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Regulatory Watch: Gauging Legislative Impacts on Franchising

Laura Michaels
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Amy Cheng expects less joint employment drama this time around for franchisors.

The running saga that is franchising's relationship with the joint employer standard will continue this year, but perhaps without the alarmist rhetoric of 2014 that had some in the industry predicting the evisceration of the franchise model.

"Now, most franchisors are familiar with this topic, and … we didn't see franchisors dramatically change their behavior with the last administration," said Amy Cheng, a partner at Cheng Cohen in Chicago. That last administration of course being the one of former President Donald Trump, who appointed new members to the National Labor Relations Board, which in turn voted to narrow the definition of joint employer to that of direct control, meaning a franchisor can be considered a joint employer only if it has direct control over a franchisee's employees and is involved in actions such as hiring and firing.

While an additional NLRB directive and Department of Labor rule further solidified that stance, the U.S. District Court for the Southern District of New York in September struck down the Department of Justice's criteria for determining when a franchisor is a joint employer, again

raising the liability concern. President Joe Biden, a Democrat, appointed a new NLRB chairperson, Lauren McFerran, and when the term of one Republican member is up in August he'll be able to add another Democratic member, likely setting the stage for a return to labor policies first advanced under President Obama.

Still, said Cheng, that shouldn't mean a drastic shift for most franchisors who'd already revised franchise agreements to better spell out franchisee control and specifically where franchisors don't have control.

"Now it's maybe just that we have to remind them," continued Cheng, "but it's not quite as harsh of a reality this time around." One of those important reminders, she said, is it's not only top-level executives who must be aware of joint employer liability, but field staff and the sales team as well, who should be clear in all dealings with franchisees that they as the operator are responsible for hiring, firing and training employees.

The addition of language in the franchise agreement expressly assigning control of employee-related matters to the franchisee has become more common over the past five years, said David Gusewelle, a transactional attorney at Drumm Law, as a way to limit liability exposure for franchisors. He's also advised clients to update their operations manuals, require visible signage to communicate that a store is independently owned and operated, and recommended in some cases that franchisees have workers acknowledge in writing that they are not employees of the franchisor.

Franchisee attorney Nancy Lanard wants to see audited numbers in Item 19 financials.

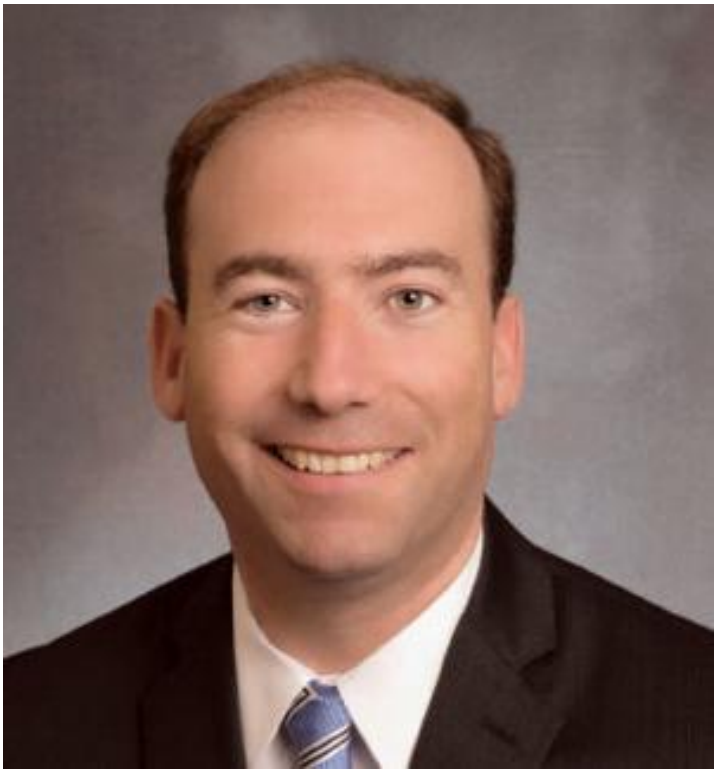
The pendulum that is joint employer "is swinging back and forth all the time," said Gusewelle, and most franchisors didn't suddenly get involved in the human resources-related matters of franchisees during the Trump presidency so as a result shouldn't need to walk back their approach.

At the state level, California's Assembly Bill 5 labor law, which codified the so-called "ABC test" that makes it more difficult for some businesses to classify workers as independent contractors rather than employees, is another to watch. The International Franchise Association, along with the Asian American Hotel Owners Association and independent Dunkin' and Supercuts franchisee associations, filed a lawsuit late last year to stop the state from enforcing the law against franchises, arguing existing statues, including the Federal Trade Commission's Franchise Rule, recognize that the relationship between a franchisor and its franchisees is a commercial relationship, not an employment relationship.

Tal Grinblat, an attorney at Lewis Hackman in California who represents franchisors and franchisees, said A.B. 5 is "a very scary prospect" for franchises because the first part of the ABC test says a hiring entity may only classify a worker as an independent contractor if the worker is "free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact."

That test "gets at the crux of what franchising is all about," said Grinblat, as franchisors set standards that apply to operations to ensure consistency across the system. He wasn't aware of any new lawsuits brought by franchisees making claims of being an employee of the franchisor since the law took effect in January 2020, but said the industry as a whole should be vigilant.

"It's up to the franchise industry, frankly, to educate the politicians about the industry and how it works, and why it shouldn't be subject to the same regulations," said Grinblat.



The negative impact of A.B. 5 on the franchise model is something franchisors and franchisees generally agree on, said Nancy Lanard, who represents franchisees as a senior partner at Lanard and Associates.

“It’s next to impossible to be considered an independent contractor under the ABC test,” said Lanard. “That changes the entire economics of the model.”

Tal Grinblat says those in franchising need to do a better job educating lawmakers.

Franchisees, she continued, “are going in believing they’re independent business owners and they’re signing on for the systems, the marketing, the support. Most of them don’t want to be employees.”

More states could take up similar legislation, and at the federal level Lanard said a Democratic administration is more likely to focus on consumer protection-oriented rules. One agency she’d like to see take action is the FTC, which is considering updates to the Franchise Rule as part of its regular review, including whether to require franchisors to disclose financial performance information in Item 19 of their franchise disclosure document. Lanard, however, wants to see the FTC take that potential requirement a step further.

“In my opinion, the best thing that could happen is the FTC would require audited financial performance representations in Item 19, but that’s not being talked about,” she said. “Item 19, these are unaudited numbers,” and if a franchisor does include this information, “prospective franchisees ultimately need to back up what’s in Item 19 by talking to other franchisees.”

Gusewelle, who noted Item 19 is arguably the most important section of the FDD for franchisees when evaluating a brand, said in practice requiring that disclosure would be a “huge burden for franchisors.” Administratively, if a franchisor doesn’t already track sales data from franchisees, “it’d be a huge undertaking to collect that data and there’s a cost that comes along with it,” he said. The accuracy of information from franchisees is also a concern, and Gusewelle added if existing franchise agreements don’t already require franchisees to provide financial performance information, those franchisors would likely be unable to meet an FTC mandate.

The FTC last amended the Franchise Rule in 2007, and a complete review is likely to take considerable time. Looking ahead, however, Gusewelle said franchisors should prepare for potential changes and think about structuring their agreements accordingly.

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