Hot Topic

Are Franchisees Now Employees of their Franchisor?

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A Discussion of the Consequences of Dynamex Operations West, Inc. v. Superior Court and California Assembly Bill 5.

**Background**

In an effort to remedy certain purported employment disparities caused by the so-called ‘gig economy’ (e.g., Uber and Lyft drivers who operate as independent contractors without any of the protections and benefits of true employees), on September 18, 2019, California Governor Gavin Newsom signed into law ‘California Assembly Bill 5’ or ‘AB-5,’ which the state’s legislature had passed on September 11, 2019. AB-5 transformed hundreds of thousands of independent contractors into employees, virtually overnight.

Importantly, while intended to address the ‘gig economy,’ AB-5 is far more reaching and has the potential to fundamentally disrupt the entire franchise business model. Specifically, AB-5 codified the ABC test utilized in the recent California court case of *Dynamex Operations West, Inc. v. Superior Court*, 4 Cal. 5th 903, 416 P.3d 1 (2018) (discussed below) in order to determine when an individual should be classified as an ‘employee’ versus an ‘independent contractor.’

Before delving into the law itself, and why it may prove devastating to the franchise business model, it is vital to understand the importance of a franchisee being deemed the independent contractor, rather than an employee, of the franchisor. The franchise business model rests on two legs: (1) a controlled license of a franchisor’s trademark to a franchisee and (2) a franchisor’s lack of day-to-day control over the franchisee’s business.

With respect to trademark control, pursuant to the United States Lanham Act (also known as the Trademark Act of 1946), a federal registration gives the registrant, except for prior uses in any given market, protective rights throughout the entire United States of America. In order to maintain ownership of a trademark, however, the owner must continuously monitor and actively control the use of its mark. By way of example, if a franchisor trademark owner engages in ‘naked’ or uncontrolled licensing (i.e., it fails to exercise control over third parties using its marks and/or require third parties to enter into trademark license agreements delineating clear quality control provisions), it may lose control of its marks and therefore risk ownership thereof. This control requirement is part of the reason franchise agreements exist to begin with – the limitations and requirements concerning use of the licensed trademark as well as standards governing the offer and sale of products and services associated with such trademark must be documented in order to prove that the franchisor has not engaged in naked licensing.

On the other hand, franchisees are independent business owners. While franchisors have an interest in ensuring that their franchisees comply with brand standards (as required in order for the franchisor to maintain ownership in its licensed trademarks), franchisors lack control over their franchisees’ day-to-day operations. The reason for this is twofold: (i) franchisees often invest hundreds of thousands or millions of dollars in order to own their own businesses
(not to merely manage a business as the franchisor’s employee) and (ii) the financial bargain reached between the franchisor and franchisee specifically accounted for each parties’ respective liabilities (if the franchisor intended to be responsible for the employment liabilities and vicarious liabilities that are associated with running the franchised business, it would have accounted for those costs and liabilities in the calculation of fees charged to franchisees; but it did not). The concept of the franchisee as an independent contractor is almost always explicitly provided for in the franchise agreement, and indeed, if a franchisor attempted to usurp a franchisees’ control over its franchised business, let alone designate employment obligations, the franchisor would find itself in breach.

It is in this backdrop that the absurdity of AB-5 rests.

**Dynamex**

As stated above, AB-5 embraces the holding and codifies the ABC test utilized in *Dynamex*.

The *Dynamex* case was commenced by individual delivery drivers of a nationwide package and document delivery company who sued on their own behalf (and on behalf of a class of allegedly similarly situated drivers) claiming that defendant Dynamex had misclassified its drivers as independent contractors rather than employees.

In California (as in most other jurisdictions), an ‘employer’ has historically been defined as an individual or entity who ‘suffers or permits’ another to work. In *Dynamex*, however, this all changed. Instead of relying on this traditional definition, the California Supreme Court relied on the ABC test in order to determine those types of relationships that are properly classified as an independent contractor relationship versus those types that should really be classified as employee-employer.

Under the ABC test, a worker is properly considered an independent contractor to whom a wage order (or other labor laws) does not apply only if the hiring entity establishes: (A) that the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact; (B) **that the worker performs work that is outside the usual course of the hiring entity's business**; and, (C) that 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.

Based on the particular facts of the case, the court determined that defendant Dynamex’s entire business was that of a delivery service company and that its drivers merely delivered items to customers that Dynamex obtained, at the address Dynamex instructed, and at the rates set by Dynamex. As such, the court held that there was sufficient ‘commonality of interest’ that Dynamex was unable to satisfy part B of the ABC test. The court further stated that if the hiring party failed any one of the three components to the ABC test, that failure was sufficient to deem the subject worker an employee for purposes of labor laws, rather than an independent contractor. Accordingly, the court affirmed the Court of Appeal’s decision below both certifying the class and denying Dynamex’s motion to decertify the class.
It is of note that although the *Dynamex* Court provided certain examples as to what types of relationships it had in mind (i.e., it distinguished between a retail store hiring an outside plumber to *repair* a leak versus a clothing manufacturer hiring work-at-home seamstresses to make dresses from cloth and patterns supplied by the company), it did not at all specifically address franchising. This lack of clarity is especially troubling, given the court’s further ruling that the burden of establishing this distinction rests on the putative employer.

**AB-5**

AB-5, which was signed into law on September 18, 2019, codified the ABC test invoked in the above described *Dynamex* case. As summarized in a California Legislative Counsel’s Digest, AB-5 provides (as in *Dynamex*) that ‘...a person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that the person is free from the control and direction of the hiring entity in connection with the performance of the work, the person performs work that is outside the usual course of the hiring entity’s business, and the person is customarily engaged in an independently established trade, occupation or business.’

**Impact of Dynamex and AB-5 on Franchising**

The distinction between an ‘employee’ versus an ‘independent contractor’ is an essential distinction in the franchise model. Virtually every franchisee is contractually deemed, and operates as, an independent contractor of its franchisor. If this paradigm changes, and a franchisee is deemed to be an employee of its franchisor, the franchisor will not only become responsible for employment liabilities, but also for all acts, errors and omissions of its franchisees under the doctrine of respondeat superior.

Notwithstanding the importance of this distinction, since the vast majority of franchisors own and operate businesses identical to those of their franchisees, it is likely that most will fail part ‘B’ of the ABC test (i.e., *that the worker performs work that is outside the usual course of the hiring entity’s business*). Indeed, it is almost always the case that a franchisee does not perform work that is outside the usual course of its franchisor’s business. And, since the ABC test is a zero sum game, in which putative employers (in this case, the franchisors) must pass all three components in order for their putative employees (in this case, the franchisees) to be properly classified as independent contractors, failing part ‘B’ of the ABC test will: (a) deem virtually every franchisor the ‘employer’ of its franchisees, subsuming all of the costs and liabilities that come along with such title, and (b) transform virtually every franchisee into nothing more than an everyday employee.

Thus – – in direct contrast to the most standard and commonplace franchise agreement provisions; federal and state franchise laws, rules and regulations (in which the definition of a ‘franchise’ assume franchisee independence); the Lanham Trademark Act; and, over half a century of judicial precedent – – franchisors will now overnight be legally mandated ‘employers’ of their franchisees. And in accordance with that title, franchisors will find themselves liable for franchisee wages; Federal Insurance Contributions Act. contributions; unemployment insurance premiums; workers’ compensation premiums; Affordable Care Act
mandates; wage-and-hour compliance; and, all of the other duties, requirements and prohibitions imposed by federal and state law upon employers. Further, as an employer, franchisors may find themselves liable for any and all acts, errors and omissions which arise from the franchisee’s business, despite its lack of day-to-day control over such business.

This change represents a dramatic shift in liability exposure that was neither anticipated nor bargained for by either party when entering into the franchise agreement. Certainly, confiscating franchisees’ businesses and their ability to earn profits therefrom, and reducing franchisees to mere employees in exchange for their franchise investment, was not the intent of those the various U.S. jurisdictions that have enacted franchise registration, disclosure and relationship laws for the sole purpose of protecting franchisees from injustices.

**Future of AB-5**

As discussed above, neither AB-5 nor the *Dynamex* decision was intended to target the franchise industry and, despite the broad language of the ABC test, do not specifically address franchising. In the wake of AB-5’s passage, which takes effect on January 1, 2020, as noted by the International Franchise Association, the industry is unfortunately left with more questions than answers (including, by way of example, when the franchisor is deemed the employer of its franchisees, who will be deemed the employer of the franchisees’ employees?). However, what is clear is that AB-5 represents a fatal threat to franchisors, franchisees and the entire franchise business model, in particular, for those franchised businesses located in California and/or for franchisors whose franchise agreements are governed by California law.

Ultimately, franchisors may only have three options available: (i) commence litigation against the State of California to challenge AB-5’s applicability and legality in the context of franchising; (ii) either cease all future franchise sales in California or dramatically change the financial relationship between the franchisor and franchisee, taking into account the shift in expenses and liabilities; and/or, (iii) terminate and/or buy back existing California franchised businesses (which strategy, of course, is rife with its own legal risks).