JONES DAY

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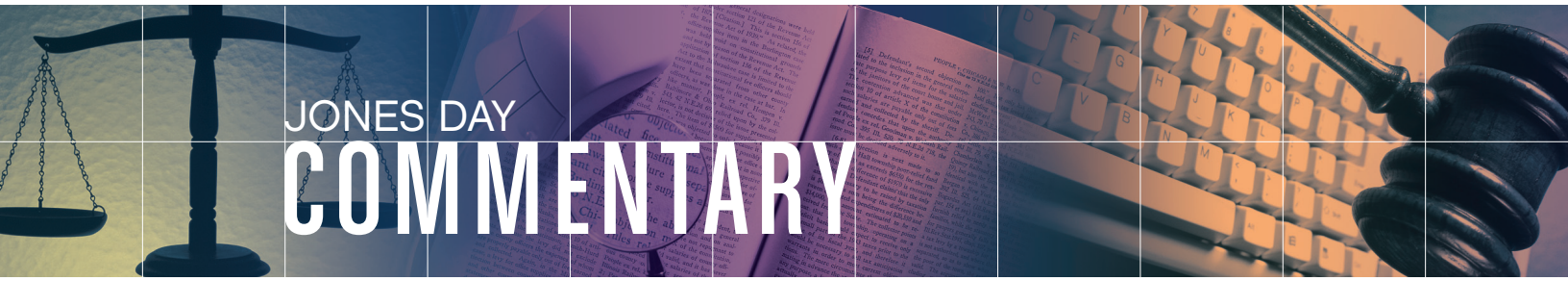

THE AFTERMATH OF *AWUAH*: ARE COURTS ENCROACHING ON A FRANCHISOR'S TRADITIONAL PROTECTIONS FROM A FRANCHISEE'S EMPLOYMENT DECISIONS?

There is growing concern over whether courts will deem franchisees "employees" or "joint employers," as opposed to contractors or wholly separate enterprises, as further decisions are handed down in the wake of the highly publicized *Awuah* case and courts grapple with today's complex franchisor-franchisee relationships.

BACKGROUND: *AWUAH V. COVERALL NORTH AMERICA, INC.*

In 2010, the United States District Court for the District of Massachusetts held in *Awuah v. Coverall North America, Inc.* that a group of janitorial franchisees were misclassified as independent contractors. *Awuah v. Coverall N. Am., Inc.*, 707 F. Supp. 2d 80, 84-85 (D. Mass. March 23, 2010).

The case began when a group of franchisees sued Coverall North America, Inc., a commercial cleaning company. The franchisees made three major arguments. First, they argued that Coverall misrepresented the amount of money they could make each month by purchasing a franchise. Second, they alleged that Coverall systematically breached franchise agreements by not providing or offering adequate work to produce the promised level of monthly income. Third, they claimed that they were improperly classified as independent contractors and thereby denied various employment benefits, including minimum wages, overtime pay, and eligibility for unemployment and workers' compensation. The plaintiffs sought compensation for the alleged violations, including statutory trebling of wage-related damages, and attorneys' fees and costs. The franchisees filed a motion for partial summary judgment on the independent contractor issue in December 2009.

In a March 23, 2010 decision granting the motion for partial summary judgment, the United States District Court for the District of Massachusetts ruled that the franchisees had been misclassified as independent contractors and instead were "employees" under

Massachusetts law. *Awuah*, 707 F. Supp.2d at 80 (D. Mass. 2010). The court held that Coverall failed to carry its burden to satisfy Massachusetts' test for determining whether an individual is an independent contractor. The Massachusetts test requires that three elements must be satisfied in order for an independent contractor relationship to exist: (i) the worker is free from control and direction in connection with the performance of a service; (ii) the service performed is outside the usual course of business of the employer; and (iii) the worker is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed.

The court found that the second prong (service outside the employer's usual course of business) was not met. The court found that Coverall was engaged in the same business as its franchisees for several reasons, including the fact that Coverall sells cleaning services, which are the same as the services the plaintiffs provide. Because the Coverall franchisees did not perform services outside the course of Coverall's business, the court held that they were not independent contractors but were instead Coverall employees.

After the March 23, 2010 ruling, both parties filed cross-motions for summary judgment regarding the damages claim of one of the misclassified franchisees. The court subsequently held that franchise fees that the franchisee paid under its contract with the franchisor were freely undertaken and would not be considered damages under the Massachusetts misclassification statute. *Awuah v. Coverall N. Am., Inc.*, 2010 WL 3766486, at *2 (D. Mass. Sept. 28, 2010). The court also stated that Coverall was required to reimburse the franchisee for any insurance premiums that Coverall was statutorily mandated to provide. In addition, the court required Coverall to pay interest on wages that were paid outside of the statutorily required time frame. *Id.* at *3. Finally, the court found that Massachusetts state law provided no clear guidance concerning damages recoverable by a misclassified franchisee and certified questions concerning damages and "related interpretations of the Massachusetts General Laws" to the Massachusetts Supreme Judicial Court for resolution. Order of Certification at 10, *Awuah v. Coverall N. Am., Inc.*, 2010 WL 3766486 (2010) (No. 07-10287-WGY).

DEVELOPMENTS SINCE THE 2010 *AWUAH* DECISIONS

2011 and 2012 *Awuah* Decisions

On August 31, 2011, the Massachusetts Supreme Judicial Court addressed the state law claims that the Massachusetts Federal District Court had certified almost a year earlier. Namely, the court answered the question of (i) whether a Massachusetts employer could use a system of customer accounts receivable financing to pay its employee at the time the customer paid the employer for the employee's work; (ii) whether, under the Massachusetts Wage Act (the "Wage Act"), an employer and employee could agree that the employee would pay the cost of workers' compensation and other work-related insurance coverage; and (iii) whether, in the case before it, Coverall could deduct "franchise fees" from such wages. *Awuah v. Coverall N. Am., Inc.*, 952 N.E.2d 890 (Mass. Aug. 31, 2011).

The Supreme Judicial Court ruled that damages the franchisee could recover from Coverall for Coverall's failure to treat the franchisee as an employee include franchise fees and insurance premiums, along with attorneys' fees and possibly treble damages. *Id.* at 895. Additionally, the court held that Coverall could not pass on workers' compensation and insurance costs to the franchisee because these costs protected Coverall. Finally, the court held that chargebacks to the franchisee for unpaid bills also violated the state's Wage Act. The court interpreted the Wage Act to prohibit Coverall from deducting or withholding payment of any earned wages. The court held that chargebacks to the franchisee violated this provision because they allowed Coverall to recapture wages already earned and paid. *Id.* at 897.

The court declined to answer or review the question of whether the plaintiffs in the case were employees, primarily because Coverall conceded for the purpose of the proceeding that the plaintiffs were employees. Thus, the court focused only on the question of damages. Specifically, the decision stated that "answers to the certified questions [were] premised on the plaintiffs' agreed-on employee status [and that] the answers ha[d] no application to properly classified independent contractors operating under franchise agreements." *Awuah*, 952 N.E.2d at 893 n.3.

Most recently, on March 15, 2012, the Massachusetts Federal District Court supplemented the Supreme Judicial Court's ruling with an order stating that successful franchisees in the case would be entitled to recover from Coverall treble damages dating back to 2006. *Awuah v. Coverall N. Am., Inc.*, 2012 WL 910260, at *1 (D. Mass. Mar. 15, 2012). (Although some plaintiffs' claims have been resolved, other plaintiffs are proceeding as a class. Some class certification issues related to the scope of the class are currently before the First Circuit.)

***Awuah*'s Impact**

Similar Cases Have Been Filed Against Franchisors in the Wake of *Awuah*. The initial holding in *Awuah* that Coverall's franchisees were misclassified as independent contractors still stands. Other complaints have been filed, and several courts have issued recent decisions relating to a franchisor's potential liability as an "employer" in connection with franchise-related operations. These include:

- ***Jan-Pro Franchising Int'l, Inc. v. Depianti*, 712 S.E.2d 648 (Ga. Ct. App. June 23, 2011)**

Jan-Pro Franchising International, Inc. ("JPI") brought a declaratory judgment action in Georgia against Giovanni Depianti and Hyun Ki Kim, seeking a judgment that Depianti and Kim were not its employees under the Massachusetts Independent Contractor Statute ("MICS"). *Id.* at 648.

After the parties filed cross-motions for summary judgment, the trial court granted summary judgment to Depianti on the ground that he was JPI's employee under the MICS. (The court concluded that issues of fact precluded summary judgment as to Kim.) JPI subsequently appealed.

The Georgia Court of Appeals reversed the decision. The appellate court applied the same three-prong test used in *Awuah* and concluded that Depianti was not an employee of JPI under the MICS.

Under the first prong of the test (whether the franchisee is free from the control and direction of the franchisor), the court found that the undisputed facts showed that Depianti was not under JPI's control because JPI had only a franchise agreement with the regional franchisee. *Id.* at 651 ("While Depianti, as a franchisee of BME, implements a business model established by JPI, Depianti's performance of cleaning services is not controlled by JPI, which is not a party to the agreement between BME and Depianti.").

The court also found that JPI met the second prong (the services of the franchisee must be performed outside the usual course of the employer's business). Specifically, the court found that the service Depianti provided—cleaning—was not in the same scope of business JPI conducted, which focused on establishing, trademarking, and licensing cleaning systems to regional franchisees. *Id.* at 651.

The third prong of the Massachusetts test (showing that the worker was customarily engaged in an independently established occupation or business) was met "for essentially the same reasons that JPI ha[d] demonstrated factors one and two." *Id.* at 652. For these reasons, no employment relationship was found to exist between JPI and Depianti, and the order granting summary judgment to Depianti was reversed.

- ***Hayes v. Enmon Enterprises, LLC, et al.* d/b/a Jani-King Franchising, Inc., No. 3:10-CV-00382-CWR-LRA, 2011 WL 2491375 (S.D. Miss. June 22, 2011)**

The court in this case faced a question concerning whether a franchisor had an employment relationship with its franchisee. The court denied the franchisor's motion for summary judgment and found the question would have to be resolved by a jury.

The court evaluated 10 factors identified by the Mississippi Supreme Court for distinguishing between an employee and independent contractor for purposes of holding an employer liable for negligent acts. The federal court reviewed the franchise agreement between Jani-King Franchising, Inc. and Enmon Enterprises, LLC., the parties with whom the plaintiff allegedly shared an employer-employee relationship. The court noted that the agreement contained a variety of conflicting factors. On the one hand, it appeared as though Jani-King and Enmon intended to create an independent contractor relationship with one another. *Id.* at *3. Their franchise agreement, for example, acknowledged that Enmon was an independent contractor, and not an agent, servant, or employee of Jani-King.

On the other hand, the court found that "all relevant evidence" would be considered to determine whether the intent, made explicit in the agreement, was actually successful. The court noted that various provisions in the agreement resembled characteristics of an employer-employee relationship, including a limitation placed on Enmon that it would not cancel or terminate the agreement and a right granting Jani-King the option to terminate immediately. *Id.* at *4. Other provisions suggesting an employer-employee relationship included provisions concerning Jani-King's control of the work premises and the kind and character of work to be performed. *Id.* at *6. These provisions, when compared with the provision specifying that Enmon was an independent contractor of Jani-King, led the court to deny summary judgment for Jani-King and refer the case to a jury.

- ***Bricker v. R&A Pizza, Inc.*, 804 F. Supp.2d 615 (S.D. Ohio April 8, 2011)**

A federal court in Ohio also addressed the question of whether a franchisor was an employer of a franchisee in *Bricker v. R&A Pizza*. The court in *Bricker* granted the franchisor's motion to dismiss a case filed by female employees against Domino's and its franchisee alleging employment discrimination under Title VII and Ohio law. The court applied a test adopted by the Sixth Circuit for determining whether a franchisor would be considered the employer of a franchisee's employees. The test considers (i) the interrelation of operations of the businesses, such as common offices, recordkeeping, and bank accounts; (ii) common management, directors, and boards; (iii) centralized control of labor relations and personnel; and (iv) common ownership and financial control. *Swallows v. Barnes & Noble Book Stores, Inc.*, 128 F.3d 990, 993 (6th Cir. 1997).

The determining factor under the test in deciding whether an agency relationship exists between a franchisor and a franchisee is the degree of control the franchisor has over the operations of the franchisee's business. *Bricker*, 804 F. Supp. at 623.

The court found no indication that the franchisor (Domino's) and franchisee (R&A Pizza) operated as a single employer because there were no factual allegations in the complaint of such a relationship. Accordingly, the court found that no special relationship could be inferred that would give rise to a duty of care owed by Domino's to the plaintiff and dismissed the case against Domino's. *Id.* The case now proceeds in the Southern District of Ohio against R&A Pizza alone.

- ***Juarez v. Jani-King of California, Inc.*, 2012 WL 177564 (N.D. Cal. Jan. 23, 2012)**

In *Juarez*, a case brought by franchisees against Jani-King in California, a federal court granted summary judgment in favor of Jani-King on the plaintiffs' state labor code claims. Like in *Enmon*, the court in this case faced a question concerning whether a franchisor had an employment relationship with its franchisee.

The plaintiffs in the case alleged 14 causes of action against Jani-King, including causes of action for statutory fraud, claims under the California Labor Code, breach of contract claims, and breach of good faith and fair dealing claims. Jani-King asserted counterclaims for breach of contract, tortious interference with contract, and tortious interference with prospective economic relations. *Id.* at *2.

The legal theory underlying plaintiffs' claims under the California Labor Code was that Jani-King's common policies and practices so tightly controlled the plaintiffs' actions as to create an employer-employee relationship between Jani-King and the plaintiffs. *Id.* at *4. Jani-King argued that the undisputed facts showed that the plaintiffs were independent contractors. *Id.*

The court evaluated the claims under California law. California law provides that the principal test of an employment relationship is whether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired. *Id.* California law also provides that other factors considered to determine if an employer-employee relationship exists include, among others: whether the principal has the power to discharge the individual at will; whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work; and the length of time for which the services are to be performed. *Id.*

The court granted summary judgment in favor of Jani-King on the plaintiffs' California Labor Code claims because it found that Jani-King did not exercise "sufficient control" over the plaintiffs to render them employees. *Id.* For example, the plaintiffs had the discretion to hire, fire, supervise, and determine the rate and manner of pay for their own employees. *Id.* The court noted that although Jani-King imposed a number of controls on the plaintiffs (such as retaining sole ownership of contracts with cleaning clients, performing billing and accounting for the franchisees, and retaining the power to terminate a franchisee's right to service a particular client), these controls "were no more than necessary to protect Jani-King's trademark, trade name, and good will and accordingly, did not create an employer-employee relationship between Jani-King and Plaintiffs." *Id.* at *5.

State Action to Clarify Whether Franchisees are Employees of Franchisors Under State Provisions Has Heightened. Additionally, leaders and policy makers in a number of states have taken action regarding this issue.

Virginia Attorney General Opinion: One example of this is an Opinion the Virginia Attorney General issued in early 2011. The Opinion clarifies that Virginia law does not find an employment relationship between a franchisor and franchisee. The test that the Attorney General relied upon in making this conclusion is articulated in the proposed Virginia Worker Misclassification Act (the "Act"), S.B. 34, 2010 Sess. (Va. 2010) (proposed Jan. 13, 2010 and continued in 2011, but not yet passed). Under a three-prong test proposed in the Act, an employment relationship does not exist when (i) an individual is free from the direction and control of the employer under contract and in fact; (ii) the service provided by the individual is outside the usual course of business of the employer; and (iii) the individual is customarily engaged in an independently established trade, occupation, profession, or business both in contract and in fact.

After the Act was proposed, an individual sought an official request for an advisory opinion from the Virginia Attorney General that would answer the question of whether the Act would consider franchisees "employees" rather than independent contractors.

In an Opinion released in early 2011, the Virginia Attorney General stated that, in general, the test described under the Act would not find an employment relationship between a franchisor and franchisee. Distinguishing franchisees from traditional employees, the Opinion states that the franchisee is performing services not for the employer, but for the "profit and account of the franchisee." Va. Op. Att'y Gen. No. 10-111 (January 25, 2011).

Further, the Opinion states that a franchisee is unlike a traditional employee because it is a corporation, rather than an individual, and is not being compensated by the franchisor. *Id.* Consequently, the Virginia Attorney General concluded that the "application of [the] test to typical franchise agreements would result in the exclusion of franchisees and franchisors from the scope of [the] statute." *Id.*

Pending Legislation in the Massachusetts House of Representatives: There is pending legislation in the Massachusetts House of Representatives that would clarify that franchisees are not employees of a franchisor. The legislation has been in committee since June 2011. Massachusetts House Bill 3513 would clarify that "an individual who owns a franchise, or is a party to a franchise agreement under which he or she is authorized to sell products and/or services (a) in accordance with prescribed methods and procedures; and (b) under service marks, trademarks, trade names and other intellectual property licensed under such agreement, shall not be considered an employee of the franchisor." H.B. 3513, 186th Leg., 2010 Sess. (Mass. 2011).

CONCLUSION

The recent cases filed and decided in the wake of *Awuah* highlight the need for franchisors to continue to engage in business practices that confirm clearly separate enterprises, especially as it relates to employment decisions. In doing so, franchisors should carefully review their franchise disclosure documents and franchise agreements, and ensure franchisees have sufficient control over the daily operations of their businesses. Such contract provisions help support independence, which is a hallmark of independent-contractor status. That, in turn, can help mitigate the risk of an

"employee" determination. Franchisors also should review other materials and resources they provide to franchisees, including training and HR materials, which can be used to demonstrate control over the employment operations of the franchisee. A good practice remains to label these documents with appropriate disclaimers that the franchisee maintains total control over the employment operations of the business.

On the other hand, especially in this growing global marketplace where information (and, indeed, allegations) flows so quickly from one part of the world to the next, there remains an increasing tension between the franchisor's desire to "control" and promote quality operations, goodwill, and the brand, and the desired separation between franchisors and franchisees. Media, weblogs, or even lawsuits lambasting the brand—even if the result of a franchisee's misstep—can be just as damaging to the franchisor as mistakes made by the franchisor itself. We see this tension continuing to increase and the franchisor's vigilance in avoiding "joint employer" arguments as important as ever.

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