The Expanding Scope of Vicarious Liability for Franchisors/Franchisees

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This article will explore the evolution of vicarious liability involved in the franchisor-franchisee relationship. It will discuss the impact of jurisdictions’ use of the “right of control” test and “instrumentality rule.” It will also address recent treatment by the NLRB of “joint employer” status. Finally, the article will discuss practice tips and suggestions regarding indemnification and contracting for potential shared risk.

A. INTRODUCTION

7.6 million people are employed by franchises across the country. 4.7% of US workers are employed by temporary help agencies or firms that contract out their labor.

Franchises account for $269.9 billion in US payroll and $404.6 billion in GDP

B. VICARIOUS LIABILITY

• “Right of Control” Test

  o Traditional – “right of control” test: results in “improperly penaliz[ing] a franchisor for exercising the degree of control necessary to protect the integrity of its trademark.” Rainey, 998 A.3d at 348. The right of control test must differentiate between efforts to protect a trademark and efforts to control a franchisee’s day-to-day operations.

  ▪ Courts recognize that the mere existence of brand controls does not equate to “operation” of the franchise by the franchisor.

• The “Instrumentality Rule”
Evolving standard – “instrumentality rule”: narrowing of the right of control test to the “instrumentality rule,” which holds that a franchisor is subject to vicarious liability for the tortious conduct of its franchisee “only if the franchisor had control or right of control over the daily operation of the specific aspect of the franchisee’s business that is alleged to have caused the harm.” *Rainey*, 998 A.3d at 342.

**Multiple Choice Questions**

A motorcyclist is suing a franchisee and Domino’s as franchisor for negligence and vicarious liability arising from a traffic accident with a pizza delivery driver. The relationship between the franchisee and Domino’s is governed by a Franchise Agreement and a “Manager’s Reference Guide”. Both documents impose comprehensive and detailed quality control requirements, marketing requirements, and minimum operational standards on the franchisee, including age limits for hiring drivers, minimum motor vehicle record requirements, seat belt usage requirements, radar detector and cell phone usage limitations, and delivery vehicle inspection and maintenance standards. However, the franchisee is responsible for scheduling its employees, determining wages, and making decisions concerning hiring, firing, training, supervising, and disciplining employees. Using the **right to control** test, should Domino’s be held vicariously liable?

- Yes, because Domino’s reserves control over the performance of the franchisee’s day-to-day operations.

- **No, because the standards set forth in the Franchise Agreement and Manager’s Reference Guide fall short of**
reserving control over the performance of the franchisee’s
day-to-day operations.

○ Explanation:

▪ *Rainey v. Langen*, 2010 ME 56, 998 A.2d 342, 2010 Me. LEXIS 56

▪ Maine Supreme Court resolved jurisdictional split by choosing "right to control" test

▪ Although the quality, marketing, and operational standards imposed by the franchisor in the Franchise Agreement and Reference Guide were numerous, the controls fell short of reserving control over the performance of the franchisee’s day-to-day operations.

▪ The franchisee: (1) determined the wages it paid its employees; (2) determined the scheduling of its employees; and (3) made all day-to-day decisions concerning hiring, firing, training, supervising, and disciplining its employees.

○ Practice Tips:

▪ Certain sections of the Manager’s Reference Guide explicitly stated that they were for “informational purposes only,” and the remaining mandatory sections of the Guide, while comprehensive and detailed, did not dictate the precise methods by which the franchisee is required to carry out its daily responsibilities, but rather set forth general standards and minimum requirements

▪ The Guide provides that "franchisees are solely responsible for the terms and conditions of employment applicable to their team members."
The Franchise Agreement should state that the franchisor and franchisee are “independent contractors,” which the court noted is relevant, but not controlling.

A plaintiff victim is suing an Arby’s franchisor for vicarious liability for the franchisee’s negligent supervision of an employee. That employee was on a work-release program from jail and left during his shift at Arby’s, waited in the Wal-Mart parking lot across the street for his ex-girlfriend and her new boyfriend to emerge and shot both of them then himself. The girlfriend survived and is now suing. The relationship between the franchisee and the franchisor was governed by a licensing agreement and an operating manual. There were several provisions in those documents and other requirements relating to the supervision and control of employees including the franchisor’s right to unilaterally terminate the relationship due to an uncured violation of the agreement, which would effectively terminate the employee’s employment. Under the instrumentality test, should Arby’s the franchisor be held vicariously liable?

Yes, because Arby’s right to unilaterally terminate the relationship is the equivalent of a right to actively manage the franchisee’s workforce since termination of the agreement effectively terminates their employment.

No, because general guidelines for hiring, training, and supervising employees do not establish a sufficient level of control over the franchisee’s hiring and supervision of employees, which is the aspect of the franchisee’s business that is alleged to have caused the plaintiff’s harm.

Explanation:

The Supreme Court of Wisconsin chose the “instrumentality” test

The license agreement did not establish that the franchisor actually controlled or had the right to control the franchisee’s hiring and supervision of the employee, which is the specific aspect/instrumentality of the franchisee’s business that is alleged to have caused the plaintiff’s harm

Arby’s right to terminate the relationship is not the equivalent of a right to control the daily operation of the restaurant or actively manage the franchisee’s workforce

Practice Tips

The agreement stated that the franchisee has sole control over the hiring and supervision of its employees, which is the specific instrumentality alleged to cause the plaintiff’s harm

Avoid reserving the right to not step in and take over the management of the franchisee’s employees

Include a provision disclaiming any agency relationship (informative but not dispositive)

Keep the controls in the agreement very general

C. JOINT EMPLOYER LIABILITY – NLRB

Joint employment determines when two employers can be jointly liable for violations of labor and employment laws by either of the employers.
- **NLRB – “direct and immediate” control test**
  
  o requires “a showing that the employer meaningfully affects matters relating to the employment relationship such as hiring, firing, discipline, supervision, and direction.” *See Laerco Transp.*, 269 NLRB at 325.

- **NLRB – “indirect” control test**
  
  o “[t]he Board may find that two or more entities are joint employers of a single work force if they are both employers within the meaning of the common law, and if they share or codetermine those matters governing the essential terms and conditions of employment.” *See Browning-Ferris Indus. of California, Inc.*, 362 NLRB No. 186 (Aug. 27, 2015). Under this expanded view of the joint employer inquiry, “control exercised *indirectly*—such as through an intermediary—may establish joint-employer status.” *Id.*
  
  o companies that merely have “potential” or “reserved” control to hire, terminate, discipline, supervise, and direct an affiliated company’s employees – but who did not *actually* exercise that right – could now be liable for various employment claims and collective bargaining requirements.

- **Legislative efforts to restrict indirect control test**
  
  o **State laws**: As of March 2017, 10 states have passed laws that guarantee, with some exceptions, that parent franchise companies won’t be considered employers of their franchisee’s workers. Similar bills are pending in 11 other states.
Save Local Business Act, H.R. 3411 – House passed the bill on 11/7/17; would effectively undo the Browning- Ferris decision by re-defining “joint employer” in the National Labor Relations Act to only cover instances when two or more companies “directly, actually, and immediately, and not in a limited and routine manner, exercises significant control over the essential terms and conditions of employment” over an employee. The definition of “employer” under the Fair Labor Standards Act would also be amended to include a reference to the NLRA’s definition, which is consistent with the Department of Labor’s decision in June 2017 to withdraw prior guidance that applied the broadened joint employer definition to the FLSA.

- **Consequences of Broadened Test (panel talking points):**

  - **May a franchisor reserve the right to control a franchisee employee’s wages, hours, and benefits?** Under a broad reading of joint employment, an entity might not have any control over the factors that lead to the liability itself. This is especially true in the franchise industry where franchisees are expected to have a certain degree of autonomy over the day-to-day operations of the business, while the franchisor must necessarily control certain factors to protect its brand and ensure uniformity of product and operations. The catch 22 is that, under the broad test, even if a franchisor does not exercise such control, it still may be held liable for the unfair labor practices of their co-employers. So, those companies are required to oversee their own compliance with the NLRA, as well as ensure compliance by their co-employers. Joint employer liability has become a very fact-dependent inquiry. What facts tend to show joint employment? Authority to hire, fire, and discipline employees,

- **Who bears the cost of producing employee handbooks, recruiting, and training materials?** During a hearing of the House Committee on Education and the Workforce, a Taco John's franchise owner testified that her franchisor used to provide a standard employee handbook, a job application form, and recruiting materials such as banners, brochures, fliers, to franchisees, but because of the expanded joint employment liability, no longer does so. She now must hire an outside attorney to write an employee handbook, which cost her $9,000, and will cost more each time the law changes and updates are needed. She incurs the cost of design and printing of the recruitment materials. Who is best positioned to provide these materials? Who has the expertise?

- **Can workers unionize across establishments?** The broad standard makes it easier for franchisee workers to unionize across establishments and sue the parent company. How big does the table need to be in order to seat all the entities that would be potential joint employers?

- **Who must engage in collective bargaining?** Each company found to be a joint employer by the NLRB may have an obligation to bargain with a union over terms and conditions of employment

- **Does this liability destroy the franchise business model?** (panel talking point) How can a franchise balance is need to exercise a certain amount of control to protect its brand under the Lanham Act, but not so much control as to eliminate the cost benefits of being a franchisor?

- **McDonald's franchisor/franchisee cases**
• Tied to the broader "Fight for $15" movement, the Service Employees International Union (SEIU) has been working to organize employees at McDonald's and other fast food chains in recent years. In 2014, the NLRB's general counsel said franchise employees would be allowed to sue McDonald’s for labor violations, making it a joint employer with its franchisees. See NLRB Office of Public Affairs, “NLRB Office of the General Counsel Authorizes Complaints Against McDonald's Franchisees and Determines McDonald's, USA, LLC is a Joint Employer,” July 29, 2014, available at https://www.nlrb.gov/news-outreach/news-story/nlrb-office-general-counsel-authorizes-complaints-against-mcdonalds. Complaints are currently pending against both the franchisees and McDonald’s.

• The NLRB argues, inter alia, that McDonalds' strict contracts, scheduling software and centralized response to minimum wage protests tends to show that it is acting like an employer. McDonald’s strongly denies this argument.

D. INDEMNIFICATION & NEGOTIATING TIPS

• Include a Time Limitation for Indemnification Claims by Franchisee
  - Examples: “Franchisee agrees in consideration of Franchisor’s execution of this contract that any claim of any kind by Franchisee based on or arising out of this contract or otherwise shall be barred unless asserted by Franchisee by the commencement of an action within 12 months after the delivery of the products or other event, action or inaction to which the claim relates. This provision shall survive any termination of this contract, however arising.”

- In that case, the First Circuit held that the one-year contractual limitations period, although brief, is valid and enforceable.
- The court dismissed the franchisee’s claim for indemnification as time-barred.

- **Be specific about exactly which liabilities are covered and not covered by the indemnity**
  - Example: “Franchisee must defend, indemnify, and hold harmless the Franchisor … against any and all claims … which arise out of, in connection with, or as a result of possession, ownership or operation of the Franchise Business or the acts or omissions of the Franchisee…”
  - “Franchisee must defend, indemnify, and hold harmless the Franchisor … against any and all claims … which arise out of, in connection with, or as a result of **possession, ownership or operation of the Franchise Business** or the acts or omissions of Franchisee…”
  - The court interpreted this language to mean that defendants must indemnify plaintiff insurance company only where a claim arises out of the “possession, ownership, or operation of the Franchise Business,” and thus is too narrow and specific to be a basis for finding that the agreement is unenforceable to a lack of mutuality.
• **Use explicit language**

Example: draft a franchise agreement that provides that a franchisee must indemnify a franchisor for any liability arising “by reason of an act or omission with respect to the business or operation” of the store.

  
  o The employee was burned when he was melting chocolate on an electric burner when a bottle of orange extract, stored on a shelf above the electric burner, leaked into the employee and the burner. The extract ignited and the flame backed up to the container and the employee also caught on fire. The franchisee argued that since the franchisor selected the containers, the labeling of containers, and the layout and design of the store itself, that the franchisor exercised operational control over those aspects of the business operation that resulted in the employee's injuries.
  
  o The franchise agreement stated that the franchisee agreed to indemnify the franchisor for any liability arising “by reason of an act or omission with respect to the business or operation” of the store.
  
  o The court stated that even if the business decisions which caused the accident, negligent or non-negligent, were exclusively those of the franchisor, the acts or omissions were “with respect to the business or operation” of the store, and thus were covered by the indemnification provision.
  
  o The court noted that the franchisee may have been obligated to comply with the franchisor's operations specifications, but the franchisee is closer to the actual operation of the business and was better positioned to notice and rectify potential safety hazards such as the proximity of a flammable extract to a hot burner.
The court also noted that the indemnification clause also included an insurance agreement that required franchisee to maintain public liability and products liability insurance.

E. TAKEAWAYS

- **Examine your contracts and handbooks** for language that can be construed as reserving the right to control certain parts of your affiliated company’s business that typically create liability such as food storage and preparation, employee’s hiring, firing, and discipline, wages and hours, and other day-to-day activities.

- **Keep up to date** with the evolving standards for vicarious and joint employer liability.

- Check with your **specific jurisdiction** to see what vicarious liability test it applies (right to control or instrumentality) and if it has adopted legislation that prevents franchisors from being held as joint employers with their franchisees.