argument, the plaintiffs had a more sophisticated direct liability theory. The court found that the actions taken by the offending franchiser were well outside the scope of employment, and the franchisee was not liable for the alleged discriminatory acts. The court noted that the original franchise agreement explicitly equated the franchisee relationship to that of independent contractor, and that there was no reason to believe that relationship had been compromised.

The franchisee as employee argument is also surfacing in tort litigation. In *Rainey v. Langen*,¹⁴ a Maine Supreme Court case, a motorcyclist was injured in an accident with a delivery driver for a franchise of Domino's Pizza. The ensuing lawsuit was brought against both the franchiser and the franchisee. The plaintiff asserted that the Domino's franchise had so much control over its franchisees that the driver should be characterized as an employee of Domino's itself.

That employee status would of course bring with it liability for the employee's acts. However, the court held that "the quality, marketing, and operational standards present in [the franchise agreement] do not establish the supervisory control or right of control necessary to impose vicarious liability."¹⁵ In other words, Domino's did not have a tight enough leash on its franchisee for the arrangement to be considered an employer-employee relationship. Consequently, the franchiser was not liable for the accident caused by its franchisee.¹⁶

That determination suggests that drafting and structuring a franchise agreement requires considerable care. The days of writing franchise agreements without considering potential employee status may be over.

¹⁴2010 ME 56 (2010).

¹⁵*Id.* at para. 28.

¹⁶That is, of course, not the first time that the Domino's Pizza franchise has dipped into tortious waters regarding the actions of their franchisee's delivery drivers. Up until the 1990s, Domino's prided itself on prompt delivery times, famously boasting that if an order was not delivered within 30 minutes, the pizza would be free. Two well-publicized cases put an end to the promotion, and Domino's was found liable. See *Wauchop v. Domino's Pizza Inc.*, 138 F.R.D. 539 (N.D. Ind. 1991); *Kinder v. Hively Corp.*, No. 902-1235 (St. Louis County Ct., Mo., verdict Dec. 17, 1993).

Franchisee-Franchiser Agency

Under agency law, the question is whether a franchisee's status is as a true franchisee or as an agent of the franchiser (and perhaps explicitly as the franchiser's employee). A franchisee is classically independent, having no power to bind the franchiser in contract or otherwise. In contrast, an employee can bind the employer in contracts within the course and scope of his employment. The employer also has vicarious liability for the tortious acts of the employee.

In *Kuchta v. Allied Builders Corp.*,¹⁷ plaintiffs sued the company and its franchisee for damages related to fraud and breach of contract for construction performed on the plaintiffs' house by the franchisee. To maintain claims against the company, plaintiffs had to show that the franchisee was not an independent contractor of the company. The court stated that in the field of franchise agreements, whether a franchisee is an independent contractor or an agent of the franchiser is a question of fact. That requires an examination of whether the franchiser exercises complete or substantial control over the franchisee.

In *Kuchta*, the franchise agreement gave the company the right to control the location of the franchisee's place of business, to prescribe minimum display equipment, to regulate the quality of the goods used or sold, to control the standards of construction, to approve the design and utility of the construction, and to assign persons to ensure that the franchisee performed according to standards set forth by the company. Furthermore, the company had the right to inspect the franchisee's plans and specifications, work progress, and finished jobs.

The court found those facts to be telling. They supported the conclusion that the company exercised substantial control over the franchisee, so that the franchisee was not an independent contractor. In the context of tort and contract claims, as in the employment context, the examination still focused on the company's *right* to control the franchisee in performing its services, whether or not such a right was exercised. The court questioned whether the company exercised control over the franchisee, but pointed to the company's rights to control, regulate, approve, and inspect.

Another example can be found in *Lockard v. Pizza Hut*.¹⁸ Like *Kuchta*, the plaintiff in *Lockard* sued the company over damages (in this case, over a hostile work environment including sexual harassment from customers). However, in *Lockard* the court

¹⁷21 Cal. App. 3d 541 (1971).

¹⁸162 F.3d 1062.

determined that the franchiser did not exercise day-to-day control over the franchisee's employment decisions. As a result, the court ruled that the franchiser was not the plaintiff's employer.¹⁹

Conclusion

Interestingly, the franchiser and franchisee model may even be used as a defense by putative employers who are defending their independent contractor relationships. That apparently occurred in a well-publicized series of cases involving FedEx and the status of delivery drivers.²⁰ The drivers were denominated as independent contractors and in their suit alleged that they were actually employees.

¹⁹See also *Evans v. McDonald's Corp.*, 936 F.2d 1087.

²⁰See *In re FedEx Ground Package Sys. Inc. Empl. Prac. Litig.*, 712 F. Supp.2d 776 (2010).

Although there was no explicit franchise arrangement, FedEx claimed that they were very much *like* franchisees. The plaintiffs alleged that the FedEx agreement simply created the illusion that they were independent contractors. The litigation is still ongoing.

Of course, a "like a franchise" argument by definition can have no franchise agreement or explicit franchise nomenclature to support it. However, if nothing else, that does suggest the growing importance that franchise arrangements and concepts may have in worker status matters.

Plainly, explicit franchise agreements should be structured very carefully with worker status issues in mind. In the past, we may have thought of franchise arrangements as simply *outside* the normal independent contractor versus employee gauntlet. Yet increasingly and in multiple contexts, that assumption appears to be incorrect.

SUBMISSIONS TO TAX NOTES

Tax Notes welcomes submissions of commentary and analysis pieces on federal tax matters that may be of interest to the nation's tax policymakers, academics, and practitioners. To be considered for publication,

articles should be sent to the editor's attention at taxnotes@tax.org. A complete list of submission guidelines is available on Tax Analysts' Web site, <http://www.taxanalysts.com/>.