

**COMMONWEALTH OF KENTUCKY
SUPREME COURT
NO. 2010-CA-000658**

DOCTORS' ASSOCIATES, INC.

APPELLANTS

v.

ON APPEAL FROM THE COURT OF APPEALS
CIVIL ACTION No. 08-CA-283-WC

UNINSURED EMPLOYERS' FUND; TONDA
MICHELLE BROWN; UBC (DBA SUBWAY); HON.
JOHN B. COLEMAN, ADMINISTRATIVE LAW JUDGE;
AND WORKERS' COMPENSATION BOARD

APPELLEES

BRIEF FOR AMICUS CURIAE INTERNATIONAL FRANCHISE ASSOCIATION

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CERTIFICATE OF SERVICE

I hereby certify that this brief has been sent this 18th day of January, 2011, to Walter L. Sales, Stoll Keenon Ogden PLLC, 500 W. Jefferson St, Suite 2000, Louisville, Kentucky 40202-2828; James R. Carpenter, Assistant Attorney General, Uninsured Employers Fund, 1024 Capital Center Dr. #200, Frankfort, KY 40601; Hon. Kevin Mullins, 48 E. Main St., Whitesburg, KY 41858; Watash, Inc., 714 Hwy 2034, Ermine, KY 41815; Hon. John B. Coleman, ALJ, 107 Coal Hollow Rd, Ste. 100, Pikeville, KY 41501; and Hon. Dwight T. Lovan, Commissioner, Dept. of Workers Claims, 657 Chamberlin Ave., Frankfort, KY 40601.

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PURPOSE OF BRIEF AND ISSUES ADDRESSED

In holding that a franchisor must make workers' compensation payments for its franchisee's employees under KRS 342.610(2)(b), the Court of Appeals did not adequately consider what this Court has called "the unique franchise arrangement." *Papa John's Int'l v. McCoy*, 244 S.W.3d 44, 54 (Ky. 2008). A franchise is "a commercial arrangement between two businesses," and its unique character requires courts to "take a more precise approach" to applying the law than simply treating franchisors as another type of employer. *Id.* at 47, 55.

To require franchisors to pay workers' compensation for workers that their franchisees employ would be antithetical to the unique nature of franchising and contrary to the text of the controlling statute. First, franchisees do not perform work for the franchisor. They perform work on their own behalf for their own customers and get paid by those customers. In the statute's terminology, they are their own "contractors," not "subcontractors" for the franchisor. KRS 342.610(2)(b). Second, the work that franchisees perform is not work "of a kind which is a regular or recurrent part" of the franchisor's own business. *Id.* "[A] franchisor typically concentrates its control on the quality and operational requirements relating to its trade or service mark," whereas franchisees focus on "the day-to-day operations and management of the business" providing a good or service to their customers (typically consumers). *Papa John's*, 244 S.W.3d at 54. Because franchisees perform their own kind of work, not that of the franchisor, their workers are their own, not those of the franchisor.

For these reasons, the Court should reverse the decision below.

INTEREST OF THE AMICUS

Founded in 1960, the International Franchise Association (“IFA”) is the oldest and largest trade association in the world devoted to representing the interests of franchising. The IFA’s mission is to safeguard and enhance the business environment for franchising worldwide. In addition to serving as a resource for current and prospective franchisors and franchisees, the IFA and its members advise public officials across the country about the laws that govern franchising, with the goals of promoting franchise growth and advancing the interests of franchisees, franchisors, and suppliers.

The IFA is the only trade association that acts as a voice for *both* franchisors *and* franchisees throughout the U.S. and the world. The IFA currently represents more than 90 industries, with more than 11,000 franchisees, 1,100 franchisors, and 500 suppliers holding memberships nationwide.

ARGUMENT

I. Franchising is Ubiquitous in Kentucky and is Recognized as a Distinct Business-To-Business Relationship by Kentucky Law.

This Court has previously recognized “the ubiquity of the franchise method of doing business in Kentucky.” *Papa John’s*, 244 S.W.3d at 47. A franchise is “a commercial arrangement between two businesses” in which a small business owner, the franchisee, is “authorized to use the franchisor’s intellectual property and brand identity, marketing experience, and operational methods in exchange for a fee paid to the franchisor.” *Id.* at 55.

Franchising is a ubiquitous part of the state, national, and global economies. Companies such as Yum!, Fazoli’s, McDonald’s, Dunkin’ Donuts, H&R Block, and Express Services, plus thousands of others, operate on a franchising model. *See* Roger D.

Blair & Francine Lafontaine, *The Economics of Franchising*, 10, Table 1-1 (Cambridge U. Press 2005). According to a 2008 study, more than 14,000 franchised establishments employ a staggering 176,000 workers and generate \$11.8 billion in annual economic output in Kentucky. *The Economic Impact of Franchised Businesses, A Study for the Int'l Franchise Ass'n Educ. Found.*, 21 Nat'l Econ. Consulting Practice of PricewaterhouseCoopers 44 (2008). Nationally, the economic impact is even greater: 900,000 franchised establishments create 21 million jobs and generate \$2.3 trillion in economic output. *Id.* at E-1, 6-20.

Franchising has become ubiquitous because it is a business model that combines the entrepreneurship of small business owners with the marketing power and efficiency of large brands. The United States Department of Commerce describes the combined effect this way:

Franchising has become so powerful partly because economic factors have made growth through company-owned units difficult for many businesses. In addition, franchisees are enjoying a competitive edge over other small business entrepreneurs by the use of trade names, marketing expertise, acquisition of a distinctive business appearance, standardization of products and services, training, and advertising support from the parent organization. Franchising represents the small entrepreneur's best chance to compete with giant companies that dominate the marketplace. Without franchising, thousands of businesspersons would never have had the opportunity of owning their own business and never have felt the immense satisfaction of being part of the free enterprise system."

See Franchising in the Economy 1986-88, U.S. Dep't of Commerce, 1 (Feb. 1988). From an economic perspective, franchisees take on part of the capital cost and risk of operating a business, in exchange for a chance to retain the profits. A franchisor gives up its ability to maximize profits and instead receives only a royalty (typically a percentage of the

franchisee's sales). The franchisee obtains a right to use a business system and the opportunity to maximize its profits.

The economic activity generated by franchising has not escaped notice by state and federal lawmakers, both of whom have acknowledged franchising as a distinct type of business-to-business relationship and regulated it as such. Nationally, franchisors are regulated by the Federal Trade Commission, which requires them to issue extensive pre-sale disclosures about the nature of the business opportunity to prospective franchisees. *See Regulation on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*, 16 C.F.R. 436 *et seq.*

In Kentucky, both the common law and statutory law have addressed franchising as a business-to-business relationship and distinguished it from ordinary employment relationships. In *Papa John's*, this Court faced the question of when a franchisor may be held vicariously liable for torts committed by an employee of one of its franchisees. A pizza delivery driver employed by a Papa John's franchisee was accused of malicious prosecution and defamation, 244 S.W.3d at 48-49, and the Court of Appeals held that the Papa John's franchisor could be held vicariously liable on an ostensible agent theory, *id.* at 50. This Court reversed, holding that, in light of the "unique franchise arrangement," *id.* at 54, "it is clear to us that the traditional rules pertaining to scope of employment and ostensible agency are inapposite to the issue of a franchisor's vicarious liability," *id.* at 55. This Court instead adopted a test unique to franchising that takes account of "the fact that a franchise is a commercial arrangement between two businesses." *Id.* Courts in other states have recognized the distinction between franchises and employee-based business models in a variety of context. *See, e.g., Allen v. Choice Hotels Int'l, Inc.*, 942

So.2d 817, 821-22 (Miss. Ct. App. 2006); *Williams v. Dresser Indus.*, 120 F.3d 1163, 1168 (11th Cir. 1997).

Kentucky statutory law has likewise recognized franchising as a distinct, business-to-business relationship. In the context of motor vehicle sales, the law provides a particular example of a franchise relationship, defining a “franchise” as an agreement between a vehicle manufacturer and a vehicle dealer that “fix[es] the legal rights and liabilities of the parties . . . and pursuant to which the dealer purchases and resells the franchise product.” KRS 190.010(21). The law requires the manufacturer and dealer to be separately owned and controlled businesses, KRS 190.070(2)(j), making it clear that the franchise relationship is a relationship between two distinct businesses. Franchises are thus treated differently as a matter of both common and statutory law.

II. KRS 342.610 does Not Require a Franchisor to Pay No-Fault Workers’ Compensation for Workers Employed by Their Franchisees.

This is the first case in which Kentucky courts have addressed how the no-fault workers’ compensation provisions of KRS 342.610 apply to the franchise relationship. The Court of Appeals did not adequately consider the unique treatment of the franchises under Kentucky law in applying the statute, and as a result erred in its application. This Court should remedy that error.

The no-fault statute provides that employers are liable, as a general matter, for paying “compensation for [the] injury, occupational disease, or death” of their employees, “without regard to fault.” KRS 342.610(1). The statute further provides that, in some instances, a person who is not an employee’s direct employer may nonetheless be required to pay compensation. Under the statute, “contractors” are liable to pay compensation for the employees of their “subcontractors”:

A contractor who subcontracts all or any part of a contract . . . shall be liable for the payment of compensation to the employees of the subcontractor unless the subcontractor primarily liable for the payment of such compensation has secured the payment of compensation as provided for in this chapter.

KRS 342.610(2). The terms “*contractor*” and “*subcontractor*” are defined, in relevant part, as follows:

A person who contracts with another:

* * *

(b) To have work performed of a kind which is a regular or recurrent part of the work of the trade, business, occupation or profession of such person

shall for the purposes of this section be deemed a contractor, and such other person a subcontractor.

KRS 342.610(2)(b). The term “*work*” is also expressly defined:

“Work” means providing services to another in return for remuneration on a regular and sustained basis in a competitive economy.

KRS 342.0011(34).

A franchisor does not qualify as a “contractor” under these provisions of the no-fault statute for several reasons.

A. A franchisor does not contract with its franchisees to “have work performed.”

First, a franchisor is not a contractor liable to pay no-fault compensation for its franchisees’ employees because it does not subcontract with the franchisees to “have work performed.”

As this Court has previously recognized, a franchise agreement is one in which a franchisee contracts “to use the franchisor’s intellectual property and brand identity,

marketing experience, and operational methods in exchange for a fee paid to the franchisor.” *Papa John’s*, 244 S.W.3d at 55. A franchisee seeks to build its own business, using methods and intellectual property that it buys the right to use from the franchisor. In exchange for a fee, a franchisee gains the right to offer “the goods, services, or name brand of another (the franchisor) ‘in accordance with the established standards and practices of the franchisor.’” *Laguardia Assoc. v. Holiday Hospitality Franchising, Inc.*, 92 F. Supp. 2d 119, 124 (E.D.N.Y. 2000) (citation omitted). Under the plain meaning of KRS 342.610(2)(b), a franchisee is not hired by the franchisor to perform work on the franchisor’s behalf.

Although no case has addressed the application of KRS 342.610(2)(b) to a franchise, this Court has addressed an analogous situation and held that a sale of rights between businesses does not create a contractor/subcontractor relationship. In *Elkhorn-Hazard Coal Land Corp. v. Taylor*, 539 S.W.2d 101 (Ky. 1976), a landowner leased the mineral rights on its property to a coal company, in exchange for a monthly fee, as well as a per-ton royalty. *Id.* at 102. When an employee of the coal company fell ill, he attempted to hold the landowner liable for workers’ compensation as a “contractor.” *Id.* at 103. This Court rejected the claim, holding that “[t]he provisions of KRS 342.610(2) setting forth conditions in which a person may be deemed a contractor are *limited in application* to persons who contract with another to have work performed for them by the other person.” *Id.* at 104. In the case before it, the coal company “was mining the coal for its own use and not for” the landowner. *Id.* Hence, the landowner was not a contractor. In the same way the coal company leased the mineral rights and used those rights to operate its own business, a franchisee licenses the trademarks and business

methods of a franchisor and uses them to operate its own business. The franchisor does not pay the franchisee to have work performed for it; the franchisee pays the franchisor to obtain rights. This type of relationship does not fall within KRS 342.610(2).

Contrast the nature of a franchise relationship with the typical subcontractor relationship that produces liability under the no-fault statute, in which a contractor hires a subcontractor to perform a specific task necessary to the contractor's ongoing business. In one case, a construction company contracted with a subcontractor to do the rough framing carpentry for one of its construction projects. *Fireman's Fund Ins. Co. v. Sherman & Fletcher*, 705 S.W.2d 459, 460 (Ky. 1986). In another case, a coal mining company hired truckers to deliver coal to the mining company's customers. *Tom Ballard Co. v. Blevins*, 614 S.W.2d 247, 249 (Ky. Ct. App. 1980). These cases are entirely dissimilar from a franchise relationship.

The exclusion of a franchise relationship from the no-fault statute becomes even clearer under the statutory definition of "work," which requires the subcontractor to provide services "in return for remuneration" paid by the contractor. KRS 342.0011(34). This is the opposite of what happens in a franchise relationship, where the franchisee pays the franchisor to use its intellectual property and business method. Indeed, that is one of the key factors that distinguishes a franchise relationship from an employment relationship. "A franchise . . . is quite different from a contract for employment. For one thing, it is the franchisee that pays, not the franchisor." *Kerl v. Dennis Rasmussen, Inc.*, 682 N.W.2d 328, 337-38 (Wis. 2004).

The Court of Appeals reasoned that "remuneration" can be defined to include benefits "given indirectly or by another entity" or "consist of a right and obligation, given

to one party, to perform a service that is, in and of itself, beneficial to both parties.” Op. at 15. If the term is interpreted this broadly, it has no limits and could apply to any contractual relationship of any kind. The Court of Appeals mistakenly relied on *R.O. Giles Enterprises v. Mills*, 275 S.W.2d 211 (Ky. Ct. App. 2008), to support its interpretation. But “KRS 342.610(2)(b) [was] *not* at issue” in that case. *Id.* at 212 n.2 (emphasis added). In addition, the case neither addresses nor attempts to apply the definition of “remuneration.” It holds simply that substantial evidence supported the ALJ’s conclusion that a landowner that had contracted with another to remove timber from the land in order to clear the land for mining had hired someone to perform work on its behalf. *Id.* at 214. Here, in contrast, the ALJ held that the franchisor had not hired a franchisee to perform work on its behalf, and substantial evidence supports that conclusion for the reasons given above. *R.O. Giles* is therefore better support for reversing the Court of Appeals’ decision than for affirming it.

B. The work that franchisees perform is not “of a kind which is a regular or recurrent part of the work” of the franchisor.

The second reason that franchises fall outside the no-fault statute is that franchisees do not perform work “of a kind which is a regular or recurrent part of the work” that a franchisor performs, as KRS 342.610(2)(b) requires.

As this Court has previously recognized, “a franchisor typically concentrates its control on the quality and operational requirements relating to its trade or service mark,” whereas franchisees focus on “the day-to-day operation and management of the business” providing a good or service. *Papa John’s*, 244 S.W.3d at 54. These categories of work are different in kind. A franchisor is in the business of licensing its “intellectual property and brand identity, marketing experience, and operational methods in exchange for a

fee.” *Id.* at 55. Franchisees, in contrast, are in the business of selling a good or service to their customers, usually consumers. *See* 16 C.F.R. 436.1(h)(1) (stating, in part, that a franchise agreement grants the franchisee “the right to operate a business that is identified or associated with the franchisor’s trademark.”); *Wieboldt v. Metz*, 355 F. Supp. 255, 260 (S.D.N.Y. 1973) (holding that franchise agreements were not securities contracts because “it would seem that the franchised business operated by the franchisee and the franchisor’s business of supplying the franchisee with goods and services are separate ‘business ventures’”) (citation omitted).

This general character of the franchise relationship is evident in this case and was noted in the ALJ’s decision. Specifically, the ALJ stated that, although DAI “owns and operates two stores itself, the vast majority of its business is as a franchisor.” The undisputed evidence is that, while DAI owns the rights and interest associated with Subway, it only runs two of the 14,800 Subway restaurants in the United States. Further, other than the few employees working in these stores, DAI’s employees are exclusively in the franchise business, and devote their time to marketing and selling franchises, not sandwiches. It is not enough to qualify under the statute, as the Court of Appeals mistakenly thought, to show that a franchisor and its franchisees are engaged in a mutually beneficial relationship. “[R]egular or recurrent . . . does not mean work that is beneficial or incidental to the owner’s business or that is necessary to enable the owner to continue in business, improve or expand its business, or remain or become more competitive in the market.” *GE v. Cain*, 236 S.W.3d 579, 588 (Ky. 2007). It is work that the owner, or franchisor, regularly performs itself. *Id.* Here, substantial evidence in the

record supported the ALJ's determination that DAI and its franchisees did not perform the same kind of work. The Court of Appeals erred in reversing that determination.

III. Sound Public Policy Supports the ALJ's Application of the Statute.

One key virtue of franchising is that it allows explosive economic growth by empowering a broad set of entrepreneurs to operate their own franchise businesses, taking on the burdens of business ownership while also realizing the benefits. *See, e.g., Kerl*, 682 N.W.2d at 337. The Court of Appeals' holding is a direct repudiation of the existence of franchisees as business owners. If left standing, it will require franchisors to act more like employers to manage their own risk, and therefore hobble the very aspect of franchising that has allowed it to contribute 176,000 jobs and billions of dollars to the Kentucky economy. *See The Economic Impact of Franchised Businesses* at 44. Nothing in the text of KRS 342.610 requires the Court of Appeals' interpretation. Indeed, nothing even supports it. The most natural interpretation of the statute, and the one that avoids the absurd result of undermining the franchise relationship that Kentucky law has otherwise embraced, *see Commonwealth v. Reynolds*, 136 S.W.3d 442, 445 (Ky. 2004) (statutes should be interpreted to avoid absurd results), is to hold that franchisees are not subcontractors for franchisors, and franchisors are therefore not liable to pay compensation under the no-fault statute for the franchisees' employees.

CONCLUSION

The franchisor-franchisee relationship is a unique business-to-business relationship that does not fall within the plain meaning of KRS 341.610. For this reason and the reasons stated above, the court should reverse the decision of the Court of Appeals and reinstate the decision of the ALJ.

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Respectfully submitted,

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