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PERSPECTIVE

Assembly Bill 5 and The Future of Franchising

By Barry Kurtz and Matthew J. Soroky

2020 has been an unprecedented year for franchisors in numerous respects. Compounding economic and operational challenges from the COVID-19 pandemic, the legal landscape in California has placed franchisors in a defensive posture. While ride-sharing companies Uber and Lyft have secured a reprieve from Assembly Bill 5 by the recent passage of Proposition 22, the franchise industry's efforts to exempt franchise businesses from the three-step "ABC" test of AB 5 have been stymied, at least for the time being. Despite damning precedent from the 9th U.S. Circuit Court of Appeals in *Vazquez v. Jan-Pro Franchising Int'l*, 923 F.3d 575 (9th Cir. 2019), that the test may apply to the franchise relationship, franchisors may have a viable argument that federal and state franchise laws preempt or supersede it following a decision by a federal district court in Massachusetts in *Patel v. 7-Eleven, Inc.*, 17-11414 (D. Ma. Sept. 10, 2020).

Whether or not courts will be persuaded to treat franchise relationships differently in misclassification cases, AB 5 as a limitation on the characterization of workers as independent contractors is only gaining traction in other states and at the federal level. The incoming administration has shown support for the PRO Act which would federalize AB 5's test for employment or independent contractor classification. The franchise industry is left with much uncertainty as it waits for the courts and considers available options, each of them bleak and/or untested, for minimizing risks of misclassification and other claims related to AB 5.

Overview of AB 5 and the ABC Test

Assembly Bill 5 took effect in California on Jan. 1, 2020, due to Uber and Lyft, both California-based companies, building their businesses with drivers categorized as independent contractors, much to the chagrin of labor unions in California experiencing declines in membership, having difficulty unionizing drivers, and taking issue with the gig economy's use of independent contractors in general. The bill has a broad scope and alters the employment landscape in a variety of industries.

Organized labor urged the California Legislature, many of whom (like AB 5 author Assemblywoman Lorena Gonzalez) either had labor union backgrounds or ran campaigns funded by labor unions, to take action. The Legislature was also incentivized by the financial benefits that would accrue by reclassification of independent contractors, including revenue to be gained from payroll taxes, Social Security and unemployment and disability contributions with more workers classified as employees.

Assembly Bill 5 governs when a business can treat a worker as an employee as opposed to an independent contractor. The bill assumes every worker in the state is an employee, unless the hiring company can prove: (A) the worker will be free from the control and direction of the hiring entity in the performance of the work, both under the contract for the performance of the work and in fact; (B) the worker will perform work that is outside the usual course of the hiring entity's business; and (C) the worker will be customarily engaged in an independently established trade, occupation or business of the same nature as that involved in the work performed. Cal. Lab. Code Section 2775.

AB 5 and Franchising

Many believed that franchising as a distribution model was in danger after AB 5's passage. The thought was that franchisors would be required to reclassify franchisees as employees, upending the entire industry. In franchising, the franchisor provides the brand name and a common marketing plan to the franchisee. The franchisee is given the opportunity to build and develop his or her own business. The business is inherently tied to the franchisor's marketing plan. Prong A (freedom from control and direction) strikes at the heart of this relationship because by custom and practice and under federal and state franchise laws, a franchisor must exert some degree of control over the operations and business practices of its franchises to protect its brand and operating systems.

Prong B requires the worker's services to be outside the main business of the hiring entity. The questions are what is the franchisor's business, and are the franchisor and franchisee in the same business. Arguably, a franchisor who only sells franchises operates in a separate industry from the franchisee who implements the marketing plan and sells products or services to consumers.

However, courts have not been swayed by this argument. When Uber argued that it was a technology company rather than a transportation company, the California appellate court affirmed that Uber was in fact in the transportation business rather than merely technology, as its revenue was derived from its drivers transporting passengers. Prong B is even more problematic when the franchisor owns and operates "company stores" that franchisees often use to model their operations. These franchisors may be unable meet Prong B by definition.

Prong C is susceptible to both interpretations, as a variety of factors impact the analysis of this prong. Franchisees are typically engaged in franchised businesses as independent business operators. However, the existence of noncompete clauses in franchise agreements and avoidance of conflicting interests indicate that a franchise business is highly dependent on the franchisor. To maintain independence of the business, while minimizing risk of joint employment claims from employees of a franchisee, franchisors are proactive in

mandating standard operating procedures to bolster the fact that the franchisee is independent. These include requiring their franchisees to operate their franchises through a business entity under their own licenses and permits and tax identification numbers, permitting franchisees to hire their own employees, refraining from requirements to adopt certain employment policies, and giving notice to employees and the public at large of the independent ownership of the franchise business.

While franchising is not mentioned in AB 5, it was not included among the large list of business relationships which received exemptions from the law. The statute has been amended by "clean-up" bills many times, now offering exemptions for more than 100 industries. The franchise industry's best chance to make inroads from an adverse ABC analysis may only be by exemption.

Failed Attempts at Franchise Exemptions

The International Franchise Association and members of the franchise community raised concerns with legislators about AB 5's potential impact on franchising. In February, several clean-up bills were introduced. One of them, Senate Bill 900, excluded certain franchise businesses with brick and mortar locations that had at least three non-owner employees, licensed a federally registered trademark, and other requirements. It would not have included service businesses such as janitorial services, which certain state legislators opposed. The bill never made it out of committee.

Later, the International Franchise Association lobbied for an exemption for franchising under AB 2257, introduced by Assemblywoman Gonzalez, which provided that a franchisee would not be deemed an employee of a franchisor unless a court determined the franchisor exercised a level of control over the franchisee or its employees not customarily exercised to protect the franchisor's trademarks, service marks and/or trade dress, including quality control of products and services.

The final draft of AB 2257 exempted 18 industries, but franchising was not one of them. It certainly did not help that Uber and Lyft were considering shifting to a franchise model at the time this bill was under consideration. Consequently, franchisors are left to wrestle with the prospect of legal actions under AB 5.

Bleak Options

With the lack of clarity and no exemption for franchised businesses in California, AB 5 poses a potential existential threat for the franchise model. Options to bring franchisors into compliance with AB 5 — short of ceasing franchise sales in the state or withdrawing altogether from the California market — include shifting to an employment-based model; redefining obligations in the franchise agreement and creating a new financial structure; or focusing on sales to larger, multi-unit owners who are less likely to bring misclassification claims.

Franchisors may continue business as usual and risk being the test case, or hope that ongoing challenges and lobbying efforts will eventually exempt the franchise industry. But how AB 5 will be enforced is an open question.

A Glimmer of Hope — Preemption?

California courts have yet to consider the argument that federal and state franchise laws mandate the exercise of significant control over the franchisees' method of operation, including control over franchisees' hours of operation, accounting practices, and personnel policies, and supersede or preempt the ABC test. For instance, the Federal Trade Commission's Franchise Rule requires that "[t]he franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation." California has a similar statutory requirement. A franchisor's "significant" control inherently conflicts with the preclusion of control under Prong A of the ABC Test.

At least one franchisor recently prevailed against a misclassification claim brought by a putative class of franchisees alleging misclassification and a franchisor's violation of state wage and hour laws. In *Patel v. 7-Eleven*, the franchisees argued that 7-Eleven exerted a level of control over the business relationship that transformed them into employees under the general independent contractor test in Massachusetts, which is the same ABC test used in California, entitling them to the benefits and protections of Massachusetts labor laws. A federal judge in Massachusetts held that the specific requirements of the FTC Franchise Rule governed over the general precepts of the ABC test in Massachusetts. The court accordingly denied the franchisees' summary judgment motion and request for class certification.

California franchisors may have a viable argument that the state's ABC test is not applicable because other law which defines the franchise relationship precludes the satisfaction of a prong of the ABC test, in which case AB 5 will not govern franchise relationships. Were the rule otherwise, a party would be subject to penalties for misclassification based on nothing more than its compliance with one law over another. Since franchising is such an integral and substantial part of the U.S. economy and cannot effectively be restructured, preemption may be the best, fastest and easiest way to save the franchise model. ■

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