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ALERT

Independent Contractors v. Employees: New Traps for Franchisors That Misclassify Workers

By Christina A. Stoneburner

Generally speaking, one of the major advantages of being a franchisor is that the business and brand name can be expanded into other regions and states without the overhead costs associated with hiring employees to staff those locations. Another advantage is that only employees of the franchisor are entitled to protection under most state and federal employment and anti-discrimination laws. As many franchisors are aware, however, the legal landscape has recently become more uncertain – and a little scarier – in this area.

State and federal courts in recent years have expanded the definition of who is – and is not – an employer for purposes of employment laws. Franchisors may now have to worry about being added to that growing list of unintended employers, particularly in light of two recent federal courts that have addressed the issue of whether a franchisor can be deemed an employer for purposes of applying Title VII or state anti-discrimination laws. See *Myers v. Garfield & Johnson Enterprises, Inc., et al.*, 2010 U.S. Dist. LEXIS 3468 (E.D. Pa. January 14, 2010); see also *Awuah v. Coverall North America, Inc.*, Civil Action 07-10287-WGY (D. Mass. March 23, 2010). The most recent case, *Awuah*, sent chills through the franchising community with its potentially far-reaching implications.

In *Awuah*, the court, showing its disdain for the ordinary franchise agreement, likened Coverall to a Ponzi scheme where the company earns money not "from the sale of goods and services, but from taking in more money from unwitting franchisees to make payments to previous franchisees." The court's comment, although gratuitous and not supported by the facts of the case, has triggered an alarm for franchisors. However, the true concern, and possibly more far-reaching effects of the case, stem from the court's analysis of what is the nature of a franchisor's business versus the nature of a franchisee's business.

In *Awuah*, Coverall franchised commercial cleaning franchises and the plaintiff was a franchisee of Coverall. Coverall, like most franchisors, required franchisees to enter into a contract that detailed the franchisees' responsibilities to comply with Coverall's detailed bid, business and cleaning standards in order to maintain Coverall's strong brand identity. Coverall also insisted that it have the exclusive right to perform all billing and collection services for the franchisees. In examining the plaintiffs' claims that they were improperly classified as independent contractors, the court looked to Massachusetts' independent contractor statute, which is similar in some respects to approximately 25 other states' independent contractor statutes and sets forth a three-prong test as to whether an individual is an independent contractor:

> (1) The individual is free from control and direction in connection with the performance of the service, both under his or her contract for the performance of service and in fact;

(2) The service is performed outside the usual course of the business of the employer; and

(3) The individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed. See Mass. Gen. Laws Ch. 149, § 148B.

The *Awuah* court rejected Coverall's argument that it was engaged in a different business than its franchisees – namely that it was in the business of franchising services and that the franchisees were in the business of cleaning. Notwithstanding the fact that Coverall itself never engaged in any cleaning services, the court held that Coverall was in the business of providing cleaning services, the same as its franchisees. The court further noted that due to the extensive controls placed into effect by Coverall, including its market and bid training, the provision of uniforms and badges and the percentage received on every cleaning service, there could be no other conclusion than Coverall was in the business of providing cleaning services, the same as its franchisees.

Under the *Awuah* court's reasoning, and possibly where the state statute is similar to that in Massachusetts, it is difficult to imagine a scenario when the franchisor would be able to establish that its franchisees were independent contractors, not employees. A finding that a franchisee and its employees are employees of the franchisor exposes the franchisor to potential liability under workers' compensation statutes, wage and hour laws, the Internal Revenue Code and whistleblower laws in addition to anti-discrimination statutes. Federal and state agencies charged with enforcing employment laws have been increasing their examination of whether an individual is an independent contractor or employee. Indeed, in February 2010, the IRS and 37 states announced that they were launching a "crackdown" on the misclassification of independent contractors.

The *Awuah* case recently went to trial. After the evidence was presented, the trial court dismissed the allegations that the plaintiffs should have been classified as employees of the franchisor. However, franchisors should be cautiously optimistic, as the dismissal of claims was based on the fact there was no proof of damages resulting from the misclassification, and not that the plaintiffs could not be deemed employees of the franchisor. It remains to be seen how expansively the *Awuah* case will be applied by other courts.

Franchisors are encouraged to contact Christina Stoneburner at 973.994.7551 or cstoneburner@foxrothschild.com or any other member of our Franchising, Licensing & Distribution Practice to review their franchise agreements and the applicable state laws in order to help craft agreements that may avoid liability.

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