

International Franchise Association  
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# 2021 Judicial Update

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**Michael D. Joblove**  
Genovese Joblove & Battista  
Miami, Florida

**Dawn Diaz**  
Reach Restaurant Group  
Plano, TX

**Christina Fugate**  
Ice Miller LLP  
Indianapolis, Indiana

**Jan S. Gilbert**  
Polsinelli LLC  
Washington, D.C.

**Jonathan Solish, Esq.**  
Bryan Cave Leighton Paisner  
Santa Monica, California

**Elizabeth M. Weldon**  
Snell & Wilmer L.L.P.  
Los Angeles, California

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# Joint Employer: Recent Filings and Decisions, as Well as State and Federal Regulatory Actions

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**Dawn Diaz**  
Reach Restaurant Group  
Plano, TX

## **Joint Employer: Recent filings and decisions, as well as state and federal regulatory actions.**

### INTRODUCTION

In recent years, franchise business enterprises have become afflicted with the looming threat of joint employer liability. Franchisors are being roped into litigation as alleged joint employers of the employees of their franchisees. As such, a franchisor may be deemed a joint employer of the franchisee's employees under applicable law. Consequently, the cost of doing business under a franchise has increased. This uncertainty of law erodes the franchise industry, increasing both the risk and expense for franchisors. In 2015 the National Labor Relations Board ("NLRB") changed the joint employer standard making more franchisors responsible for labor violations of their franchisees. The subsequent effect to franchising was a cost of \$33 billion per year, litigation against franchised businesses almost doubled, and 376,600 jobs were not created over the next four years.<sup>1</sup>

The expansion of the joint employer standard on the federal level has caused many states to take action to limit the scope of the standard in their states and protect the viability of the franchise business enterprise. Currently there is no consensus among the states as to when joint employer liability should be found. The federal standard has varied in the past couple of years, and under the Biden administration the Department of Labor is once again moving in the direction to hold franchisors liable for the actions of their franchisees as it relates to employees. Understanding the ever-evolving joint employer standard is important for franchise lawyers and business owners so that they may adequately assess the liability risk to their clients and their businesses.

### CURRENT STATE OF THE LAW

The joint employer theory provides that two or more entities -- in the case of franchising, a franchisor and franchisee -- may be deemed jointly and severally liable for labor and employment law claims asserted by the franchisee's employees. The franchisor only becomes jointly liable if the franchisor exercised sufficient control over day-to-day employment matters. The amount of control that must be exercised varies by jurisdiction.

### BACKGROUND

Historically, an entity could be held liable as a joint employer under the theory of vicarious liability and common law agency principles for exercising direct control over

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<sup>1</sup> Michael Layman and Caleb Gunnels, *Pro Act Legislation Threatens Franchise Small Business*, International Franchise Association, <https://www.franchise.org/blog/pro-act-legislation-threatens-franchise-small-businesses> (Feb. 4, 2021).

employment matters related to the franchisee's employees. However, in 2015, the National Labor Relations Board and the Department of Labor ("DOL") expanded the standard under the National Labor Relations Act ("NLRA") and the Fair Labor Standards Act ("FLSA") to include liability for a franchisor that exerted even indirect control over the franchisee's employees.<sup>2</sup> The expansion was spurred by the NLRB's decision in *Browning-Ferris*, a case in which a union attempted to organize workers, employed by a staffing agency contracting with a recycling company, into a single bargaining unit with the employees of the recycling company. In that case, the NLRB made the decision to expand the standard of joint employer, opening the door to companies becoming responsible for the workers of their subcontractors. The NLRB moved the standard from one of direct control to one of indirect control. The decision made it possible for unions to find a path to organize franchisee employees by bringing more entities under the joint employer umbrella.<sup>3</sup>

Following this expansion, uncertainty ensued among the states as to when an entity may be deemed to have exerted sufficient control to be held liable as a joint employer. States began enacting their own statutes to clarify this issue and restrict the circumstances in which a franchisor may be held as the joint employer of its franchisees or franchisees' employees. Eighteen states--Alabama, Arizona, Arkansas, Georgia, Indiana, Kentucky, Louisiana, Michigan, New Hampshire, North Carolina, North Dakota, Oklahoma, South Dakota, Tennessee, Texas, Utah, Wisconsin, and Wyoming--enacted legislation in regard to joint employer liability from 2015 through 2017.<sup>4</sup>

Under the Trump administration, the states' efforts were reciprocated by the DOL. On January 16, 2020 the DOL published a FLSA Joint Employer Final Rule that took effect March 16, 2020 and narrowed the circumstances in which entities may be deemed joint employers. The rule set forth a four-part test to determine whether a franchisor is a joint employer of a franchisee. The test requires the franchisor to exercise one of four factors to qualify as a joint employer. Those factors are whether the franchisor: (1) hires or fires the employee; (2) supervises and controls the employee's work schedule or

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<sup>2</sup> See *Browning-Ferris Indus. of Cal., Inc.*, 362 N.L.R.B. 186, 18 (Aug. 27, 2015) (abandoning 30 years of precedent by adopting a new, broad standard for joint employers under the National Labor Relations Act).

<sup>3</sup> David J. Kauffman, *NLRB contends franchisors are joint employers*, KG&R, <https://www.kaufmannguildin.com/articles/nlrb-contends-franchisors-are-joint-employers/> (last visited Apr. 5, 2021).

<sup>4</sup> Allison R. Grow and Adrienne L. Saltz, *Effectiveness of the Legislative Response to Joint Employer Liability*, 37 Franchise L.J. 349, 351 (2018).

conditions of employment to a substantial degree; (3) determines the employee's rate and method of payment; and (4) maintains the employee's employment records.<sup>5</sup> However, on September 8, 2020, this rule was found to violate the Administrative Procedure Act "APA" by a New York federal district court for being unduly narrow in its interpretation of definitions set forth in the Fair Labor Standards Act.<sup>6</sup> (An appeal is currently pending in the Second Circuit Court of Appeals.) On March 11, 2021, under the Biden administration, the DOL announced a Notice of Proposed Rule Making to rescind its regulation interpreting joint employer status under the Fair Labor Standards Act.<sup>7</sup> The administration has indicated a desire to broaden the standard to hold franchisors accountable for wage violations of their franchisees.<sup>8</sup>

## LEGISLATIVE EFFORTS

### Protecting the Right to Organize Act

The Protecting the Right to Organize ("PRO") Act of 2021 seeks to codify the broad standard adopted by the NLRB and the DOL in 2015.<sup>9</sup> The bill has been met with support and opposition by numerous advocacy groups. Advocates in opposition to the bill fear that the broad standard in the PRO Act is so wide that it will inhibit a franchisor's ability to implement brand standards. They assert that most franchisors do not assert control beyond maintaining brand standards--which is vital to the prosperity of a franchise. The broader the joint employer standard becomes, the more difficult it will become for franchisors to successfully control brand image without subjecting themselves to liability for employment decisions of their franchisees. This, in turn, erodes the core function of a

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<sup>5</sup> 29 C.F.R. § 791.2(a)(1).

<sup>6</sup> *New York v. Scalia*, No. 1:20-cv-1689-GHW 2020 U.S. Dist. LEXIS 163498 (S.D.N.Y. Sep. 8, 2020).

<sup>7</sup> *Final Rule: Joint Employer Part 791*, Dep't Lab. (last visited Mar. 11, 2021), <https://www.dol.gov/agencies/whd/flsa/2020-joint-employment>; see Wage and Hour Division, Rescission of Joint Employer Status Under the Fair Labor Standards Act Rule (Mar. 12, 2021), [federalregister.gov/d/2021-04867](https://www.federalregister.gov/d/2021-04867).

<sup>8</sup> Ben Penn, DOL Proposes Ditching Trump's Narrowed Joint Employer Rule (1), Bloomberg L. (Mar. 11, 2021, 11:11 AM), <https://news.bloomberglaw.com/daily-labor-report/biden-dol-proposes-ditching-trumps-narrowed-joint-employer-rule>.

<sup>9</sup> Protecting the Right to Organize Act of 2021 (H.R. 842), <https://edlabor.house.gov/imo/media/doc/Section%20by%20Section%20-%20PRO%20Act.pdf>.

franchise—to create successful methods of distribution of goods or services.<sup>10</sup>

In in a nutshell, the PRO Act would amend the NLRA if it were to pass the Senate, making it “the most significant change to United States labor law in decades.”<sup>11</sup> The PRO Act employs the “ABC test” used in California, which states that all three of the below factors must be met for a worker to be classified as an independent contractor:

- (A) 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;
- (B) the worker performs work that is outside the usual course of the hiring entity’s business; and
- (C) the worker is customarily engaged in an independently established trade, occupation, or business of the same natures as that involved in the work performed.<sup>12</sup>

The IFA put it best regarding the PRO Act, “it may be the worst legislation for franchising ever considered by Congress. . .”<sup>13</sup> With this bill, the 2015 National Labor Relations Board holding that franchisors can be held responsible for the actions of their franchisees will be resurrected, after the NLRB had gone back to the more favorable joint employer standard in 2019.<sup>14</sup> Additionally, the above “ABC test” would allow for more workers to be classified as direct employees. The results could be disastrous to franchising as under this test franchisees could be considered the employees of the franchisor.<sup>15</sup> If a franchisee is no longer the business owner, but the employee of its

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<sup>10</sup> Ron Gardner and Lee J. Plave, *Protecting the Right to Organize (PRO) Act (H.R. 842)*, <https://plavekoch.com/protecting-the-right-to-organize-pro-act-hr-842/> (Mar. 9, 2021).

<sup>11</sup> John Lomax Jr., Gerard Morales, Jessica Van Ranken, *The PRO Act’s potential Effect on Employers*, Snell & Wilmer, <https://www.jdsupra.com/legalnews/the-pro-act-s-potential-effect-on-5634391/#:~:text=Changing%20the%20Independent%20Contractor%20Test,in%20the%20collective%20bargaining%20process> (March 16, 2021).

<sup>12</sup> AB 5, the California bill that is the basis for the ABC test in the PRO Act, is available at [https://leginfo.ca.gov/faces/billTextClient.xhtml?bill\\_id=201920200AB5](https://leginfo.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB5).

<sup>13</sup> Michael Layman and Caleb Gunnels, *Pro Act Legislation Threatens Franchise Small Business*, International Franchise Association, <https://www.franchise.org/blog/pro-act-legislation-threatens-franchise-small-businesses> (Feb. 4, 2021).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

franchisor, this piece of legislation would threaten the very purpose of franchising, to allow a person to own their own business.

This bill has more than 50 significant changes and would overhaul the National Labor Relations Act for the first time since it was enacted in 1935.<sup>16</sup> A few of the more significant changes that would occur under the PRO Act:

- Effectively overturn state “right to work” laws
- Codify the “ABC test” to deem independent contractors “employees” covered by the NLRA
- Limit the ability of employers to contest union election petitions and allow unions to engage in coercive tactics long held to be unlawful
- Restrict the ability of employers to obtain labor relations advice
- Facilitate union organizing in micro-units
- Redefine the definition of “supervisor” to include more frontline leaders as “employees” covered by the NLRA
- Change the definition of “joint employment” and force businesses to alter their structure or face liability
- Give employees the right to utilize employer electronic systems to organize and engage in protected concerted activity
- Prohibit employers from using mandatory arbitration agreements with employees
- Force parties into collective bargaining agreements via interest arbitration
- Expand penalties for violations of the NLRA<sup>17</sup>

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<sup>16</sup> Alan I. Model, Kevin E. Burke, Maury Basking, and Michael J. Lotito, *PRO Act Would Upend U.S. Labor Laws for Non-Union and Unionized Employers Alike*, <https://www.littler.com/publication-press/publication/pro-act-would-upend-us-labor-laws-non-union-and-unionized-employers> (Feb. 10, 2021).

<sup>17</sup> Alan I. Model, Kevin E. Burke, Maury Basking, and Michael J. Lotito, *PRO Act Would Upend U.S. Labor Laws for Non-Union and Unionized Employers Alike*, <https://www.littler.com/publication-press/publication/pro-act-would-upend-us-labor-laws-non-union-and-unionized-employers> (Feb. 10, 2021).

Until the Senate votes on this bill, this is another potential threat that lays in limbo for franchising.

## RECENT STATE DECISIONS

Although federal regulation guidance may expand the joint employer standard, states have not wavered in their restricted stances. Recent decisions display the array of tests applied per state to determine whether an entity is a joint employer.

### Pennsylvania

*In Diflavis v. Choice Hotels Int'l, Inc.*, a Pennsylvania district court found that no joint employment relationship existed when the only authority the franchisor exercised over the franchisee were the standards set out in the franchise agreement.<sup>18</sup> The court considered the total employment situation and economic realities of the work relationship with emphasis on four specific factors: (1) authority to hire and fire employees; (2) authority to promulgate work rules and assignments, and set conditions of employment, including compensation, benefits, and hours; (3) day-to-day supervision, including employee discipline; and (4) control of employee records, including payroll, insurance, taxes, and the like.<sup>19</sup> The court found that the standards set out in the franchise agreement were limited to maintaining brand standards and do not amount to control of the working condition or responsibilities of the franchisee's employees.<sup>20</sup>

### Ohio

An Ohio federal district court, in determining a motion to dismiss, stated that joint employer status depends on the economic reality of the relationship between a plaintiff and defendant.<sup>21</sup> The court went on to state that the inquiry requires consideration of the circumstances of the whole business activity and is a fact issue under the Fair Labor Standards Act ("FLSA").<sup>22</sup> Thus, it denied a motion to dismiss where the Plaintiff alleged

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<sup>18</sup> *Diflavis v. Choice Hotels Int'l, Inc.*, No. 18-3914, 2020 U.S. Dist. LEXIS 20801 (E.D. Pa. Feb. 3, 2020).

<sup>19</sup> *Id.* at 14 citing *Enterprise Rent-A-Car Wage & Hour Emp't Practices Litig.*, 683 F.3d 462, 471 (3d Cir. 2012).

<sup>20</sup> *Diflavis v. Choice Hotels Int'l, Inc.* at 26.

<sup>21</sup> *Branning v. Romeo's Pizza*, No. 1:19 CV 2092, 2020 U.S. Dist. LEXIS 108358 (N.D. Ohio Apr. 6, 2020).

<sup>22</sup> *Id.*

that the franchisor, Romeo's Pizza Franchise, LLC was involved in employment matters. In so holding, the court cited the Sixth Circuit's factor test used to determine whether an entity is an employer under the FLSA and allowed the plaintiff pizza delivery driver to pursue his claim against the franchisor. The Sixth Circuit's three factor test considers: (1) whether the entity exercises authority to hire, fire, and discipline the employee; (2) whether the entity has control over the employee's pay and insurance; and (3) whether the entity supervises the employee.<sup>23</sup> Thus, although the franchise agreements and operations manual clearly stated that the franchisee was responsible for its employees, and any matters arising out of that employment relationship, the court held it would rely on the FLSA and examine the specific facts of this case to make its determination.

#### Tennessee

In *Alford v. CNG Rests., LLC* the Tennessee federal district court used Sixth Circuit precedent more heavily in the determination of joint employer status.<sup>24</sup> The plaintiffs were former "Twin Peaks Girls" who claimed defendants did not provide notice of a tip credit that was applied against their minimum wage, in addition to not paying overtime. Although the court considered the franchisor's ability to set standards for training, uniforms and promotional requirements, the court determined that these were not enough for purposes of establishing that the franchisor was the plaintiffs' joint employer. Instead, the court used the following factors taken from precedent to determine whether the franchisor is a joint employer of the employee: (1) the ability to hire, fire, and discipline employees; (2) the ability to affect compensation and benefits; and (3) the ability to direct and supervise performance of employees. The court found that the plaintiffs' allegations that the franchisor enforced brand standards listed in the Franchise Agreement were not sufficient to show that the franchisor exercised control over the employees to the extent to make the franchisor a joint employer.<sup>25</sup>

#### North Carolina

A North Carolina federal district court in *Elsayed v. Family Fare LLC*<sup>26</sup> relied on the

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<sup>23</sup> Id. at 9 citing *Montanez v. Voss Indus., LLC.*, No. 1:18CV1378, 2019 WL 2330511, at 5 (N.D. Ohio May 31, 2019) (citing *Sanford v. Main St. Baptist Church Manor, Inc.*, 327 F. App'x 587, 594 (6th Cir. 2009)).

<sup>24</sup> *Alford v. CNG Rests., LLC*, No. 3:18-cv-01225, 2020 U.S. Dist. LEXIS 107413 (M.D. Tenn. Apr. 21, 2020).

<sup>25</sup> *Alford v. CNG Rests., LLC*.

<sup>26</sup> *Elsayed v. Family Fare LLC*, No. 1:18-cv-1045, 2020 U.S. Dist. LEXIS 142546 (M.D.N.C. Aug. 10, 2020).

test articulated by the Fourth Circuit in *Salinas v. Commercial Interiors, Inc.*<sup>27</sup> to determine whether an employee-employer relationship existed between the franchisee of a gas station and convenience store and its franchisor in an FLSA claim brought by the gas station employee. The test includes six factors the court must consider:

- (1) Whether, formally or as a matter of practice, the putative joint employers jointly determine, share, or allocate the power to direct, control, or supervise the worker, whether by direct or indirect means;
- (2) Whether, formally or as a matter of practice, the putative joint employers jointly determine, share, or allocate the power to—directly or indirectly—hire or fire the worker or modify the terms or conditions of the worker's employment;
- (3) The degree of permanency and duration of the relationship between the putative joint employers;
- (4) Whether, through shared management or a direct or indirect ownership interest, one putative joint employer controls, is controlled by, or is under common control with the other putative joint employer;
- (5) Whether the work is performed on a premises owned or controlled by one or more of the putative joint employers, independently or in connection with one another; and
- (6) Whether, formally or as a matter of practice, the putative joint employers jointly determine, share, or allocate responsibility over functions ordinarily carried out by an employer, such as handling payroll; providing workers' compensation insurance; paying payroll taxes; or providing the facilities, equipment, tools, or materials necessary to complete the work.<sup>28</sup>

The court specifically rejected applying the four-factor balancing test outlined in the 2020 DOL's Final Rule, as it is currently being litigated. The Final Rule, effective March 16, 2020, looked to whether the putative joint employer engaged in the following four factors: (1) hires or fires the employee (2) supervises and controls the employee's work schedule or conditions of employment to a substantial degree (3) the employee's rate and method of payment (4) maintains the employee's employment records. The Final Rule does not give more weight to one factor over that of another and recognizes the possibility that other factors may be considered if they allowed additional control over

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<sup>27</sup> *Salinas v. Commercial Interiors, Inc.*, 848 F.3d 125, 141-42 (4<sup>th</sup> Cir. 2017).

<sup>28</sup> *Elsayed v. Family Fare LLC* at 14.

the worker by the putative joint employer.<sup>29</sup>

Instead, the court relied on precedent established in the Fourth Circuit, noting that it would have likely reached the same conclusion using the DOL's Final Rule.<sup>30</sup> The court pointed out that the Fourth Circuit, as well as other circuit courts, have been able to find the existence of a joint employer relationship between a franchisor and the employees of its franchisees, allowing for the franchisee's employees to recover for FLSA violations against the franchisor. But, when it comes to franchisees trying to establish that they are the employees of their franchisor, to date there has not been one case in which a franchisee has been successful in holding its franchisors liable as a joint employer.<sup>31</sup> In this case, the franchisees asserted an FLSA claim against their franchisor alleging that the franchise structure was "a sham" and that they were actually the employees of the franchisor and as such they were entitled to the FLSA's wage and hour protections.<sup>32</sup> This court did not break from the status quo and concluded that the plaintiffs were not employees of the franchisor.

The ability to distinguish the level of control that is required to establish brands standards in a franchise system, from the level of control exerted over a franchisee's employer-employee relationship is critical when it comes to determining the existence of a joint employment relationship. The court's interpretation and application of factors three and five of the *Salinas* test took into account the difference between a franchise relationship from that of a subcontractor/contractor relationship, as was the case in *Salinas*. Had the court not done so, both factors would have given weight to the existence of a joint employment relationship.

New York

A New York federal district court heeded Second Circuit precedent applying the FLSA's economic realities test to joint employer claims under New York state law in *Griffith v. Coney Food Corp.*<sup>33</sup> The *Griffith* court explained the economic realities test in

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<sup>29</sup> Lindsey R. Camp, Peter N. Hall, Daniel L. Buchholz, Todd D. Wozniak, *DOL May Rescind Final Rules on Independent Contractor, Joint Employer Status*, Holland & Knight Alert, <https://www.hklaw.com/en/insights/publications/2021/03/dol-may-rescind-final-rules-on-independent-contractor>, (March 25, 2021).

<sup>30</sup> *Elsayed v. Family Fare LLC*. at 13.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 9-10.

<sup>33</sup> *Griffith v. Coney Food Corp.*, No. 19-CV-1601 (NGG) (JO), 2020 U.S. Dist. LEXIS 148099 (E.D.N.Y. Aug. 17, 2020); see also *People v. Domino's Pizza, Inc.*, 2020 NY Slip

this manner:

Under the economic realities test, “whether an employer-employee relationship exists. . . should be grounded in ‘economic reality’ rather than technical concepts.” The test is a “flexible concept to be determined on a case-by-case basis by review of the totality of the circumstances.” When evaluating employer status under the economic realities test, the amount of control exercised by the defendant is the key inquiry [internal citations omitted].<sup>34</sup>

In *Griffith*, the plaintiff was a former Checkers employee who alleges she was terminated because she was pregnant and that she was owed \$42.40 in unpaid wages.<sup>35</sup> The court determined that in the general contractor/subcontractor relationship the application of the FLSA economic realities test would result in a joint employment relationship most of the time, and as such would not be applied in that context.<sup>36</sup> As for the franchisor/franchisee relationship, the court saw no reason why not to apply the economic reality test to New York Labor Law.<sup>37</sup>

There are two tests in this jurisdiction to determine whether the franchisor is a joint employer--the formal control test and functional control test. An employee need only establish formal or functional control.<sup>38</sup> The following four factors signaling the existence of formal control are whether the alleged employer:

- (1) had the power to hire and fire employees,
- (2) supervised and controlled employee work schedules or conditions of employment,
- (3) determined the rate and method of payment, and
- (4) maintained employment records.<sup>39</sup>

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Op 31615(U) (N.Y. Sup. Ct. May 27, 2020).

<sup>34</sup> *Id.* at 12.

<sup>35</sup> *Id.* at 4.

<sup>36</sup> *Id.* at 11.

<sup>37</sup> *Id.* at 12.

<sup>38</sup> *Id.*

<sup>39</sup> *Griffith* at 12, citing *Carter v. Dutchess Cmty. Coll.*, 735 F.2d 8, 12 (2d Cir. 1984).

The six factors indicating functional control include:

- (1) whether the alleged employers' premises and equipment were used for the plaintiffs' work;
- (2) whether the employer had a business that could or did shift as a unit from one putative joint employer to another;
- (3) the extent to which plaintiffs performed a discrete line-job that was integral to the alleged employers' process of production;
- (4) whether responsibility under the contracts could pass from one employer to another without material changes;
- (5) the degree to which the alleged employers or their agents supervised plaintiffs' work; and
- (6) whether plaintiffs worked exclusively or predominantly for the alleged employers.<sup>40</sup>

The court determined that the facts of *Griffith* supported both of the above tests.<sup>41</sup> The court did not distinguish the differences of a franchise system from that of other businesses when it analyzed the facts. Instead, the court came to the conclusion that facts that are specific to most franchised systems, such as the franchisor maintaining the franchisees' point of sale system and the franchisors' ability to inspect its franchisee's operations and records contributed to the court's conclusion that the franchisor was in fact the employer of the franchisee's employee.<sup>42</sup>

The Supreme Court of New York had a different application when it applied the economic realities test in the *People v. Domino's Pizza, Inc.*<sup>43</sup> In this case the Office of the Attorney General's position was that a joint employment relationship can exist between the franchisor and the franchisee's employees, as a matter of law.<sup>44</sup> The New York Supreme Court concluded that courts had found that the opposite was true. Applying both the four-factor formal control test and the six factor functional control test, the court

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<sup>40</sup> Id. at 13, citing *Zheng v. Liberty Apparel Co, Inc.*, 355 F.3d 61 (2d Cir. 2003).

<sup>41</sup> Id. at 14.

<sup>42</sup> Id. at 15.

<sup>43</sup> *People v. Domino's Pizza, Inc.*, 2020 NY Slip Op 31615(U) (N.Y. Sup. Ct. May 27, 2020).

<sup>44</sup> Id.

determined that material issues existed as to Domino's being the joint employer of its franchisee's employees. The court also looked to case law that held that a franchisor's right to inspect its franchisee's operations, as franchisors must do to ensure system standards are met, is not a factor that would create a joint employment relationship.<sup>45</sup> The same factors applied, but the court conclusion was not to find the franchisor to be a joint employer.

## California

In *Salazar*, the Ninth Circuit Court of Appeals found that a McDonald's franchisor was not a joint employer.<sup>46</sup> McDonald's did not retain or exert direct or indirect control over its franchisee's employees' hiring, firing, wages, hours, or material working conditions.<sup>47</sup> The franchisor did exercise control over the means and manner of work performed at its franchises for quality control and maintenance of brand standards.<sup>48</sup> The Ninth Circuit stated that although there is evidence that McDonald's was aware that its franchisee was violating California's wage-and-hour laws it did not create a joint employer relationship as there was no evidence the franchisor had the necessary control over the franchisee's employees as established in previous precedent.<sup>49</sup>

## CONCLUSION

Courts clearly differ as to when a franchisor should be held liable as a joint employer of its franchisee's employees on the state and federal level. It should be noted that a court has yet to hold a franchisor to be the employer of its franchisee, but that potential finding exists as an unsettling possibility if the Pro Act of 2021 is enacted into law. While one would imagine that factors such as which entity has the control of hiring/firing, work conditions, and wages will still be considered, the new federal standard is poised to broaden those circumstances in which a franchisor will be deemed a joint employer. As we await the appeal of *New York v. Scalia*, the uncertainty is costly as franchisors anticipate the final rules of the Biden Administration.

Unfortunately, the Department of Labor's joint-employment "Final Rule" is no longer truthful in its labeling. Making a franchisor responsible for the acts of its franchisees

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<sup>45</sup> *People v. Domino's Pizza, Inc.* at 39-40.

<sup>46</sup> *Salazar v. McDonald's Corp.*, 944 F.3d 1024 (9th Cir. 2019).

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Martinez v. Combs*, 49 Cal. 4<sup>th</sup> 35, 109 Cal. Rptr. 3d 514, 231 P.3d 259, 277-79 (Cal. 2010).

is destroying a system that has allowed less advantaged people to run their own businesses. According to Franchise Direct, minorities comprise almost 30% of franchised businesses versus 18% of non-franchised businesses, closely reflecting minority representation in the general population.<sup>50</sup> While federal rules typically create a more uniform system, this back and forth as different administrations take over, creates anything but uniformity. For now, national franchisors seeking to mitigate risk must evaluate their operations on a state-by-state basis as consistency among the states is lacking.

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<sup>50</sup> Anne Daniells, *Minority-Owned Franchises – Where Are We Now, and What Are We Doing?* Franchise Direct. <https://www.franchisedirect.com/blog/minority-owned-franchiseswhere-are-we-now-and-what-are-we-doing#:~:text=Nearly%2030%25%20of%20franchises%20are,are%20started%20by%20minority%20owners>, (Oct. 14, 2020).

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# 2021 Judicial Update Force Majeure and Insurance COVID-19 Decisions and Trends

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**Christina Fugate**  
Ice Miller LLP  
Indianapolis, Indiana

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## **Force Majeure/Insurance COVID-19 Decisions and Trends**

### **I. COVID-19 Insurance Coverage Cases:**

As we all know, COVID-19 has had a devastating impact on the world economy. “Stay at home” and other similar quarantine orders forced companies to close locations, reduce staff or furlough employees, cancel events, issue refunds, or otherwise significantly change their operations—all of which resulted in devastating losses. As such, many businesses began filing claims with their commercial liability insurance carriers, claiming their losses were covered under the “business interruption” or “civil authority” provisions in their policies. For the most part, insurers have been uniformly denying these claims, maintaining that the government orders and other resulting damages from COVID-19 were not the type of damages covered by the existing policy language. As a result, numerous lawsuits have been filed (and are continuing to be filed) across the nation in both federal and state courts challenging the insurers’ denials. Insurers have routinely been moving to dismiss these lawsuits, typically on the basis that the closures and losses caused by COVID-19 and the subsequent government orders do not represent physical damage or loss as it is referred to in most insurance policies. This argument has been accepted by most courts across the country—especially in late 2020 and early 2021, when perhaps the initial shock from the pandemic, and courts’ willingness to help insureds, eased. A handful of these decisions have been appealed, but we have yet to see any rulings from the appellate courts. There are a few cases where courts have determined that losses from COVID-19 closures are, indeed, physical, but these decisions are few and far between and have been heavily criticized by other courts.

As there have been a plethora of cases filed with respect to insurance coverage for COVID-19 business losses, we summarize only a few of them to illustrate the trends.

#### **A. Courts Routinely Dismissing Coverage Cases.**

#### ***Diesel Barbershop, LLC v. State Farm Lloyds*, 479 F.Supp.3d 353 (W.D. Tex. 2020) (Case No. 5:20-cv-461)**

This was one of the early decisions handed down in summer 2020, and it began the trend of various courts dismissing COVID-19 cases. Plaintiffs were a group of several barbershops, which were deemed non-exempt and non-essential businesses under various Texas state orders that were put forth to address the COVID-19 outbreak in 2020. *Id.* at 356. Plaintiffs had insurance policies on their properties, and these policies all stated that State Farm would pay for “accidental direct physical loss to that Covered Property[.]” *Id.* However, the policies also outlined certain “excluded events,” which State Farm did “not insure under any coverage for any loss which would not have occurred in the absence of one or more” of those excluded events. *Id.* at 357-57. One such excluded event, which was at issue here, was for “[v]irus, bacteria or other microorganism that induces or is capable of inducing physical distress, illness or disease.” *Id.* at 357. After State Farm failed to pay out under the policies following plaintiffs’ claim from losses due to the COVID-19 orders, plaintiffs brought suit. State Farm moved to dismiss.

In analyzing the motion to dismiss, the trial court looked to whether there was actually “physical loss” under the policy and to whether the virus exclusion applied. Looking at the physical loss question, the court noted that its circuit adheres more to the necessity that the loss be literally physical. As the court noted, “It appears that within our Circuit, the loss needs to have been a distinct, demonstrable physical alteration of the property.” *Id.* at 360 (internal quotations and citation omitted). Because the COVID orders had rendered no such physical damage to plaintiffs’ properties, the court found that plaintiffs had failed to plead a direct physical loss. *Id.*

Regarding the virus exclusion provision of the policies, the court noted that, even if the damage were physical, this exclusion barred plaintiffs’ claims. *Id.* In finding that the virus exclusion clause applied, the court noted that the virus exclusion clause was explicit and should be followed and that, because a virus—COVID-19—ultimately caused the closure of the businesses, the virus exclusion clause applied. *Id.* at 361. The court granted State Farm’s motion to dismiss with prejudice. *Id.* at 362.

***Pappy’s Barber Shops, Inc. v. Farmers Group, Inc.*, 487 F.Supp.3d 937 (S.D. Cal. Sept. 11, 2020) (Case No. 20-cv-907-CAB-BLM)**

This is another barbershop case. Plaintiff barbershop owners filed suit against the defendant insurance companies after they denied the Plaintiffs’ claims for business income losses incurred as a result of city and state COVID orders in California. *Id.* at 940. Under the business income provision of the policies in question, the insurance companies agreed to pay for losses due to the suspension of business because of “direct physical loss of or damage to property at the described premises.” *Id.* As the court noted, in assessing the motion to dismiss that was filed by the Defendants, the key analysis was whether the effects of COVID-19 and the related governmental orders amounted to physical loss sufficient to trigger the business income provision of the policies. The court stated that it was not the first court to undertake this analysis: “Plaintiffs are not the first policyholders to argue in court that governmental orders forcing their businesses to stop operating as a result of the COVID-19 pandemic trigger insurance under provisions similar or identical to the ones in the Policy here. Most courts have rejected these claims, finding that the government orders did not constitute direct physical loss or damage to property.” *Id.* at 943.

Indeed, the court agreed with these other courts in rejecting Plaintiffs’ claim and granting the motion to dismiss. The court noted that the loss of ability to use property doesn’t amount to a direct physical loss under California law, and it clarified that “An insured cannot recover by attempting to artfully plead temporary impairment to economically valuable use of property as physical loss or damage.” *Id.*

***Henry’s Louisiana Grill, Inc. v. Allied Ins. Co. of America*, 2020 WL 5938755 (N.D. Ga. Oct. 6, 2020)**

Plaintiffs here were a restaurant and its affiliated private party and event space. Plaintiffs sued their insurance company after it denied coverage of their claim, which was that government orders imposed to rein in COVID-19 caused Plaintiffs to close their

business and therefore incur a “Business Income” loss as it was defined under the policy. *Id.* at \*2. “Business Income” was defined in the policy as a loss related to the suspension of business “caused by direct physical loss of or damage to property at the described premises[.]” *Id.* at \*1.

In seeking to have the case dismissed, Defendant argued that, because there was no literal physical change at the Plaintiffs’ business due to COVID and the government orders, the Business Income provision of the policy did not apply. *Id.* at \*3. Plaintiffs responded by arguing that the government order made Plaintiffs’ dining room physically unavailable to patrons, thus implicating the Business Income provision. *Id.*

The court agreed with Defendant: there was no physical loss. As the court noted, “The Plaintiffs’ allegation of physical change here is curious. The Plaintiffs repeatedly note that COVID-19 has never been identified on the premises. Therefore, no physical change as a result of the virus’ presence can be argued here. Instead, the Plaintiffs cast the Governor’s Executive Order as imposing some physical change on the covered premises. Under the Plaintiff’s logic, a minute before the Governor issued the Order, the dining rooms existed in one state. A minute later, the Governor issued the Order, and the Restaurant underwent a direct physical change that left the dining room in a different state. *This interpretation of the contractual language exceeds any reasonable bounds of possible construction, pushing the words individually and collectively beyond what any plain meaning can support.*” *Id.* at \*4 (emphasis added).

The Plaintiffs have appealed this decision of the trial court to the Eleventh Circuit, and that appeal is currently pending. Notably, the Restaurant Law Center, which is a public policy organization affiliated with the National Restaurant Association, filed an amicus brief in support of Plaintiffs’ position. In the amicus brief, the Restaurant Law Center pushes back heavily on the trial court’s—and, indeed, many other trial courts’—position that the loss was not a physical loss. As the amicus brief states, “[These decisions denying coverage] have favored insurers, often they are not well reasoned, overlook important differences in factual allegations, fail to apply the reasonable-interpretation rule, or are effectively the result of a self-fulfilling feedback loop.” Amicus Brief at \*14-15. The Restaurant Law Center noted the importance of a restaurant’s physical space to its financial success: “Restaurant dining is an experience, not just a financial transaction. The physical space and layout plays a crucial role in that experience . . . In barring on-premise dining, the executive orders caused millions of square feet of vibrant physical space that once served guests to be lost. The orders caused both property loss and property damage by dispossessing restaurants of their tangible spaces and forcing very real, material detrimental physical changes and alterations to their premises.” Amicus Brief at \*11-\*12.

***Uncork & Create LLC v. Cincinnati Ins. Co.*, 2020 WL 6436948 (S.D. W. Va. Nov. 2, 2020)**

In this case, Plaintiff, a creative events company, sued its insurance company after the insurer denied Plaintiff’s claim for coverage (which was premised on the COVID-19-related closures imposed by the state government). *Id.* at \*2.” Plaintiff “contend[ed] that

the Governor's order requiring the business to close constitutes a covered loss under the Policy, and/or that the virus itself causes direct physical loss or damage and is thus a covered cause of loss." *Id.*

The court did not accept the Plaintiff's argument. In granting the Defendant insurance company's motion to dismiss, the court said that "The novel coronavirus has no effect on the physical premises of a business. Non-essential businesses were ordered to shut down to prevent people from exposing one another . . . Recover for the Plaintiff here would be purely economic, solely for lost business without any accompanying repairs to the premises." *Id.* at \*4.

***Chattanooga Professional Baseball LLC v. National Casualty Co.*, 2020 WL 6699480 (D. Az. Nov. 13, 2020)**

Here, the court granted the insurance company's motion to dismiss the breach of contract claim brought by Plaintiff entities, who provide services to a number of Major League Baseball teams, because of a virus exclusion clause in the insurance policies. This decision has been appealed to the Ninth Circuit, USCA9 Case No. 20-17422

***Whiskey River on Vintage, Inc. v. Illinois Cas. Co.*, 2020 WL 7258575, \*10 (S.D. Iowa Nov. 30, 2020)**

In this case, the court granted the insurance company's motion for judgment on the pleadings in a breach of contract claim brought by Plaintiff restaurant operators because, among other reasons, "Although Plaintiffs attempt to paint their losses as physical, they have essentially pleaded loss of use, which is insufficient to establish a direct physical loss [from COVID and related government proclamations]." *Id.* at \*10. This decision has been appealed to the 8th Cir., USCA8 Case No. 20-3707

***TJBC, Inc. v. The Cincinnati Ins. Co.*, 2021 WL 243583 (S.D. Ill. Jan. 25, 2021)**

In this case, the Southern District of Illinois granted the insurer's motion to dismiss finding that the presence of COVID-19 did not cause a physical loss or damage to the plaintiff's steakhouse and brewery. The court stated, "Mere loss of use or diminishment in value of Plaintiff's business without underlying tangible damage or loss to the business property or structure is not enough to trigger coverage under the policy." In March 2021, the plaintiff filed a notice of appeal with the Seventh Circuit Court of appeals seeking to overturn the dismissal.

***Egg and I, LLC v. U.S. Specialty Ins. Co.*, 2021 WL 769658 (D. Nev. Feb. 25, 2021)**

Staying with the theme of the need for physical loss in order for a claim to be successful, the court here granted the defendant insurance company's motion to dismiss the claim by the insured franchisor because the insurance policy only covered the actual food not the service of food to onsite customers, which had been limited by the pandemic. See *id.* at \*2.

***Legal Sea Foods, LLC v. Strathmore Ins. Co.*, 2021 WL 858378 (D. Mass. Mar. 5, 2021) (Case No. 20-10850-NMG)**

In this case, the court granted the insurance company's motion to dismiss and noted that "The COVID-19 virus does not impact the structural integrity of property in the manner contemplated by the Policy and thus cannot constitute direct physical loss of or damage to property. A virus is incapable of damaging physical structures because the virus harms human beings, not property."). *Id.* at \*3. (internal citation and quotations omitted).

Other cases to note in which courts have dismissed insured's lawsuits include: *Manhattan Partners LLC v. American Guarantee and Liab. Ins. Co.*, 2021 WL 1016113 (D. N.J. Mar. 17, 2021) (Case No. 2:20-cv-14342) (finding that the business interruption losses suffered by the owners of over 120 restaurant franchises including Wendy's, T.G.I. Friday's, Marriott and Hilton, caused by COVID-19 and the government shutdown orders did not trigger coverage because the businesses had not sufficiently shown that there was a physical loss or damage to their properties); *Out West Restaurant Grp. Inc. v. Affiliated FM Ins. Co.*, 2021 WL 1056627 (N.D. Cal., Mar. 19, 2021) (Case No. 20-cv-06786) (granting insurer's motion for judgment on the pleadings against the franchisee of 100 Outback Steakhouse restaurants finding the insured franchisees had not plausibly alleged "direct physical loss of or damage to" their property as required by the insurance—the franchisee insured has appealed this decision to the Ninth Circuit).

B. A Minority of Courts Have Allowed the Litigation to Proceed Forward.

***Studio 417, Inc. v. Cincinnati Ins. Co.*, 478 F.Supp.3d 794 (W.D. Mo. 2020) (Case No. 20-cv-03127-SRB)**

Here, plaintiffs were hair salon and restaurant operators whose policies defined a "Covered Cause of Loss" as "accidental [direct] physical loss or accidental [direct] physical damage." *Id.* at 797. The policies did not have a virus or communicable disease exclusion. *Id.* Based on various provisions in the policy, plaintiffs filed claims for losses due to the direct physical damage and loss caused by COVID-19 and the corresponding government closure orders in response to the virus. *Id.* at 798. These claims were denied, and plaintiffs filed suit. The defendant insurance company moved to dismiss. The claims under the policy that were in question were varied, but the resolution of this motion to dismiss essentially came down to whether the pandemic and the governmental orders resulted in physical damage or loss to the properties. *See id.* at 800.

The court determined that plaintiff had adequately alleged a physical loss. *Id.* Plaintiffs alleged that COVID-19 is a "physical substance" that attached to plaintiffs' property and made it unsafe. *Id.* As the court said, "Based on these allegations, the Amended Complaint plausibly alleges a 'direct physical loss' based on the plain and ordinary meaning of the phrase." *Id.* (internal citation and quotations omitted). The court denied the defendant's motion to dismiss but stated that, following further discovery, more light may be shed on plaintiffs' contentions and that they could be revisited on summary judgment if Defendants moved as such. *Id.* at 805. This case is still pending.

It should be noted that, in perhaps an indication of how courts would address these types of arguments in the future (as the influence of the pandemic waned), this decision was criticized by *Gilreath Family & Cosmetic Dentistry, Inc. v. Cincinnati Ins. Co.*, 2021 WL 778728, \*6 (N.D. Ga. Mar. 1, 2021) (Case No. 1:20-cv-02248-JPB) (noting that “the Court disagrees [with the *Studio 417, Inc* court’s] analysis that the potential attachment of a virus with a limited life cycle to the walls of a building equals physical damage or loss.”). It was also criticized by a number of other decisions. See, e.g., *15 Oz Fresh & Healthy Food LLC v. Underwriters at Lloyd's London Known as Syndicates AML 2001, WBC 5886, MMX 2010, & SKB 1897*, No. 20-23407-CIV, 2021 WL 896216, at \*6 (S.D. Fla. Feb. 22, 2021) (denying coverage and disagreeing with *Studio 417, Inc.* case); *Santo's Italian Cafe LLC v. Acuity Ins. Co.*, No. 1:20-CV-01192, 2020 WL 7490095, at \*11 (N.D. Ohio Dec. 21, 2020) (same); *Kirsch v. Aspen Am. Ins. Co.*, No. 20-11930, 2020 WL 7338570, at \*6 (E.D. Mich. Dec. 14, 2020) (granting insurance company’s motion to dismiss, disagreeing with *Studio 417, Inc.* case, and noting that “Plaintiff has not even attempted to establish that COVID-19 caused tangible, physical damage to the property itself.”); *T & E Chicago LLC v. Cincinnati Ins. Co.*, No. 20 C 4001, 2020 WL 6801845, at \*5 (N.D. Ill. Nov. 19, 2020) (granting insurance company’s motion to dismiss and disagreeing with *Studio 417, Inc.* case); *Turek Enterprises, Inc. v. State Farm Mut. Auto. Ins. Co.*, 484 F. Supp. 3d 492, 502 (E.D. Mich. 2020) (granting insurance company’s motion to dismiss and distinguishing case from the *Studio 417, Inc.* case); *Indiana Repertory Theater, Inc. v. The Cincinnati Casualty Co.*, Case No. 49D01-2004-PL-013137 (Ind. Marion County Sup. Ct. 1, Mar. 12, 2021) (granting insurer’s motion for summary judgment, finding that *Studio 417 Inc.* does not apply to the insured’s claims as there was no evidence that the virus was ever present at its theater).

Two other cases demonstrate how the minority of courts have viewed physical loss or damage in light of the pandemic and its related government orders. In *Elegant Massage, LLC v. State Farm*, 2020 WL 7249624, \*10 (E.D. Va. Dec. 9, 2020), the court denied in part and granted in part the insurance company’s motion to dismiss claim by Plaintiff massage company, noting that “Here, while the [business] was not structurally damaged, it is plausible that Plaintiff’s experienced a direct physical loss when the property was deemed uninhabitable, inaccessible, and dangerous to use by the Executive Orders because of its high risk for spreading COVID-19, an invisible but highly lethal virus.”

In *Ungarean, DMD v. CNA*, No. GD-20-006544, 2021 WL 1164836, \*7 (Pa.Com.Pl. Mar. 25, 2021), the court granted summary judgment to a business on its insurance claim related to COVID-19-related closures and stated that “Plaintiff’s loss of use of its property was both direct and physical. The spread of COVID-19, and a desired limitation of the same, had a close, logical, causal, and/or consequential relationship to the ways in which Plaintiff materially utilized its property and physical space.”

The Northern District of Ohio has seen several cases involving these issues. In January 2021, the court gave insureds a glimmer of hope in *Henderson Rd. Rest. Sys., Inc. v. Zurich Am. Ins. Co.*, 2021 WL 168422 (N.D. Ohio Jan. 19, 2021) where the court found that Plaintiff restaurant company’s “business operations were suspended by direct physical loss of or damage to property at the premises.” *Id.* at \*13. Here, the court granted

summary judgment on Plaintiff restaurant owners claim for coverage. *Id.* at \*17. Plaintiffs, the court said, had adequately alleged a business income loss based on physical loss of or damage to property at the premises. *Id.* at \*13.

However, just as the *Studio 417* case, discussed above, *Henderson* has received skeptical criticism from later decisions by courts, including two subsequent cases from the same court. The first case, *Mikmar, Inc. v. Westfield Ins. Co.*, 2021 WL 615304, \*11 (N.D. Ohio Feb. 17, 2021) involved the court granting the insurance company's motion to dismiss. There, the court noted that "reading the policies as the *Henderson Road* Court does creates a host of potential practical and legal problems." The second case, handed down just the next day, was *Ceres Enterprises, LLC v. Travelers Ins. Co.*, 2021 WL 634982, \*11 (N.D. Ohio Feb. 18, 2021), in which the court granted the defendant insurance company's motion to dismiss Plaintiff hotel operator's declaratory judgment action and noted the practical and legal problems of some of the logic in the *Henderson Road* decision.

### C. *SMR Hospitality III LLC v. Robert J. Provost et al.* – A New Trend?

In early April 2021, a Marriott franchisee filed a lawsuit in the District Court of South Carolina against its insurance broker seeking to recoup its COVID-related business losses through allegations of the broker's malpractice. In *SMR Hospitality III, LLC v. Robert J. Provost et al.*, the Marriott franchisee alleged that its broker offered less insurance coverage in 2020 than in 2019 and that the broker did not allegedly communicate the availability of certain coverage for events like a pandemic. Case No. 7:21-cv-00980-TMC. The franchisee also claims that its broker did not give proper notice and submit claims to the insurer, FM Global, for business interruption when the franchisee was forced to close its hotel in response to government shut down orders. The complaint alleges claims against its broker for negligence and violation of South Carolina's Unfair Trade Practices Act. As insurers continue to deny coverage, we may see more claims against the brokers as businesses continue to look for ways to recover their business losses.

## II. Force Majeure:

Many contracts have clauses (commonly known as "Force Majeure" clauses) that excuse performance where events occur that are beyond the control of the parties. Indeed, the generally accepted meaning of "Force Majeure" is "[a]n event that can be neither anticipated nor controlled. The term includes acts of nature (e.g., floods and hurricanes) and acts of people (e.g., riots, strikes and wars)." *Black's Law Dictionary* 657-58 (7th ed. 1999). These causes intend to excuse a party's performance under a contract in the event of a force majeure event. The language of Force Majeure clauses varies widely from contract to contract and among industries. The type of events that constitute a force majeure event depends on the specific language of the contract, including who has the right to invoke the force majeure event (some contracts do not make it mutual) and whether explicit reference to the event giving rise to the failed performance (i.e., COVID-19) is included within the Force Majeure clause.

Since the start of the pandemic, we have seen a number of cases attempting to invoke the Force Majeure clause to avoid contractual performance. Although there are still few reportable decisions involving COVID-19, what we have seen is that courts are typically finding that COVID-19 qualifies as a force majeure event and that the contract language will be narrowly construed.

***In re Hitz Rest. Grp.*, 616 B.R. 374 (Bankr. N.D. Ill. 2020)**

This is one of the first decisions applying a Force Majeure clause to a commercial tenant's rental obligations in light of the government shutdown orders in the State of Illinois. The United States Bankruptcy Court for the Northern District of Illinois considered whether a restaurant tenant could successfully invoke a force majeure provision in a lease to avoid its monthly rent. *Id.* at 376. The Force Majeure provision in the subject lease provided:

Landlord and Tenant shall each be excused from performing its obligations or undertakings provided in this Lease, in the event, but only so long as the performance of any of its obligations are prevented or delayed, retarded or hindered by . . . laws, governmental action or inaction, [or] orders of government . . . Lack of money shall not be grounds for Force Majeure.

The restaurant argued that its obligation to pay rent was excused because of this clause, which was triggered when the Governor of Illinois issued a stay-at-home order in response to the COVID-19 outbreak in mid-March 2020. *Id.* at 377.

The court agreed with the restaurant—at least, to a degree. The court stated that the Force Majeure clause excused the obligations (to an extent) for April, May, and June 2020; however, because March rent had become due and payable on March 1, 2020—and the executive order wasn't entered until March 16, 2020—the restaurant was still obligated to pay March rent. *Id.* As the court stated, the governmental order was the proximate cause of the restaurant's inability to pay rent: “[the order] prevented Debtor [restaurant] from operating normally and restricted its business to take-out, curbside pick-up, and delivery.” *Id.* at 377-78.

Notably, however, the court stated that the rent obligations were excused, but only to a degree. The restaurant estimated that 25% of its operations—the very pick-up and delivery still allowed by the executive order—was still open. Therefore, the court said that the rent obligations were still present—they were just reduced to 25% of what they would have been without the executive order in place. *Id.* at 379.

***E2W, LLC v. Kidzania Operations, S.a.r.l.*, No. 1:20-cv-02866-ALC (S.D.N.Y. 2020)**

In this case, the plaintiff, a children-based amusement park franchisee, sued its franchisor for breach of the parties' franchise agreement after the franchisor sought to terminate the agreement for failing to open and operate the required number of franchises and pay certain royalty payments. Under the parties' agreement, the franchisee agreed to open and operate at least ten franchises in the United States by specific dates. In order to do so, the franchisee depended on third-party financing to fulfill

their obligations. When the lender backed out due to COVID-19, the franchisee could not fulfill its obligations under the franchise agreement. In response to the termination notice sent by the franchisor, the franchisee invoked the Force Majeure clause in the franchise agreement.

The franchisee thereafter filed a lawsuit asking the court for an injunction pending arbitration to enjoin the franchisor from terminating the franchise agreement—that the Force Majeure clause excused performance because their failure to perform was due to “acts of God” and the government shutdown orders. The court granted the franchisee’s injunction, finding that the franchisee demonstrated a likelihood of success on the merits and that COVID-19 served as a basis to excuse its performance under the franchise agreement. The court’s order compelled the parties to maintain status quo during the pendency of their arbitration.

This case remains pending in the Southern District of New York. According to the most recent status report filed with the court, the parties’ arbitration is scheduled for July 2021.

***Future Street Limited v. Big Belly Solar, LLC, 2020 WL 4431764 (D. Mass. July 31, 2020) (Case No. 20-cv-11020-DJC)***

This case is notable in that it makes clear that obligations that arise *before* the pandemic, will not be excused under the Force Majeure clause. Big Belly and Future Street were parties to a licensing agreement under which Big Belly granted Future Street an exclusive and perpetual license to distribute its products in a defined territory. *Id.* at \*2. Pursuant to the agreement, Big Belly agreed to provide support and maintenance services for the products it supplied. *Id.* Future Street’s suit stemmed from allegations that it was receiving defective products from Big Belly beginning in April 2019. *Id.* at \*3. When Big Belly did not respond to Future Street’s concerns about these defects, Future Street indicated its intention to start withholding payment in January 2020. *Id.* Subsequently, in a March 2020 meeting, Future Street informed Big Belly that it was going to stop future payments to allow Big Belly to fix the quality issues, and, also in March 2020, Future Street sought to be excused temporarily from making orders and payments due the COVID-19 pandemic. *Id.* In April 2020, Big Belly terminated its agreement with Future Street. *Id.* at \*4.

Future Street sought a declaratory judgment and argued that the Force Majeure clause of the parties’ agreement excused it from its minimum purchase obligations under the agreement due to the COVID-19 pandemic. *Id.* at \*6. The court disagreed, noting that Future Street’s obligation to pay Big Belly *predated* the pandemic, as did Future Street’s refusal to pay Big Belly. *Id.* Thus, because the performance failure arose *before* the COVID-19 pandemic, its performance could not be excused.

***Palm Springs Mile Assocs., Ltd. v. Kirkland's Stores, Inc.*, 2020 WL 5411353 (S.D. Fla. Sept. 9, 2020) (Case No. 20-21724-Civ-Scola)**

In this opinion, the Southern District of Florida ruled that a party seeking to excuse its contractual obligations based on a force majeure event needed to connect the dots between the cause (the government shutdown orders) and its inability to perform the contractual obligation. Plaintiff Palm Springs (a commercial landlord) brought suit against its tenant, Kirkland, for Kirkland's failure to pay rent beginning in April 2020. *Id.* at \*1. Kirkland moved to dismiss, arguing that, "according to the Lease, government-mandated quarantine and county restrictions on business operations, that arose as a result of the current COVID-19 pandemic, suspend its obligation to pay rent." *Id.* Kirkland grounded this argument in the Force Majeure clause of the lease agreement. *Id.* at \*2.

The court firmly rejected Kirkland's motion to dismiss. Kirkland urged the court to find that its rent payment obligations were automatically suspended because the government restrictions and shutdown orders qualified as force majeure events. The court did not agree, finding that Kirkland failed to demonstrate any causation between the government restrictions and Kirkland's inability to pay rent. The court stated that Kirkland "fail[ed] to explain how the governmental regulations it describes as a force majeure event *resulted* in its inability to pay rent." *Id.*

Second, the court found that even if Kirkland could demonstrate causation, the analysis of Kirkland's affirmative defense of force majeure was a factual determination that is improper to resolve at the motion to dismiss phase. *Id.* The parties subsequently settled this action.

***In re CEC Entm't, Inc.*, 2020 WL 7356380 (Bankr., S.D. Tex. Dec. 14, 2020)**

In this case, CEC Entertainment, Inc., the operator of Chuck E. Cheese restaurants, filed for Chapter 11 Bankruptcy in light of the COVID-19 pandemic. *Id.* at \*1. CEC initially sought rent relief with dozens of its restaurant locations and was able to settle with landlords for all but six locations in North Carolina, Washington and California. These landlords continued to insist that CEC was required to pay rent despite the pandemic and CEC's bankruptcy filing. As a result, through the bankruptcy proceeding, CEC filed an abatement motion, seeking an order abating rent payments for those locations. *Id.* CEC's arguments for its proposed abatement included: sections 105 and 365 of the Bankruptcy Code authorized the court to suspend its rent obligations; COVID-19 and the resulting government orders constituted force majeure events; and CEC's inability to fully utilize the leased premises entitled CEC to a frustration of purpose, equitable defense with respect to each location.

The bankruptcy court denied CEC's request for various reasons, including the fact that the Force Majeure clause did not allow for rent abatement, as the Force Majeure clause explicitly stated that payment of rent would not be excused. *Id.* at \*5. The court stated that the Force Majeure clause of CEC's lease with one of the lessors at issue explicitly stated that "This Section shall not apply to the inability to pay any sum of money

due hereunder or the failure to perform any other obligation due to the lack of money or inability to raise capital or borrow for any purpose.” *Id.*

***JN Contemporary Art LLC v. Phillips Auctioneers LLC*, 2020 WL 7405262 (S.D. N.Y. Dec. 16, 2020) (Case No. 20-cv-4370-DLC)**

In December 2020, the United States District Court for the Southern District of New York issued an opinion finding that the COVID-19 pandemic was a “natural disaster” within the meaning of a Force Majeure clause.

The case involved the auctioning of a painting by an art seller to an auction house pursuant to an agreement entered into by the parties in June 2019. *Id.* at \*1. The auctioning of the painting in question was scheduled to be done in May 2020; however, because of the COVID-19 pandemic, the auction house terminated the agreement to auction the painting and refused to pay the art seller the minimum price that it was guaranteed in connection with the auction. *Id.* In response, the art seller sought an order from the court compelling the auction house to honor the contract. The auction house moved to dismiss on various theories, including the applicability of the force majeure clause of the contracts. *Id.* at \*5.

The court granted the motion to dismiss. *Id.* at \*1. In granting the motion, the court noted that the force majeure clause clearly applied, stating: “The COVID-19 pandemic and the attendant government-imposed restrictions on business operations permitted [the auction house] to invoke the Termination provision. The pandemic and the regulations that accompanied it fall squarely under the ambit of Paragraph 12(a)’s force majeure clause. That clause is triggered when the auction ‘is postponed for circumstances beyond our or your reasonable control.’ Paragraph 12(a) also provides examples of circumstances beyond the parties’ reasonable control. Those circumstances include ‘without limitation’ a ‘natural disaster.’ It cannot be seriously disputed that the COVID-19 pandemic is a natural disaster.” *Id.* at \*7. The court also rejected the argument that art seller took too long to notify the auction house of its invocation of the Force Majeure clause, finding that the art seller had done so within a reasonable time and that the auction seller should have known that this was possible since the auction had been postponed.

What is most notable about this case for future cases is the court’s determination that a pandemic is a “natural disaster” within the meaning of a force majeure event.

***Rudolph v. United Airlines Holdings, Inc.*, 2021 WL 534669 (N.D. Ill. Feb. 12, 2021) (Case No. 20-cv-2142)**

This case was a class action lawsuit against United Airlines alleging breach of contract for its failure to refund travel fares following the outbreak of the COVID-19 pandemic. *Id.* at \*1. United moved to dismiss the claim. The force majeure clause at issue here was contained in United’s Contract of Carriage. The clause stipulated what would occur in the event of an “involuntary” cancellation of a flight, which includes cancellation due to a force majeure event. In the event of a cancellation due to a force majeure event (which was defined in the contract of carriage to include things such as “unsettled

international conditions . . . [and] any emergency situation requiring immediate care or protection for a person or property[.] *Id.* at \*1-2), passengers were entitled to a travel credit, but not to a refund. *Id.*

United's theory on the motion to dismiss was that, because COVID-19 and its related restrictions referenced in the complaint amounted to force majeure events, passengers were only entitled to a travel credit, not a refund. *Id.* at \*6. In analyzing whether this was a valid argument, the court noted that "even assuming COVID-19 and/or the related restrictions United cites qualify as Force Majeure Events, that is not enough to excuse United from offering a refund for flights it cancels. *Those events also must have directly and proximately cause the cancellations.*" *Id.* at \*7 (emphasis added).

As such, whether each individual defendants' claim was validly stated depended on whether or not the force majeure events proximately caused the cancellations. For one defendant, this was not true: he had validly stated a claim that survived a motion to dismiss because he raised questions of fact as to whether United had actually made the cancellations for economic, not pandemic, reasons. *Id.* \*8. As to another defendant, whose flight to Costa Rica was cancelled, force majeure had proximately caused that cancellation because United was explicitly barred from flying there because it had closed its borders—therefore, that claim was dismissed. *Id.* at \*8.

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# 2021 Judicial Update Anti-Poaching & FPRs from a State Regulator Activity Perspective

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**Jan S. Gilbert**<sup>51</sup>  
Polsinelli LLC  
Washington, D.C.

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<sup>51</sup> My appreciation to Diana Vilmenay, who assisted me in the preparation of the paper.

## Anti-Poaching & FPRs from a State Regulatory Activity Perspective

### A. Anti-Poaching

In the franchise context, “anti-poaching,” “no-poach” and “no-hire” agreements generally refer to provisions within franchise agreements that restrict or prohibit a franchisee from employing a current or recent employee of another franchisee within the same franchise system, or of the franchisor itself. Such provisions have been relatively common in franchise agreements for decades and, until recently, received little regulatory or judicial scrutiny.

Legal challenges to anti-poaching provisions have typically focused on federal and state antitrust laws. The most significant of these is Section 1 of the Sherman Act, 15 U.S.C. Section 1, which makes unlawful “[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade of commerce among the several States, or with foreign nations.”<sup>52</sup> Since the enactment of the Sherman Act, considerable case law has evolved interpreting its broad reach. A full explanation of this jurisprudence is beyond the scope of this paper, which focuses on legal developments occurring since the last IFA Legal Symposium in 2019 (the 2020 IFA Legal Symposium was not held, due to the COVID-19 pandemic). Thus, we have written this paper with the assumption the reader possesses a basic understanding of antitrust law.

#### i. Background

The current progression of anti-poaching activity in the franchise context dates back to October 2016, when the U.S. Department of Justice (the “DOJ”) and the Federal Trade Commission (the “FTC”) released their Antitrust Guidance for Human Resource Professionals (the “2016 Guidance”).<sup>53</sup> The 2016 Guidance announced that the DOJ and the FTC viewed as *per se* unlawful and potentially criminal, “naked” wage-fixing or no-poach agreements among competitors, defined as agreements that are “separate from or not reasonably necessary to a larger legitimate collaboration between the employers.”<sup>54</sup> The DOJ further noted that it intended to proceed criminally against these agreements.

The 2016 Guidance set into motion a chain of events seeking to declare or deem anti-poaching provisions contained within franchise agreements as unlawful. The most significant of these events are described below.

- In February 2017, the *Bautista/Carl Karcher* case is filed. In *Bautista v. Carl Karcher Enters., LLC*, No. BC649777 (Cal. Sup. Ct. L.A. Cty. Feb. 8, 2017), current and former employees of two Carl’s Jr. franchisees in Los Angeles filed a class action complaint against franchisor Carl’s Jr. Restaurants, LLC (“Carl’s Jr”) and its predecessor alleging that an anti-poaching provision in Carl’s Jr’s franchise agreements and standard preliminary agreement for franchise applicants violated the Cartwright Act, California’s primary state antitrust law prohibiting anti-competitive conduct, and the California Business and Professions Code which prescribes unfair competition and illegal covenants not to compete. The plaintiffs

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<sup>52</sup> 15 U.S.C. § 1.

<sup>53</sup> U.S. DEP’T OF JUSTICE & FEDERAL TRADE COMM’N, ANTITRUST GUIDANCE FOR HUMAN RESOURCES PROFESSIONALS (2016), <https://www.justice.gov/atr/file/903511/download>.

<sup>54</sup> *Id.* at 3.

alleged that the anti-poaching provisions were an illegal agreement among competitors that prevented franchisees from competing against each other and the franchisor for restaurant management personnel and that this agreement led to reduced wages and diminished working conditions. After the defendants moved to dismiss the complaint, the court issued an order requesting further briefing. As part of that order, the court acknowledged the benefits of inter-brand competition, noting that it ultimately requires some cooperation by parties operating within a system, but the court did not address the allegations of horizontal competition between the franchisees and Carl's Jr. The parties ultimately settled the case in 2019, and the court did not render a final decision on the motion to dismiss.

- In June 2017, the Deslandes/McDonalds case is filed. In *Deslandes v. McDonald's USA, LLC*, 1:17-cv-04857 (N.D. Ill. June 28, 2017), an employee of a McDonald's franchisee in Florida filed a class action complaint against franchisor McDonald's USA, LLC ("McDonald's") alleging that an anti-poaching provision in McDonald's franchise agreement violated Section 1 of the Sherman Act, the Illinois Antitrust Act and the Illinois Consumer Fraud and Deceptive Trade Practices Act. The plaintiff alleged that the anti-poaching provision was an unlawful restraint on franchisee competition with the franchisor and other franchisees for restaurant management and staff personnel. The plaintiff claimed that as a result, she was prevented from being offered a higher paying position with another McDonald's restaurant and that putative class members earned reduced wages and experienced diminished working conditions. After McDonald's moved to dismiss the complaint, the court issued an order that granted McDonald's motion in part and denied it in part. The court held on one hand that the plaintiff's claims were not covered by the state statutes. On the other hand, it determined that the anti-poaching provision was both a vertical and horizontal restraint on trade in the restaurant worker labor market, because franchisees competed with each other and with McDonald's company-operated restaurants for labor. The court held that the anti-poaching provision was not *per se* unlawful, because the restraint was ancillary to the franchise agreement, which was procompetitive in that it improved output in the market by permitting other parties to establish and operate McDonald's restaurants. Since the provision was ancillary to a pro-competitive arrangement, it was subject to a rule-of-reason or quick look analysis of the alleged anti-competitive conduct. The quick look analysis is an abbreviated version of the rule of reason analysis, under which a plaintiff must only show there has been a market injury and the court is not required to engage in a deep dive of the underlying market and anticompetitive effects of the challenged conduct.<sup>55</sup> Courts apply a quick look analysis where the anticompetitive conduct so likely leads to anticompetitive effects that a full analysis is unnecessary. The court permitted the case to proceed under a "quick look" analysis and the plaintiff was granted leave to amend the complaint to state such a claim. The court rejected McDonald's argument that the plaintiff lacked standing to sue because she was never denied a McDonald's job based on the anti-poaching provision. The case was pending as of April 2021.
- In September 2017, two Princeton University economists, Alan Krueger and Orley Ashenfelter, published a paper titled "Theory and Evidence on Employer Collusion

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<sup>55</sup> Nat'l Collegiate Athletic Ass'n v. Bd. of Regents of Univ. of Oklahoma, 468 U.S. 85, 109 n. 39 (1984) ("The essential point is that the rule of reason can sometimes be applied in the twinkling of an eye.") (citations omitted).

in the Franchise Sector.”<sup>56</sup> The paper stated that 58% of major franchisors’ franchise agreements included anti-poaching provisions and suggested that these provisions suppress wage competition and limit job mobility.<sup>57</sup> The authors did not examine any empirical evidence.

- In September 2017, The New York Times published an article citing and highlighting Krueger and Ashenfelter’s paper.<sup>58</sup>
- In November 2017, the *Ion/Pizza Hut* case is filed. In *Ion v. Pizza Hut, LLC*, 1:17-cv-00788 (E.D. Tex. Nov. 3, 2017), an employee of a Pizza Hut franchisee in Texas filed a class action complaint against franchisor Pizza Hut, LLC (“Pizza Hut”) alleging that the anti-poaching provision in Pizza Hut’s franchise agreements violated Section 1 of the Sherman Act, the Texas antitrust law and the Texas Deceptive Trade Practices Consumer Protection Act. The plaintiff claimed that the anti-poaching provision prevented franchisees from competing against each other and other franchisees for the talent pool of restaurant managers, and suppressed wages, benefits and growth opportunities. The anti-poaching provision stated that the restriction did not apply if the former employer gave prior written consent. Pizza Hut moved to dismiss the complaint on the grounds that the plaintiff lacked standing to sue and that existing case law supports the conclusion that the provision was not *per se* unlawful, since it can conceivably have procompetitive benefits. The plaintiff dismissed the complaint voluntarily in July 2018 and the court did not issue a final order on Pizza Hut’s motion to dismiss.
- In November 2017, U.S. Senators Elizabeth Warren and Corey Booker sent a letter to then-Attorney General Jeff Sessions asking if DOJ intended to enforce its no-poach policy in the 2016 Guidance.<sup>59</sup>
- In January 2018, then Assistant U.S. Attorney General for the Antitrust Division, Makan Delrahim, affirmed that the DOJ was following the 2016 Guidance in that it viewed naked no-poach agreements as *per se* unlawful.<sup>60</sup> To that point, the DOJ had only brought civil actions for alleged impermissible conduct.
- In January 2018, the Washington State Attorney General’s office, under Attorney General Robert Ferguson, launched an investigation into anti-poaching clauses, focusing on the franchise systems listed on the Krueger and Ashenfelter paper.

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<sup>56</sup> Alan B. Krueger & Orley Ashenfelter, *Theory and Evidence and Employer Collusion in the Franchise Sector*, Working Paper #614, Princeton University Industrial Relations Section, (Sept. 28, 2017) <https://dataspace.princeton.edu/jspui/handle/88435/dsp014f16c547g>.

<sup>57</sup> *Id.* at 6.

<sup>58</sup> Rachel Abrams, *Why Aren’t Paychecks Growing? A Burger-Joint Clause Offers a Clue*, N.Y. TIMES (Sept. 27, 2017), <https://www.nytimes.com/2017/09/27/business/pay-growth-fast-food-hiring.html>.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

- In March 2018, the Butler/Jimmy Johns case is filed. In *Butler v. Jimmy John's Franchise, LLC*, No. 3:18-cv-00133 (S.D. Ill. Jan. 24, 2018), an employee of a Jimmy John's franchisee in Illinois filed a class-action complaint against franchisor Jimmy John's Franchise, LLC ("Jimmy John's") claiming that an anti-poaching provision in Jimmy John's franchise agreements violated Section 1 of the Sherman Act, the Illinois antitrust law, and the Illinois Consumer Fraud and Deceptive Trade Practices Act. The plaintiff claimed that the anti-poaching provisions prevented franchisees from competing against each other and the franchisor for restaurant employees, which led to suppressed wages, worsened work conditions and limited growth opportunities.

The anti-poaching provision at issue in *Jimmy John's* is notable because it was far more restrictive in scope than the others described above. For example, the Jimmy John's provision prohibited franchisees from soliciting or recruiting any person that was then employed or who was employed within the prior 12 months by the franchisor, any of its affiliates or another franchisee. Pursuant to the franchise agreement, all current and former Jimmy John's franchisees were third-party beneficiaries of the anti-poaching provision and had an independent right to enforce it. The franchise agreement provided for the payment of liquidated damages by the offending franchisee if the poached employee was a manager. Moreover, the franchise agreement contained a non-compete clause that stated that franchisees were required to restrict their own employees from working with another Jimmy John's franchisee for at least 12 months after they left the current franchisee's employment and to advise their employees that other Jimmy John's restaurants were contractually prohibited from hiring them for at least 12 months after they left the franchisee's employment, regardless of the reason for the employee's departure. Jimmy John's provided franchisees with a form of non-competition covenant that: (i) contained this language and other language which prohibited a franchisee's employee from working in a competing sandwich shop within a defined radius in-term and 2 years post-term; (ii) required the employee to notify the franchisee if it received any employment offers from a competitor and (iii) imposed an obligation on the employee to reimburse the franchisee and Jimmy John's for all costs and expenses to enforce the covenant.

Jimmy John's moved to dismiss the complaint in March 2018 and it lodged similar defenses to the plaintiff's claims. The franchisor argued that the plaintiff lacked standing to sue, and that the provision was not *per se* unlawful. It claimed that the anti-poaching restriction was simply a vertical restraint of trade and subject to a rule of reason analysis, and that the fact that only 2% of the restaurants in the system were company-owned was insufficient to deem the restraint horizontal. It also moved to dismiss the state law claims on the basis that they were excluded from coverage under the language and scope of those laws. The court granted the motion in part and denied it in part. The court dedicated a large part of its ruling to address whether there was a horizontal restraint where there were few company-owned restaurants in the system, but ultimately determined that it was plausible that a horizontal restriction could be found based on the Sherman Act "hub-and-spoke" theory. In a hub-and-spoke arrangement, a conspiracy is structured so that a buyer or supplier acts like the hub of a wheel and vertical relationships up or down a supply chain operate as the spokes of the wheel. The so-called conspirators' horizontal agreement not to compete is the rim of the wheel. The Sherman Act

makes it unlawful for horizontal competitors to collude to set prices, rig bids or dive markets through their own accord or via an intermediary.

The case was pending as of April 2021.

- In March 2018, Senators Warren and Booker co-sponsored a bill in the U.S. Senate entitled the “End Employer Collusion Act” (S.2480) that sought to prohibit anti-poaching agreements between franchisors and franchisees. The bill was referred to the Senate subcommittee in April of 2018, where no further action was taken.
- In April 2018, a companion House bill was introduced by Representative Keith Ellison (H.R. 5632). The bill was referred to the House subcommittee in May 2018, where no further action was taken.
- In July 2018, the State of Washington announced that it had entered into its first Assurances of Discontinuance (“AODs”) with seven franchisors in the quick service restaurant industry regarding anti-poaching provisions. The AODs effectively removed anti-poaching provisions from the franchise agreements of the signatories. Since that time, the Washington Attorney General’s scope expanded to other industries and the state has entered into AODs with franchisors in at least 12 other industries.
- In July 2018 and soon after, several other states—California, Illinois, Iowa, Maryland, Massachusetts Minnesota, New Jersey, New York, North Carolina, Oregon, Pennsylvania, Rhode Island and the District of Columbia—jointly (or separately) initiated inquiries with franchisors regarding anti-poaching provisions in their franchise agreements beginning with QSR industry franchisors.
- In August 2018, the SK Bakeries case is filed. In *Yi v. SK Bakeries, LLC*. No. 3:18-cv-05627 (W.D. Wash. Sept. 3, 2018), an employee of a Cinnabon franchisee in Washington filed a class-action complaint against franchisor Cinnabon Franchisor SPV, LLC (“Cinnabon”) claiming that an anti-poaching provision in Cinnabon’s franchise agreements violated Section 1 of the Sherman Act and the Washington Unfair Competition Act. The plaintiff claimed that the anti-poaching provisions unlawfully restricted franchisees from competing against each other and the franchisor for restaurant crew members, which led to low wages. Cinnabon moved to dismiss the complaint, but the court denied the motion finding that the plaintiff had alleged sufficient facts to support her claims. This is notable because both of the parties and the court acknowledged that the plaintiff failed to plead sufficient facts to support a full rule of reason analysis. However, the court stated that she could move to amend her complaint to plead a full rule of reason claim. In April 2019, the court granted the parties’ motion to dismiss the complaint after the parties’ settled the matter.

- In October 2018, the Washington Attorney General's Office sues Jersey Mike's Franchise System, Inc. for its use of an anti-poaching provision after Jersey Mike's refuses to enter into an AOD with the state.
- In October 2018, the Ogden/Little Caesar case is filed. In *Ogden v. Little Caesar Enterprises, Inc.* No. 2:18-cv-12792 (E.D. Mich. Oct. 26, 2018), an employee of a Little Caesar's franchisee in Tennessee filed a class-action complaint against franchisor Little Caesar Enterprises, Inc. ("Little Caesar") claiming that an anti-poaching provision in Little Caesar's franchise agreements violated Section 1 of the Sherman Act. The plaintiff claimed that the anti-poaching provisions unlawfully restricted franchisees from competing against each other and the franchisor for restaurant managers, which led to reduced wages, benefits and worsened work conditions.

The provision was similar to the provisions at issue in *Deslandes* and *Ion*, because it applied to all franchisees and covered employee movement for 6 months post-employment with the original franchisee. It was similar to the Jimmy John's provision in providing third-party beneficiary rights to franchisees and requiring the payment of liquidated damages by the "offending" franchisee. The franchisor moved to dismiss the complaint in October 2018 and the court granted the motion in July 2019. In sum, the court determined that the plaintiff failed to state a case under the rule of reason analysis and failed to plead sufficient facts to fit within the narrow set of cases subject to a *per se* analysis or quick look review. The court also held that under any antitrust analysis, the plaintiff failed to plead sufficient facts to establish a cognizable injury. The Sixth Circuit Court of Appeals affirmed the dismissal in July 2020.

- In October 2018, the *Arrington v. Burger King* case, described below, is filed in federal court in Florida.
- In November 2018, economists Daniel Levy and Timothy Tardiff publish an economic study titled "Measurement of Market Concentration Faced by Labor Pools: Theory and Evidence from Fast Food Chains in Rhode Island with No-Poaching Clauses." Levy and Tardiff's study refutes the conclusions in the Krueger and Ashenfelter paper.
- In March 2019, the DOJ files a statement of interest in *Stigar v. Dough Dough, Inc.*, stating that most anti-poaching provisions between franchisors and franchisees are not naked no-poach agreements between competitors, that the franchise relationship is a vertical one in many respects because franchisors and franchisees normally conduct business at different levels of the market structure<sup>61</sup> and taking the position that, for this reason, any antitrust analysis of the alleged competitive conduct should be viewed under the lens of a rule of reason analysis. The Washington Attorney General subsequently files an amicus brief which did not take

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<sup>61</sup> The DOJ noted that even though the typical no-poach agreement between a franchisor and a franchisees is vertical, it could be horizontal if it restrains competition between the two interrelated entities.

a position on the merits of the underlying suit, but aimed to explain to the court the extent to which the state's antitrust laws differ from their federal counterparts. In its brief, the Attorney General argued that under Washington state law, franchise anti-poaching agreements can be *per se* unlawful, depending on the facts of the case. The Washington Attorney General argued that it would be a mistake to view a franchise agreement as vertical in all cases, and that where a franchisor owns and operates company locations and the underlying franchise agreement restricts solicitation and hiring among franchisees and a company-owned location the agreement should be analyzed as a *per se* restraint.

- In 2019, the DOJ also files statements of interest in other then-pending Washington anti-poaching cases (Carl's Jr., Auntie Anne's and Arby's) stating that anti-poaching provisions in franchise agreements which prohibit franchisees from hiring other franchisees' employees are vertical restraints that should be reviewed under the rule of reason analysis. The DOJ also states that an agreement that prevents franchisees and franchisors from hiring each other's employees may be unlawful *per se* if the franchisor and franchisees actually compete for employees and if the anti-poaching agreement is not reasonably ancillary to the franchise agreement. These cases settle before dispositive motions can be argued and decided by the court.
- In 2019, franchisor defendants in other anti-poaching class actions cases begin using the DOJ's statements of interest to support their defense of the claims against them.
- In August 2019, Jersey Mike's settles with Washington. Jersey Mike's agrees to remove the anti-poaching provision from its franchise agreements and pay the state \$150,000.
- In October 2019, the Washington Attorney General's Office issues a press release highlighting a milestone of the Attorney General's Office having entered into AODs with over 100 "corporate chain" covering an estimated 147,000 locations nationwide.
- In February 2021, the International Franchise Association files an amicus brief in the *Arrington v. Burger King* case arguing, as discussed below, that the lower court ruling should be affirmed.

## ii. Recent Developments

The most significant recent developments in the area of anti-poaching no doubt center upon *Jarvis Arrington, et al. v. Burger King Worldwide, Inc., et al.* 1:18-cv-24128 (S.D. Fla. 2020). On March 15, 2019, the plaintiffs, three employees at franchised Burger King restaurants, filed an amended class action complaint against Burger King Worldwide, Inc. and its affiliates ("Burger King"), franchisor of the Burger King restaurant system. The complaint alleges that the no hire provision contained in Burger King's franchise agreements violated Section 1 of the Sherman Act. 15 U.S.C. Section 1.

According to the amended complaint, from at least 2010 to September 2018, all Burger King franchise agreements contained the offending provision:

Neither BKC [Burger King Corporation] nor Franchisee will attempt, directly or indirectly, to entice, induce, or attempt to entice or induce any employee of the other or of another Franchisee of BKC to leave such employment, or employ such employee within six (6) months after his or her termination of employment with such employer, except with the prior written consent of such employer.

Plaintiff Jarvis Arrington was a line cook at a franchised Burger King restaurant located in Dolton, Illinois. He sought to work at a franchised Burger King location in Chicago, was told that he needed the consent of the Dolton franchisee, and then received no further communication from the prospective Chicago employer.

Plaintiff Sandra Munster was a general manager at a franchised Burger King restaurant located in Ottawa, Illinois. She applied for a job at a franchised Burger King location in Marseilles, Illinois, but was denied the job when the Ottawa franchisee refused to grant the requisite consent.

Plaintiff Geneva Blanchard was a crew member at a franchised Burger King restaurant located in Slidell, Louisiana. She experienced a reduction in pay and reduced shifts.

Each of the plaintiffs alleged that “[a]s a result of Defendants’ and their co-conspirators’ collusive and anticompetitive conduct...[the plaintiffs were] paid artificially depressed wages and suffered decreased benefits and job mobility.”

Burger King did not own any Burger King restaurants in either Illinois or Louisiana. Rather, Burger King owned approximately 50 Burger King restaurants located in and around Miami, Florida.

The plaintiffs sought to characterize the no-hire clause as a horizontal, unreasonable restraint among competitors, and thus, *per se* unlawful under Section 1 of the Sherman Act. In this regard, they relied heavily on the franchisees’ status as independent contractors. The plaintiffs asserted that “in a properly functioning and lawfully competitive marketplace, Burger King and its franchisees would compete for labor.” However, the no-hire provision contained in Burger King’s franchise agreement “eliminates any incentive for, and in fact prohibits, Burger King branded restaurants from competing with each other for employees. Thus the employees are deprived of higher wages and better job growth opportunities.”

Alternatively, the plaintiffs claim that Burger King is liable under a “quick look analysis,” where “an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect on employees and labor.”<sup>62</sup>

The plaintiffs sought damages and equitable relief on behalf of every person who worked at a Burger King branded restaurant from “at least 2010 to the present.”

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<sup>62</sup> Am. Compl. at ¶ 157, *Jarvis Arrington, et al. v. Burger King Worldwide, Inc., et al.* 1:18-cv-24128 (S.D. Fla. 2020) (No. 1:18-cv-24128).

Burger King moved to dismiss the amended complaint under Fed. R. Civ. P. 12(b)(6), arguing, among other things, that (1) the no-hire provision was ancillary to a vertical agreement meant to promote interbrand competition and so should be judged under a rule of reason analysis, rather than the *per se* rule or the quick look doctrine; (2) the amended complaint did not make any allegations concerning the relevant market, as required under a rule of reason analysis; and (3) Burger King and its franchisees could not conspire for purposes of the Sherman Act, because of their commonality of interest and Burger King's degree of control over the franchisees.

The District Court granted Burger King's Motion to Dismiss, addressing only Burger King's assertion that Burger King and its franchisees were legally incapable of conspiring under Section 1 of the Sherman Act. Citing *Copperweld Corp. v. Indep. Tube Corp.*, 467 U.S. 752 (1984), the District Court noted that "Section 1 of the Sherman Act... reaches unreasonable restraints of trade effected by 'contract, combination... or conspiracy' between separate entities. It does not reach conduct that is wholly unilateral." It explained that "entities are legally capable of engaging in concerted action if the arrangement alleged to exist between them 'deprives the marketplace of independent centers of decisionmaking... and thus of actual or potential competition.'" (citing *American Needle, Inc. v. Nat'l Football League*, 560 U.S. 183 (2010)). To make this determination, the District Court concluded, one must look at how the parties actually operate.

The District Court ultimately found that the arrangement between Burger King and its franchisees more closely resembled a corporation organized into divisions or de facto branches, or that of a parent-subsidary, rather than independent centers of decision-making, focusing on the unity of interest between Burger King and its franchisees. In support of this conclusion, the District Court cited, among other things, the following requirements imposed by Burger King on its franchisees: (1) payment of royalties, (2) payment toward joint advertising budget, (3) use of a uniform operations manual, and (4) other indicia of uniformity of operations. The District Court noted that one must look at the totality of the circumstances and placed heavy emphasis on the uniformity of interest, stating "in the absence of uniformity guaranteed by the Burger King franchise agreement, there would be no franchise and hence, no independent source of economic power. The relationship here is more than merely symbiotic. It is totally derivative." Moreover, the court noted that "the success of [Burger King] and its franchisees is wholly dependent on systemwide uniformity."

The District Court found that the individual franchisee's retention of some "residual economic autonomy with respect to employment decisions is insufficient to convert it into a separate economic actor."

On appeal, Burger King asserted that the District Court properly determined that Burger King and its franchisees were legally incapable of conspiring for purposes of Section 1 of the Sherman Act. It also proffered an alternative ground to affirm the dismissal – the constraint between Burger King and its franchisees is vertical and, under applicable law, vertical constraints are always subject to a rule of reason analysis. Burger King further asserted that a quick look analysis is not proper because the no-hire provision is part of a vertical arrangement with clear pro-competitive effects and the overall economic impact of the no-hire provision is not readily apparent to someone with rudimentary understanding of economics, but rather requires a fuller rule of reason analysis. Finally, Burger King asserted that, even under a quick look analysis, the plaintiffs must define the product or geographic market, and the plaintiffs failed to do so.

Three amicus briefs were filed with the 11<sup>th</sup> Circuit Court of Appeals, on behalf of the DOJ, the IFA and the American Antitrust Institute (“AAI”).

The DOJ agreed with the District Court’s conclusion that the concerted action analysis should be functional and fact-based, but argued that the District Court incorrectly applied a formalistic and categorical rule. The District Court gave “controlling significance” to the fact that the no-hire provision was contained in Burger King’s franchise agreement. The DOJ asserted that, “according to the court, because the franchise agreement established certain uniform standards across the Burger King franchise system, it did not matter whether Burger King and the franchisees engaged in what it called ‘micro-competition’ in the labor market; Burger King and its franchisees were a single economic unit.” In short, the DOJ claims that the District Court should not have analogized the Burger King/franchisee arrangement to that of corporate divisions or subsidiaries, as in *Copperweld*. Rather, “[t]he court should have followed the analysis set forth in *American Needle* evaluating how the franchise system allegedly operates in practice, and determined whether the complaint plausibly pleaded that the franchisor and franchisees had disparate economic interests concerning employee hiring.”

The AAI also took issue with much of the District Court’s analysis. The AAI opined that the existence of a vertical agreement in one market does not dictate the standard to be applied in all markets (i.e., a franchisor and franchisee can have a vertical relationship in one market and a horizontal relationship in another). “The court’s ability (or inability) to draw confident conclusions about the effect of the restraint, not the characterization of the relationship between the parties as vertical or horizontal, should drive the analysis of which standard to apply.” With respect to the permissible ancillary restraints, the AAI noted that a restraint must not only be part of a broader efficiency-enhancing agreement or existing business relationship, but it must also be connected to the procompetitive purpose of the broader agreement and be reasonably necessary to effectuate that purpose. Only if both conditions are met, the AAI argued, should a rule of reason analysis apply, rather than a *per se* or quick look inquiry.

The IFA brief insisted upon a rule of reason analysis. It asserted that franchise agreements are vertical agreements and, as such, must be evaluated under the rule of reason. Citing *Ohio v. American Express*, 138 S. Ct. 228384 (2018) and *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007), the IFA took issue with the plaintiffs’ arguments that the Burger King franchise agreements are horizontal, pointing to the fact that Burger King’s company-owned restaurants located in the Miami area do not compete against the franchised units in Illinois and Louisiana, where the plaintiffs were employed and sought employment. Moreover, even if the plaintiffs had been employed in franchised Miami-based Burger King restaurants or sought employment in franchised or company-owned Miami-based Burger King restaurants, the result would be the same (citing *Tidmore Oil Co. v. BP Oil Co.*, 932 F.2d 1384 (11<sup>th</sup> Cir. 1991)). The IFA also noted that an alleged horizontal effect on the market for labor does not make the franchise agreements horizontal and that the *per se* rule and the quick look doctrine apply only to horizontal restraints, not vertical restraints. Finally, the IFA asserted that, even if the relationship between Burger King and its franchisees were horizontal, which it is not, the rule of reason would still apply because the no-hire clause is ancillary and not a naked restraint, as it facilitates interbrand competition. The IFA noted, that among other things, it incentivizes franchisees to invest in employee training, it promotes an environment of cooperation and team-mindedness among franchisees, and it promotes franchisee communication and sharing of information.

## B. FPRs from a State Regulatory Activity Perspective

### i. COVID-19 Guidance

Since at least March 2020, franchisors have had to scramble to address the multi-faceted operational and legal issues presented by the COVID-19 pandemic. These challenges were compounded by a jurisdiction-by-jurisdiction patchwork of timetables, requirements, and restrictions regarding closing and reopening various businesses. Many franchisors were also forced to assess how to address the pandemic within the four corners of their FDDs.

In response to requests from state franchise administrators for guidance in reviewing historical financial performance representations (“FPRs”) in FDDs filed with state franchise authorities in 2020, the NASAA Franchise and Business Opportunity Project Group (“NASAA Franchise Project Group”) released in June 2020 guidance titled, “Disclosing Financial Performance Representations in the Time of COVID-19”. Prior to this point, many state franchise administrators were issuing comment letters to franchisors, asking those franchisors to explain whether they had a *reasonable basis*<sup>63</sup> for making an FPR based on data entirely from a pre-COVID-19 period.

The NASAA Franchise Project Group reiterated that under federal and state franchise disclosure laws, a franchisor is permitted to make an historical FPR if the franchisor has a reasonable basis and written substantiation for the representation, and the franchisor discloses the material bases for the representation. It observed that under the FTC Franchise Rule, franchisors that have already provided FDDs to prospective franchisees may have to provide updated information, including revised FPRs, to those prospective franchisees to reflect material changes in the information provided. It also observed that under state franchise disclosure laws, franchisors have an affirmative obligation to continue to update all material disclosures that they include in their FDDs, including FPRs. These state franchise laws make it unlawful, generally, for a franchisor, in connection with the offer or sale of a franchise, to make an untrue statement of material fact or to omit to state a material fact that would make a statement not misleading. An FPR that discloses historically accurate data may contain an omission of a material fact, or an untrue statement of material fact, if material changes have occurred in connection with that FPR by the time it is provided to a prospective franchisee.

In its updated guidance, the NASAA Franchise Project Group observed that not all franchisors have been negatively impacted by the pandemic. However, it rejected the premise that an FPR consisting entirely of pre-COVID-19 data should in all cases be permitted if the pre-COVID data is factually accurate. According to the NASAA Franchise Project Group, factual accuracy is simply half of the legal standard for determining whether an FPR is permissible. The other half is having a reasonable basis—which are “two

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<sup>63</sup> See, e.g., THE NASAA FRANCHISE PROJECT GROUP, DISCLOSING FINANCIAL PERFORMANCE REPRESENTATIONS IN THE TIME OF COVID-19 (June 10, 2020), <https://www.nasaa.org/wp-content/uploads/2020/06/FPRs-in-the-time-of-COVID-19.pdf> (“Under federal and state franchise disclosure laws, a franchisor is permitted to make a Historical FPR if the franchisor has a reasonable basis and written substantiation for the representation, and the franchisor discloses the material bases for the representation.”). See also FTC Franchise Rule, 16 CFR Part 436.5(s).

distinctly different requirements”. The NASAA Franchise Project Group opined that factual accuracy by itself ignores the potential effect of COVID-19 on existing franchises and a franchise network’s operating requirements. Accordingly, they noted that an FPR that discloses historically accurate data may still omit a material fact necessary to make the statements presented not misleading under applicable state anti-fraud provisions.

The guidance states that for franchise systems that had been significantly impacted by the COVID-19 pandemic, franchisors should consider whether they can continue to make a historical FPR in 2020 that did not include updated disclosure reflecting the impact of the COVID-19 pandemic on the franchise system. Moreover, if a franchisor’s management concluded that it would make changes to its franchise system or business model that would materially impact a historical FPR (such as changes that would increase costs, where the FPR provided historical profit figures), the guidance states that the franchisor may not include a historical FPR in its FDD that is not updated to reflect those changes and their impact on the FPR.

The NASAA Franchise Project Group guidance also identified factors that state franchise administrators should look to in order to determine whether a franchisor may continue to make an FPR based on pre-COVID-19 data without updating its FDD or amending its state registration:

- Whether the franchise business has been significantly impacted by the COVID-19 pandemic;
- The type of data that the franchisor includes in the FPR;
- The reasonable inferences that a prospective franchisee can draw from the FPR;
- When the franchisor estimates that a prospective franchisee can expect to open for business after entering into a franchise agreement;
- Whether and how the franchisor adapts the franchise business to account for current market conditions resulting from the COVID-19 pandemic; and
- Whether and how the franchisor adapts the franchise business to account for future market conditions resulting from the COVID-19 pandemic.

The Washington State Department of Financial Institutions subsequently issued its own notice informing franchisors and their counsel that the Washington State Securities Division would be following the NASAA Franchise Project Group guidance in reviewing FPRs.

During the IFA’s Franchise Law Virtual Summit in August 2020, state franchise administrators from California, Maryland, and Washington described FPRs during the

pandemic as highly problematic.<sup>64</sup> Unlike other unanticipated business interruptions which tend to be short in duration, the administrators expressed concern that the pandemic's impact on some businesses would likely be long-lasting and affect not just ongoing operations, but consumer preferences and attitudes toward certain businesses (e.g. avoiding dine-in facilities, crowds and certain travel methods). The administrators explained that they were reviewing FDDs that were mostly based on pre-COVID-19 data. Due to the timing of the pandemic and a carousel of shuttering businesses, the administrators were unable to tell from many FPRs whether the franchisors had reasonable bases to represent to prospective franchisees in 2020 that the prospective franchisees could fairly rely on pre-COVID-19 data to judge their own likely experience establishing and operating a franchised business. During the seminar, the administrators noted that franchisors at the time could continue to make historical FPRs during the pandemic based on pre-COVID-19 data if they could demonstrate in an application transmittal letter or comment letter response to a state administrator that the franchisors considered thoughtfully the impact of the pandemic on their business model.

The administrators offered a few tips to make this showing, including that franchisors endeavor to:

- address whether outlets closed either temporarily or permanently in 2020;
- explain the extent to which outlets in 2020 materially modified their operating routines since 2019 and the impact of these changes on 2020 results;
- share a comparison of 2019 and 2020 data over the same period (e.g. April to June 2019 versus April to June 2020). The administrators emphasized that they were not requiring franchisors to include 2020 data in their FPRs, but found comparative same-period data (e.g., showing comparable results for the first six months of 2019 and 2020) to be highly probative to establish a franchisor's reasonable basis for making an FPR based on pre-COVID data, and to determine whether the franchisor has complied properly with state anti-fraud requirements; and
- explain any franchise system modifications they have made with an explanation of how these changes affected actual 2020 financial results.

The administrators also discouraged franchisors from, among other things, emphasizing the historical accuracy of pre-COVID-19 data without addressing the pandemic's impact

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<sup>64</sup> Suzanne Beall, CFE, VP, Gov't Relations & Public Policy and Counsel, International Franchise Association (IFA); Michelle Webster, Senior Financial Legal Examiner, Washington Department of Financial Institutions; Dale Cantone, Assistant Attorney General, Maryland Attorney General's Office & Theresa Leets, Assistant Chief Counsel, California Dep't of Bus. Oversight, IFA Franchise Law Virtual Summit Presentation: Franchise Regulator Panel: State of Play in COVID Era (Aug. 13, 2020).

on the franchise system's 2020 operations; claiming an inability to predict future results as a reason for not addressing the pandemic's impact on their 2020 results; and deemphasizing material adverse changes experienced by franchised outlets in 2020 while emphasizing industry-wide outcomes during the pandemic.

After the guidance was issued, many franchisors saw an uptick in comment letter requests from multiple state franchise administrators to address the impact that the COVID-19 pandemic had on the financial performance of the underlying franchise system. As a result, this drew out the renewal registration season and several franchisors opted to remove Item 19 from their FDDs in particular states or to remove Item 19 altogether.

#### **i. Current Developments as of April 2021**

More than a year has elapsed since the COVID-19 pandemic began to disrupt businesses and lives across the globe and franchisors have many questions about how the state franchise administrators will treat historical FPRs this year. In April 2021, we contacted a sampling of state franchise administrators in approximately half of the registration states to ask them how they intended to address Item 19 this year.

Through our informal inquiries we learned that the NASAA Franchise Project Group does not intend to issue any new guidance at this time. The administrators expressed the view that current law, which was explained in the 2020 guidance, adequately addresses a franchisor's disclosure obligations and their application to materials changes resulting from the COVID-19 pandemic. As one administrator put it, "the 2020 NASAA guidance still works." As of this writing, we are also not aware of any individual states that intend to issue any guidance regarding Item 19.

The most common administrator observation noted from our inquiries was the concern that franchisors improperly include disclaimers within their FPRs. Numerous administrators cautioned that disclaimers, which seek to mitigate a franchisor's responsibility for the content of its FPR, are prohibited unless expressly permitted by the FTC Rule. While they noted that explanatory language is permissible, more than one administrator offered that they have seen disclaimers couched as explanations and would require the removal of such disclaimers. In the words of one administrator, franchisors "should stay factual – leave it in the numbers." Yet another shared that they "do not want conclusions, analysis or opinions or anything directing the franchisee how to think."

Other concerns included the following:

1. Excluding closed units from the FPR. Administrators noted that units that were temporarily closed during 2020 due to the pandemic should be included within the FPR, as their exclusion could provide a misleading result. One administrator suggested that franchisors include all of these closed units, but may disclose subgroups (e.g., units closed for less than one month, more than one month, and not closed at all) if so desired and not misleading.

2. FPRs based on partial 2020 data. One administrator raised concern that franchisors will wish to base their FPRs on less than a full calendar year's operating results. They shared that they would require results for the full calendar year.
3. Improved business results during 2020. Yet another administrator indicated that they would be focusing on FPRs that showed improved results over 2019. The administrator expressed concern that the 2020 improvement may be short lived and would likely require that the franchisor include both 2020 and 2019 figures in its FPR in order to provide a fuller picture.
4. PPP loans. More than one administrator expressed the potential need to disclose the number of franchisees who received federal government assistance loans in order to survive the pandemic, and the average amount of such loans.

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# Update on the Application of the ABC Test to Franchising in California.

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**Jonathan Solish**  
Bryan Cave Leighton Paisner  
Santa Monica, California

## I. Introduction

In the three years since the California Supreme Court brought the ABC employment test to California, the franchise business model has been disrupted by the threat that courts may now mistakenly identify franchise relationships as employment relationships. Before turning to the recent California cases that have considered the application of the ABC test to franchise relationships, the stage must first be set as to how the misclassification issue had been dealt with historically in California. To put the new legal standard into perspective, this paper begins by addressing the tests California had previously developed for identifying independent contractors; the manner in which California courts had previously conceptualized the franchise relationship; and whether the analysis of franchise vicarious liability cases in California is relevant to franchise misclassification claims, before getting on the roller coaster ride that California law has taken since the ABC test from Massachusetts, a non-native species, was transplanted to California soil.

## II. Setting the Stage

### A. The California Common Law Employment Test

From 1946 to 2018, California distinguished employment from independent contractor relationships by applying a common law multi-factor test. The California common law test for employer status was set forth in the 1946 California Supreme Court decision in *Empire Star Mines Co. v. Cal. Emp. Com.* (1946) 28 Cal.2d 33. Two months after the publication of the *Empire Star Mines* decision, the Lanham Act was enacted, enabling the licensing of trademarks and the development of the modern franchise relationship. California's test for identifying independent contractor relationships was, therefore, already in place before the development of the franchise business model. California has subsequently struggled in developing the proper test for determining whether the parties to franchise agreements are independent contractors.

The *Empire Star Mines* common law, multi-factor test was most fully developed in *S. G. Borello & Sons, Inc. v. Dep't of Indus. Relations* (1989) 48 Cal.3d 341, and is now commonly referred to as the *Borello* test. The primary test is the right to control the manner and means of accomplishing the result desired. Among the secondary factors considered are the intentions of the parties as stated in their agreement (*Beaumont-Jacques v. Farmer's Group, Inc.* (2013) 217 Cal.App.4th 1138); the right to terminate at will (*Toyota Motor Sales U.S.A., Inc. v. Sup. Ct.* (1990) 220 Cal.App.3d 864, 875); whether workers in a "practical sense" are "entrepreneurs operating independent businesses" (*Borello, supra*, 48 Cal.3d at 345); the right to hire assistants (*Torres v. Reardon* (1992) 3 Cal.App.4th 831, 838); and whether payment is made by time expended or by the job (*Arnold v. Mutual of Omaha Ins. Co.* (2011) 202 Cal.App.4th 580, 589). Others factors include the length of time of the relationship (a negative in franchise relationships) and which party supplies the instrumentalities of the work. For more than seven decades, the multi-factor common law test was used in California to separate independent contractor and employment relationships.

## **B. The California Test for Workers Not Hired Directly**

California developed a different test for determining whether there was an employment relationship with an entity that had not directly hired the worker. In *Martinez v. Combs* (2010) 49 Cal.4th 35, strawberry pickers on a farm sued the companies that purchased the strawberries from their employer after their employer had failed to pay them. The *Martinez* court noted that the workers' attempt to recover unpaid wages "from persons who contracted with their ostensible employer raises issues that have long avoided the attention of California's courts." *Id.*, 49 Cal.4th at 50.

The *Martinez* court drew on the standards set forth in the California Industrial Welfare Commission Wage Orders. Over the years, the Commission has issued 18 "wage orders" addressing wages, hours, and working conditions and setting standards for various industries. Under the wage orders, the word "employ" has three meanings: (a) to exercise control over the wages, hours, or working conditions, (b) to suffer or permit to work, or (c) to engage, thereby creating a common law employment relationship. These definitions had their roots in child labor laws and were meant to reach "irregular working arrangements" where there would have been no "common law employment relationship." *Id.* at 58.

In *Martinez*, the California Supreme Court held that the strawberry buyers had not hired, fired, or supervised the strawberry pickers and, therefore, were not their employers. The relationship between the parties was not a "sham arrangement." The *Martinez v. Combs* test worked reasonably well in the franchise context because franchisors generally do *not* hire, fire or supervise their franchisees' employees.

As of 2018, California applied the *Borello* multi-factor test to determine if there was an independent contractor relationship and the *Martinez v. Combs* test to determine whether an "irregular working arrangement" qualified as an employment relationship.

## **C. California Agency Law as Applied to Franchisors**

As the business model was developing, courts had a great deal of difficulty in pigeonholing the franchise relationship. Courts struggled to place the franchise business model into a pre-existing category of relationships. For example, one early case concluded that the relationship created a "landlord and tenant," rather than a "master and servant" relationship. *Texas Co. v. Wheat*, 140 Tex. 468 (1943). Because the business model had developed "with little relationship to traditional legal concepts in the field of master and servant, . . . it is perhaps not surprising that attempts by the courts to discuss the relationship in the standard terms have led to some difficulties and confusion." *Status of Gasoline and Oil Distributor as Agent*, 83 A.L.R. 2d 1282, 1284 (1960). Although some courts tried to view the franchise relationship in the context of "master and servant" relationships, it was apparent that "the franchise relationship is quite different from an employer-employee relationship." Keating, *Franchising Advisor*, 1.02, p. 3 (1987).

California is the birth-place of many iconic franchise brands, including McDonald's (1937), Carl's Jr. (1945), Jack-in-the-Box (1951), IHOP (1958), and Taco Bell (1962). 7-Eleven became a franchisor when it acquired the California chain Speedee Mart in 1963.

Franchising has been “heavily regulated” since the California Legislature passed the first franchise law in the country in 1970. See *Cislaw v. Southland Corporation* (1992) 4 Cal.App.4th 1284, 1288. California courts have generally exhibited an appreciation for the franchise model and have generally fostered its growth.

As franchised businesses proliferated in California, cases arose as to whether a franchisor should be liable for the wrongful conduct of its franchisee, commonly referred to as “vicarious liability.” A series of early franchise decisions focused on whether the franchisor of the Arthur Murray dance schools was liable for violations of the Dance Act arising from franchised locations. These cases generally concluded that Arthur Murray had retained excessive control over its franchisees’ employees sufficient to establish vicarious liability against the franchisor for the misconduct of its franchisees. See, e.g., *Nichols v. Arthur Murray, Inc.* (1967) 248 Cal.App.2d 610. In response to these cases, franchise agreements have been modified over the years so that most agreements now allocate general control over the franchisees’ employees to the franchisee alone.

Once franchisors relinquished control over their franchisees’ employees, California courts have shown respect for the franchise business model. In the *Cislaw v. Southland Corp.* (1992) 4 Cal.App.4th 1284 case, the plaintiff had died after smoking a clove cigarette purchased from a franchised 7-Eleven store. The plaintiff brought a vicarious liability action against the franchisor, arguing that its brand-related controls had created an agency relationship with the franchisee. The court ruled that the owner of a franchise brand may impose brand-related restrictions on a licensee “without incurring the responsibilities or acquiring the immunities of a master, with respect to the person controlled.” *Id.* at 1295. Although *Cislaw* was a vicarious liability case, note that the court analyzed the relationships in terms of “the immunities of a *master*,” a dated word for employer.

The holding of the appellate court in *Cislaw* was adopted by the California Supreme Court in *Patterson v. Domino’s Pizza LLC* (2014) 60 Cal. 4th 474, where a teenaged employee had sued Domino’s after she had been molested by a franchisee’s employee. The plaintiff claimed that Domino’s should be liable because it controlled its franchisee’s business by requiring it to follow detailed brand standards.

In analyzing the franchise relationship, the California Supreme Court observed that “[i]n the typical arrangement, the franchisee decides who will work as his employees, and controls day-to-day operations in his store.” *Id.* at 491. There are, therefore, “sound and legitimate reasons for business format contracts . . . to allocate local personnel issues almost exclusively to the franchisee.” *Id.* at 497. Because franchisees are “owner-operators who hold a personal and financial stake in the business,” a “major incentive is the franchisee’s right to hire the people who work for him, and to oversee their performance each day.” *Id.*

The California Supreme Court also considered the “economic effects of franchising are profound,” because the franchise sector “employs millions of people, carries payrolls in the billions of dollars, and generates trillions of dollars in total sales.” *Patterson, supra*, at 490. The Court recognized that “[f]ranchising is different” because franchisors *must* impose brand controls. *Id.* at 488. The California Supreme Court

concluded that the “‘means and manner’ test . . . cannot stand for the proposition that a comprehensive operating system alone constitutes the ‘control’ needed to support vicarious liability claims like those raised here.” *Id.* at 497. “The imposition and enforcement of a uniform marketing and operational plan cannot *automatically* saddle the franchisor with responsibilities for the employees of the franchisee who injure each other. . . .” *Id.* at 478 (emphasis in original). The Court acknowledged that: “Any other guiding principle would disrupt the franchise relationship.” *Id.* at 498.

The *Patterson* court concluded that a franchisor is liable for the actions of franchisees’ employees “only if it has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisee’s employees.” *Id.* at 497-98. The concept that a franchisor could impose brand controls without establishing an agency or employment relationship with the franchisee came to be known as the “*Patterson* gloss.”

After *Patterson* was decided in 2014, several courts considered whether the principles of an agency case should apply to employment claims. Whether applying the *Borello* test or the *Martinez* test to employment claims, California courts were generally receptive to applying the doctrine from the *Cislaw* and *Patterson* cases, in both vicarious liability and misclassification actions.

Prior to the 2018 *Dynamex* decision, courts were consistently applying *Borello*, with the *Patterson* gloss, to franchise misclassification cases. Favorable decisions (all subsequently remanded after the adoption of the ABC test) include *Roman v. Jan-Pro Franchising, Inc.*, No. C 16-05961 WHA, 2017 WL 2265447 (N.D. Cal. May 24, 2017); *Haitayan v. 7-Eleven, Inc.*, CV 17-7454-JFW (JPRx) 2018 WL 1626248 (C.D. Cal. March 14, 2018); and *Juarez v. Jani-King of California, Inc.*, 273 F.R.D. 571 (N.D. Cal. 2011) (citing *Cislaw*). In *Ambrose v. Avis Rent A Car Sys., Inc.*, No. 2:11-CV-09992-CAS (AGRx), 2014 WL 6976114 (C.D. Cal. Dec. 8, 2014), a federal district court found the reasoning in *Patterson* “persuasive” in a misclassification case, but was unwilling to apply franchise cases to a non-franchise licensing arrangement.

### **III. The ABC Test Comes to California**

#### **A. California Adopts the Massachusetts ABC Test**

In 2018, the California Supreme Court, in a non-franchise case, *Dynamex Operations West, Inc. v. Superior Court of Los Angeles* (2018) 4 Cal.5th 903, considered the proper test for analyzing misclassification claims. As the Court observed, *Borello* is frequently characterized “as embodying the common law test . . . for distinguishing employees and independent contractors [citation].” *Dynamex, supra*, 4 Cal.5th at 934. It was more accurate, however, to describe *Borello* “as calling for resolution of the employee or independent contractor question by focusing on the intended scope and purposes of the particular statutory provision or provisions at issue.” *Id.* at 934-35. The Court decided that the *Borello* test no longer served its purpose and, *sua sponte*, chose to adopt the Massachusetts ABC test instead. The ABC test is now set forth in Labor Code § 2750.3.

## **B. Labor Code § 2750.3**

California Assembly Bill 5 (AB-5) became California Labor Code § 2750.3 on January 1, 2020. The statute codifies the California Supreme Court decision in *Dynamex Operations West, Inc. v. Superior Court of Los Angeles* (2018) 4 Cal.5th 903, and the ABC test that the California Supreme Court imposed upon California in that opinion. The statute expands the holding in *Dynamex* in calling for the application of the ABC test not only to the provisions of the wage orders of the Industrial Welfare Commission (as the *Dynamex* court had done), but also to the entire Labor Code. See *Crossley v. California*, 479 F. Supp. 3d 901, 909 (S.D. Cal. 2020).

Labor Code § 2750.3 provides some exclusions that generally are inapplicable to franchise relationships.

Labor Code § 2750.3 provides:

(a) (1) *For purposes of the provisions of this code and the*

*Unemployment Insurance Code, and for the wage orders of the Industrial Welfare Commission, a person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that all of the following conditions are satisfied:*

- (A) The person 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.
- (B) The person performs work that is outside the usual course of the hiring entity's business.
- (C) The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

(3) If a court of law rules that the three-part test in paragraph (1) cannot be applied to a particular context based on grounds other than an express exception to employment status as provided under paragraph (2), then the determination of employee or independent contractor status in that context shall instead be governed by the California Supreme Court's decision in *S. G. Borello & Sons, Inc. v. Department of Industrial Relations* (1989) 48 Cal.3d 341 (*Borello*).

(b) Subdivision (a) and the holding in *Dynamex Operations West, Inc. v. Superior Court of Los Angeles* (2018) 4 Cal.5th 903 (*Dynamex*), do not apply to the following occupations as defined in the paragraphs below, and instead, the determination of employee

or independent contractor status for individuals in those occupations shall be governed by *Borello*.” [listing several exemptions with no general relevance to franchising]. [Emphasis added]

Labor Code § 2750.3 does not address franchising and, although attempts were made to include a franchise exemption, none was included in the final bill.

The author of AB-5, Lorenz Gonzalez, wrote a letter to the Chief Clerk of the Assembly on September 13, 2019 to “clarify the intent of AB 5.” The primary purpose of the letter was to explain that there had been “a drafting error” in the language of the final bill (dealing with the medical workers’ right to collectively bargain). In the course of her letter, Gonzalez states: “AB 5 is not intended to replace, alter, or change joint employer liability between two businesses.”

Under the ABC test, franchisors may be particularly vulnerable to claims that they exert control over their franchises and that the franchisee and the franchisor are in the same business. Under the previous *Borello* test, where there were multiple factors presented in various combinations, it was difficult to win a summary judgment.

This concerned the *Dynamex* court, which stated that under the “six-factor, highly fact-bound *Borello* standard, ‘the significance of any one factor and its role in the overall calculus may vary from case to case depending on the nature of the work and the evidence.’” *Dynamex*, 4 Cal.5th at 941, fn. 15. As later characterized by another court, the *Dynamex* court developed a new test to avoid this problem:

“Compared to the six-factor, fact-bound *Borello* test for independent contractor status—which can be very difficult for plaintiffs to meet at an early stage of litigation, short of a full-blown trial—the *Dynamex* court “create[d] a simpler, clearer test for determining whether the worker is an employee or an independent contractor,” one that “presumes a worker hired by an entity is an employee and places the burden on the hirer to establish that the worker is an independent contractor.” *People v. Uber Techs., Inc.* (2020) 56 Cal.App.5th 266, 302.

Because misclassification claims can be resolved by establishing any one of the A-B-C factors, misclassification claims are now more likely to be resolved on summary judgment.

Under the *Borello* standard, there were barriers to certifying a class action of misclassified franchisees because there were variations among franchisees on the various common law factors. Under the ABC test, there are simple, common questions—e.g., whether the franchisor exerts controls or whether the franchisor is in the same business as the franchisee. A positive answer on *any* of the ABC factors is determinative. Certification of a class is, therefore, far more likely under the ABC test.

Courts have stumbled when applying the one-size-does-not-fit-all ABC test to franchisee misclassification claims. Is the franchisee entity the employer of all workers, including the individual owners of the franchisee’s business? If so, should the relationship

be analyzed under the *Martinez v. Combs* test for joint employment or under the ABC test?

#### IV. The ABC Test and the Franchise Relationship

##### A. The Shell Oil Decisions

*Curry v. Equilon Enterprises, LLC* (2018) 23 Cal.App.5th 289, as modified on denial of reh'g (May 18, 2018), review denied (July 11, 2018), analyzed a licensing arrangement between Shell and its licensee, ARS, that might meet the statutory definition of a franchise, although the parties stipulated that they were *not* in a franchise relationship. *Id.* at 316, fn. 1. Curry, who had been hired by ARS, brought a misclassification claim against Equilon, which was doing business as Shell. The court held that Shell “was not in a position to terminate Curry or hire a different person to perform the tasks Curry performed.” *Id.* at 311. There was, therefore, no employment relationship between Curry and Shell.

Curry argued that the court should apply the new “‘ABC test’ definition of the ‘suffer or permit to work’ set forth in *Dynamex* . . . .” *Id.* at 312. The *Curry* court considered whether *Dynamex* meant to apply the ABC test to irregular relationships, because “arguably,” the California Supreme Court may have intended the ABC test to “extend beyond the independent contractor context to the joint employer context.” *Id.* at 314.

The court determined that the ABC test was meant to resolve the issue of “whether employees were misclassified as independent contractors. . . [it does not appear that the Supreme Court intended for the ‘ABC’ test to be applied in joint employment cases.” *Id.* at 314. The *Curry* court concluded that the ABC test was *not* meant to apply to the relationship between Curry and Shell Oil.

The court also did a quick ABC analysis and determined that Shell met none of the prongs of the ABC test. The court ultimately concluded that there was no triable issue as to whether Shell met the ABC test to the extent it applied to the relationship between Shell and the plaintiff. *Id.* at 316. Shell also met none of the three legal definitions of “employer” set forth in the wage orders and the *Martinez v. Combs* test for irregular relationships.

In *Henderson v. Equilon Enterprises, LLC* (2019) 40 Cal.App.5th 1111, review denied (Feb. 11, 2020), the court considered the same type of relationship in a misclassification claim and also concluded that the ABC test “does not fit analytically with and was not intended to apply to claims of joint employer liability.” *Id.* at 1125.

Though the *Henderson* court recognized that *Dynamex* had considered the “suffer or permit to work” test from *Martinez* in formulating the ABC test, the court still rejected the plaintiff’s argument that the test applied. The *Henderson* court considered both the policy reasons underpinning *Dynamex* and the absurd and unintended result from a “literal application” of parts B and C of the test. Neither supported extending *Dynamex* to the relationship between Shell and Henderson. The court held that the test for irregular relationships under *Martinez* governed, and the burden for

establishing an employment relationship remained with the putative employee.

### ***B. Moreno v. JCT Logistics***

In *Moreno v. JCT Logistics, Inc.*, 2019 WL 3858999 (C.D. Cal. May 29, 2019), a non-franchise misclassification case, a truck driver had been hired by more than one of several related trucking companies. The court viewed the case as a joint employment claim.

The plaintiff alleged that, under *Curry*, the ABC test should not apply. The court did not believe that *Curry* had rejected the use of the ABC test in a joint employment case, because the *Curry* court had applied the ABC test, as a safeguard. In *Curry*, the court had not thought that the policies behind the ABC test should apply, because there was a primary employer in place to take primary responsibility for wage and hour claims. The *Moreno* court was uncertain as to the relationship between the various defendant parties and, therefore, could not tell whether there was a primary employer responsible for the plaintiff's basic wage and hour claims. The court felt that if there was no such primary employer, the reasoning of the court in *Curry* should not apply.

The *Moreno* court noted that *Dynamex* had held that the ABC test “applied to the ‘suffer or permit to work’ definition as to ‘all workers.’” The *Moreno* court acknowledged that *Dynamex* did not involve joint employment, but believed that the court meant its comments on “suffer or permit” to apply across-the-board to *all* workers. The *Moreno* court noted that *Dynamex* had drawn extensively on *Martinez*, but “did not distinguish the circumstances of that case as ones in which the ABC test did not apply.” The *Moreno* court, therefore, concluded that the *Dynamex* ABC test now applies to *all* employers, including joint employers.

*Moreno* held that the ABC test applied to meal and rest break claims, minimum wage and Unfair Competition Law claims, with the *Borello* test applying to business expense claims, as well as Unfair Competition Law claims arising from those claims. This distinction between wage and hour and expense reimbursement claims may have been altered by the codification of the ABC test, which purports to apply to all sections of the Labor Code. The *Moreno* court determined that common issues did not predominate as to the *Borello* claims, but certified the wage order claims.

Even though *Moreno* was not a franchise case, the conclusion that the ABC test applied to *all* putative employment relationships is unsettling.

### ***C. Vazquez v. Jan-Pro***

Even more unsettling, however, is the Ninth Circuit opinions in *Vazquez v. Jan-Pro Franchising Int'l, Inc.*, 923 F.3d 575 (9th Cir. 2019), *reh'g granted, opinion withdrawn*, 930 F.3d 1107 (9th Cir. 2019), 939 F.3d 1045 (9th Cir. 2019), 939 F.3d 1050 (9th Cir. 2019), 10 Cal. 5th 944 (Cal. 2021) and 986 F.3d 1106 (9th Cir. 2021), *en banc petition denied*, March 25, 2021.

The *Vazquez* dispute began with the filing of a class action in Massachusetts in

2008, made its way through the courts of Georgia, and finally came to the Ninth Circuit court in 2019. After the district court had dismissed the putative class action on summary judgment, the California Supreme Court decided *Dynamex Ops. W, Inc. v. Superior Court* (2018) 4 Cal.5th 903. The Ninth Circuit reversed the district court's decision and remanded for further proceedings.

Vazquez had purchased a Jan-Pro unit franchise from master franchisor New Venture of San Bernardino, LLC for \$2,800. He sued Jan-Pro Franchising, the franchisor of the Jan-Pro system. Apparently, no claim was filed against New Venture to avoid an arbitration agreement.

The agreement between New Venture and Jan-Pro provided that upon its termination, Jan-Pro had the right to assume New Venture's rights and obligations to unit franchisees. The agreement between New Venture and Vazquez followed Jan-Pro's requirements in disclaiming an employment relationship. Vazquez believed that he was a "Jan-Pro" employee, though he did not necessarily think he had contracted with Jan Pro Franchising International and was not aware of the existence of that entity.

The district court had concluded that, because there was no direct contractual relationship between Vazquez and Jan-Pro, the *Martinez v. Combs* test applied. The district court had accordingly applied the *Martinez* test with the "*Patterson* gloss," concluding that there was no employment relationship between Vazquez and Jan-Pro.

The Ninth Circuit began its analysis with a review of the *Dynamex* decision, which it believed had clarified and expanded the meaning of "suffer or permit" in wage order cases. The court concluded that, under *Dynamex*, a "hiring entity" "'suffers or permits' a putative employee to work if the hiring entity cannot overcome the 'ABC test.'"

The *Vazquez* court gave an example where Company A contracts with Company B for services, and Company B then enters into agreements to perform work. Ordinarily, Company A would not be liable for misclassification of third-party workers because *Company B* would be the "agent of any misclassification." However, where Company A "designed and implemented the contractual framework" then Company A is the "agent of misclassification" and may be directly liable under the ABC test. The court concluded that, "as a doctrinal matter, Jan-Pro could be Plaintiffs' employer under the ABC test even though it is not a party to any contract with Plaintiffs." 923 F.3d at 596.

In other words, by designing a franchise program in which franchisees are supposed to be independent contractors, the designer of the franchise program become *the agent of the misclassification*. Here, the court's opinion slips its moorings. If Company A did not hire an employee, then Company A is not the primary employer of the franchisee and the far more forgiving (and far more accurate) joint employer test should have been applied.

The *Vazquez* court cited other cases that had found employment relationships in "three-tier franchise structures." Even where the putative employer and employee are "not parties to the same contract," so that "the putative employee was providing a service to the hiring entity even *indirectly*, the hiring entity can fail the ABC test and be treated

as an employer.” 923 F.3d at 595 (emphasis in original).

“As an aid to the [district] court,” the *Vazquez* panel offered some observations and guidance on remand. It encouraged the district court to consider authorities from other jurisdictions that apply the ABC test. Even though *Patterson* included “extensive dicta” on the special features of the franchise relationship, “it has no application to the ABC test applicable to wage and hour cases.” 923 F.3d at 594. The court saw no reason why the test for employee status must necessarily be the same in wage order cases and vicarious liability cases. The court concluded that “the franchise context does not alter the *Dynamex* analysis, and the district court *need not* look to *Patterson* in applying the ABC test.” *Id.* at 595 (emphasis added).

The *Vazquez* decision reflects a deep-seated disdain for the franchise business model. For example, the court claimed that the California Supreme Court in *Dynamex* had “favorably cited” two Massachusetts decisions that applied the ABC test in the franchise context. But the *Dynamex* decision does not mention franchising at all, and cited the two cases only as examples of cases where it had been more efficient to address “the latter two parts of the [ABC] standard” on summary judgment, rather than filing a motion on all three prongs. *Dynamex*, 4 Cal.5th at 48. The *Vazquez* court compounds the insult by quoting a Massachusetts decision that compared Coverall’s franchise business model to a “modified Ponzi scheme.”

*Vazquez* also cited favorably to an unreported Massachusetts Superior Court opinion in which “a top-level franchisor in a nearly identical business structure was the employer of bottom-level franchisees” because the franchisor’s revenue was “directly dependent on commercial cleaning work” done by franchisees. 923 F.3d at 596. The court also suggested that a “common-sense” analysis could be done to determine whether unit franchisees are necessary or incidental to the “hiring entity’s business.” *Id.* at 597. The court observed that “Jan Pro’s business ultimately depends on someone performing the cleaning.” *Id.* at 598. Further, “Jan-Pro is not indifferent to how much work franchisees do” because it “earns a percentage of the payments that customers pay for cleaning services.” *Id.* Jan-Pro, the court observed, was “not simply renting out its trademark and goodwill,” but was “actively and continuously profiting from those cleaning services as they are being performed.” *Id.* The same observations apply to virtually all franchise business relationships.

*Vazquez* instructed the district court to consider whether Jan-Pro’s business model “relies on unit franchisees continuously performing services.” *Id.* In analyzing Prong B of the ABC test, the district court was to consider how the franchised business described itself. To help that analysis along, the court noted that Jan-Pro’s websites and advertisements say it is in the business of cleaning. The court was dismissive of claims that Jan-Pro was in the franchising business. The court disregarded the analysis as to the proper test to apply in the *Curry* decision as “slim on its own terms.”

#### **D. The Ninth Circuit’s Approach in *Salazar v. McDonald’s***

*Salazar v. McDonald’s Corp.*, 944 F.3d 1024 (9th Cir. 2019), is a joint employment case, a topic separately addressed in this program. It is discussed briefly here just to

contrast it with the approach taken by the Ninth Circuit panel in *Vazquez*. The court in *Salazar* understood that “Plaintiffs are [the franchisee’s] employees,” determining that “the relevant question is whether they are also McDonald’s employees.” *Id.* at 1032. The district court in *Vazquez* had taken the same approach, but the Ninth Circuit in *Vazquez* simply disregarded the issue of whether there was a putative primary employer.

The Ninth Circuit in *Vazquez* had dismissed the reasoning in the *Curry v. Equilon* case as “slim,” but the *Salazar* panel considered the *Curry* decision to be “well explained.”

Instead of disregarding the *Patterson* gloss, the *Salazar* court cites to it often, expressly stating that “McDonald’s involvement in its franchises and with workers at the franchises is central to modern franchising and to the company’s ability to maintain brand standards, but does not represent control over wages, hours, or working conditions.” *Id.* at 1030. The *Salazar* opinion, strikingly, holds that *Dynamex* has “no bearing here, because no party argues that Plaintiffs are independent contractors.” *Id.* at 1032. This clashes with the holdings of the courts in *Moreno* and *Vazquez*, that the ABC test applied to all workers, whether or not there was a joint employment claim. The court found “no evidence that McDonald’s had the requisite level of control over Plaintiffs’ employment to render it a joint employer under the principles set forth in *Martinez*, *Curry*, and other applicable California precedents.” *Id.*

### **E. The California Supreme Court Decision in *Vazquez***

In the course of its various decisions in *Vazquez*, the Ninth Circuit certified the issue of retroactivity of the *Dynamex* decision to the California Supreme Court. The California Supreme Court concluded that *Dynamex* did have retroactive effect. *Vazquez v. Jan-Pro Franchising Int’l, Inc.* (2021) 10 Cal. 5th 944, 957.

Jan-Pro argued that prior to *Dynamex*, a putative employer would have reasonably expected that employee status would be determined in accordance with the *Borello* decision. The Court rejected this argument because *Borello* “was not a wage order case and that decision did not purport to determine who should be interpreted to be an employee for purposes of a wage order.” 10 Cal.5th at 953.

The California Supreme Court believed that putative employers in California should not have been surprised by the *Dynamex* decision because they “were clearly on notice well before the *Dynamex* decision that, for purposes of the obligations imposed by a wage order, a worker’s status as an employee or independent contractor might well depend on the suffer or permit to work prong of an applicable wage order—and that the law was not settled in this area.” *Id.* at 955.

Because the California Supreme Court had previously stated that the applicability of *Borello* to wage orders was an open question, the Court believed that there was no reason for anyone to assume that *Borello* would be the test for wage order claims. The Court viewed *Dynamex* as an issue of first impression. When the Court adopted the ABC test in *Dynamex*, therefore, it did not change a settled rule of law upon which the parties could have relied. “No decision of this court prior to *Dynamex* had determined how the

‘suffer or permit to work’ definition in California’s wage orders should be applied in distinguishing employees from independent contractors.” *Id.* at 948.

Jan-Pro also argued that it could not have anticipated that the Court would adopt the ABC test, making it unfair to apply the new test retroactively. The Court rejected “the contention that litigants must have foresight of the exact rule that a court ultimately adopts in order for it to have retroactive effect.” *Id.* at 955.

The California Supreme Court’s discussion of *Martinez v. Combs* in its *Vazquez* decision is instructive. The Court characterized *Martinez* as a wage order case addressing whether “the plaintiff workers could properly be considered employees of business entities other than the workers’ *most direct or immediate employer.*” *Id.* at 954 (emphasis added). The Court characterized *Martinez* as a case that “did not present the question of whether the workers were properly considered employees or, instead, independent contractors for purposes of the wage order.” *Id.*

Paradoxically, the Court makes no comment about the fact that the Ninth Circuit had applied the ABC test to a party who was *not* the direct and immediate employer of the plaintiff in the same *Vazquez* case, before certifying the retroactivity issue to the California Supreme Court. The California Supreme Court dismisses the franchise issue with a footnote that acknowledges that the case before it arises from a franchising arrangement, noting that the question the Court agreed to answer “does not involve any inquiry into the general relationship or applicability of the *Dynamex* decision to franchise agreements or arrangements, and we do not address that subject.” *Vazquez*, 10 Cal.5th at 1210, fn. 1. The Court had been requested by the parties to address the franchise issue but declined to do so.

The California Supreme Court in *Vazquez* held that *Dynamex* “did not overrule any prior California Supreme Court decision or disapprove any prior California Court of Appeal decision.” *Id.* at 952. The courts in *Moreno* and *Vazquez* concluded that because *Dynamex* addressed the “suffer or permit” standard in the wage orders, and because “suffer or permit” was one of the three tests for employment endorsed by the *Martinez* court, that the ABC test had supplanted the “suffer or permit” test in *Martinez*. The statement in *Vazquez* that the Court did not overrule any of its prior decisions, seems to support the argument that *Dynamex* sets forth the independent contractor test for direct employers only and that the Ninth Circuit may have erred in determining that *Martinez* had been substantially altered, if not overruled outright, by *Dynamex*.

The Court also maintained that its *Dynamex* decision had not departed very far from *Borello*. The Court asserted that the “three elements of the ABC test are prominent factors already listed in *Borello*, so that the ABC test was “not beyond the bounds of what employers could reasonably have expected.” *Id.* at 957.

## **F. Post-*Vazquez* Application of the ABC Test to Franchising**

In *Fleming v. Matco Tools Corp.*, 2020 WL 6461327 (N.D. Cal. Nov. 03, 2020), Matco Tools franchisees brought a class action asserting that they had been misclassified as independent contractors. Matco invoked *Patterson*, but the court refused

to consider a vicarious liability case. The court further cited *Vazquez* for the proposition that “the franchise context does not alter the *Dynamex* analysis.” *Id.* at \*4.

The court revisited the franchise issue in a later decision on the plaintiffs’ motion for class certification. *Fleming v. Matco Tools Corp.*, 2021 WL 673445 (N.D. Cal. Feb. 21, 2021). Matco argued that the court could decline to apply the ABC test “if it cannot be applied to a particular context,” citing Cal. Lab. Code § 2775(b) (3). The court saw no reason not to apply the ABC test, because *Vazquez* had already “applied the ABC test to a complex three-tier franchise scheme where ‘master franchisees’” had direct contact with customers and the “putative class of unit franchisees had no direct relationship with the defendant.” *Id.* at \*7.

The *Fleming* court felt that the same result should necessarily occur in a direct franchisee-franchisor relationship that “more closely mirrors a typical employee-employer relationship.” *Id.* The court concluded: “If it was possible to apply the ABC test to the franchises at issue in *Vazquez*, I see no reason why the test cannot be applied to the franchises at issue in this case. For these reasons, I conclude that the ABC test likely applies to this case.” *Id.* at \*7-8. The court held that the issue was whether Matco controlled its franchisees “in the way a business [sic] typically controls employees.” *Id.* at \*10.

### **G. Vicarious Liability and Employment Standards**

The *Vazquez* court held that the *Patterson* gloss applied only to vicarious liability claims and “has no application to the ABC test applicable to wage and hour cases.” 923 F.3d at 594. *Fleming* reached the same conclusion. In truth, under California law, the law on the independent contractor issue in the vicarious liability and employment contexts developed together and should not be so easily separated.

The analysis is not exactly the same, because a person claiming misclassification is presumed to be an employee because of the strong public policy supporting wage and hour claims. See Cal. Labor Code § 3357 (“Any person rendering service for another, other than as an independent contractor, or unless expressly excluded herein, is presumed to be an employee”).

Despite this consideration, vicarious liability and misclassification analysis developed together in California and there should not be a substantial difference in the result—especially, when there is a strong public policy that favors the franchise business model. For all intents and purposes, the laws of agency and employment are virtually congruent. Where there is no agency or employment relationship, the parties are characterized in both instances as “independent contractors.” See, e.g., *Patterson v. Domino’s*, 143 Cal.Rptr.3d at 400 (reasonable inferences that franchise was “not an independent contractor”) (reversed by Supreme Court opinion).

Witkin, the best-known commentator on California law, observes that the “concept of common law employment, i.e., employment as defined and developed by custom and case law, originally fixed the boundaries of vicarious liability in tort actions. . . . More recently, the doctrine has been applied in employment law. . . .” Witkin, *Summary of*

*California Law* (10<sup>th</sup> Ed. 2012), Agency and Employment, § 3. Accordingly, “[t]here is seldom any reason to distinguish between the service of an agent and that of an employee,” because “[m]ost of the rules relating to duties, authority, liability, etc., are applicable to employees as well as other agents.” *Id.*, § 4. The Restatement generally makes “its sections on agency applicable to employers and employees by cross-references.” *Id.*

*The Restatement (Second) of Agency* § 2 (2014), explains that a “master is a species of principal, and a servant is a species of agent,” further noting that the “word ‘employee’ is commonly used in current statutes to indicate the type of person [described in the Restatement] as servant.” “Master” is another word for “employer.” See *Restatement (Second) Agency*, § 2.

Historically, under California law, the same control test has been used to identify independent contractors, whether in the context of agency or employment. For example, in *Cislav v. Southland Corp.* (1992) 4 Cal.App.4th 1284, a vicarious liability agency case, the plaintiffs claimed that the relationship between the franchisor and the franchisee “could be interpreted to demonstrate an employment or agency relationship.” *Id.* at 1287. The court held that a trademark owner has the right to “exercise certain controls over the enterprise without running the risk of transforming its independent contractor franchisee into an agent,” as long as the controls imposed did not go beyond what was necessary to protect “the trade mark, trade name and goodwill.” *Id.* at 1292, 1296. The owner of a brand may, therefore, impose restrictions on a licensee “without incurring the responsibilities or acquiring the immunities of a master, with respect to the person controlled.” *Id.* at 1295 (emphasis added). See also *Kaplan v. Coldwell Banker* (1997) 59 Cal.App.4th 741, 746 (if a franchise relationship alone created an agency relationship, “every franchisee who independently owned and operated a franchise would be the true agent or employee of the franchisor”).

#### **H. Despite *Vazquez*, the ABC Test is Not Necessarily Retroactive**

In *Haitayan v. 7-Eleven, Inc.*, 2021 WL 757024 (C.D. Cal. Feb. 8, 2021), 7-Eleven franchisees asserted claims for recovery of expenses or losses under California Labor Code § 2802. Although the franchisees asserted that the issue should be decided by the ABC test, the court disagreed. The court held that the case was *not* covered by the *Dynamex* decision, because that decision had been limited to wage order claims only. *Id.* at \*5. AB-5 did not purport to be retroactive and, therefore, the ABC test in the statute did not apply either. The *Borello* test, therefore, applied. The trial of this case took place as these materials were being finalized.

#### **I. Refusal to Apply the ABC Test to a Franchise Relationship**

In *Cruz v. MM 879, Inc.*, 2020 WL 6938843, \*3 (E.D. Cal. Nov. 25, 2020), Merry Maid franchisees claimed that the ABC test should be applied to their relationship with their franchisor. The court disagreed, citing *Salazar, Curry* and *Henderson* as “well-reasoned decisions” holding that *Dynamex* was irrelevant to the question of whether a franchisor was a joint employer of a franchisee’s employees. The court ruled that, as in *Curry*, no parties claimed to be misclassified independent contractors. The court ruled

that it was obligated to follow the rulings of the state’s intermediate appellate courts in *Curry* and *Henderson* and dismissed the claims against Merry Maids.

## V. Issues Arising from the Application of the ABC Test to Franchising

### A. The Hiring Entity

Although the word “employee” appears in Labor Code § 2750.3, the word “employer” does not. Instead, there is the undefined term, “the hiring entity.” Can a franchisor claim at the outset that the ABC test does not apply because it was not the “hiring entity?” In a sense, this would import the *Martinez* analysis into the ABC test.

*Vazquez* simply identified the “hiring entity” as the putative employer. In other words, a party becomes a hiring entity just because the plaintiff has alleged an employment relationship.

The *Moreno* court had initially been troubled about whether the concept of the “hiring entity” could fairly be applied to drivers who had not been hired by the defendant trucking company. The court determined, however, that because the *Dynamex* court had drawn extensively on *Martinez* and “did not distinguish the circumstances of that case as ones in which the ABC test did not apply, the Court determines that the ABC test is equally applicable to drivers who contracted directly with [the trucking company] and drivers hired by carriers who contracted with [the trucking company].” *Moreno*, 2019 WL 3858999, at \*7. In other words, it made no difference whether a “hiring entity” actually hired a worker.

In *Fleming v. Matco, supra*, the court held that “the term ‘hiring entity’ does not create a separate threshold inquiry into whether the ABC test applies at all to a particular entity.” 2021 WL 673445, at \*6.

The issue of “hiring entity” was addressed in *People v. Uber Techs., Inc.* (2020) 56 Cal.App.5th 266, where Uber and Lyft argued that *they* were not the “hiring entity”—that *the customer* hired the drivers. The court refused to consider a “threshold ‘hiring entity’” analysis. The court believed that the term “hiring entity” had been used in *Dynamex* “for its neutrality, so that it covers both employment status and independent contractor status, and thus does not presuppose an answer one way or another.” *Id.* at 288.

The *Uber* court refused to consider “hiring entity” as a legal issue subject to dispute:

“Most fundamentally, to make the determination of whether the party acquiring a worker’s service is a “hiring entity” an additional step in the ABC test—an analytical move that, in effect, creates a step zero and pretermits further analysis unless answered in the affirmative—is inconsistent with the holding in *Dynamex*: As our Supreme Court carefully delineated in that case, there are three steps to the ABC test, these steps may be considered in any order, and the analysis is at an end if the putative employer fails at any step.” *Id.* at 289.

The *Uber* court concluded that the only “threshold test” for employment status is “not whether the putative employer is a ‘hiring entity,’” but whether there is an express statutory exemption or whether the “particular context” called for the *Borello* standard, an argument not advanced in the *Uber* case. *Id.* The court concluded that the “hiring entity” issue “collapses into prong B of the ABC test, which looks to whether the drivers’ work is “outside the usual course” of defendants’ businesses.” *Id.*

After the voters exempted Lyft and Uber from the ABC test, the court invited a motion to dissolve the preliminary injunction in *People v. Uber Techs., Inc.*, 2020 BL 455101 (Cal. App. Nov. 20, 2020). Whether the preliminary injunction is dissolved, the analysis of the court may still be cited as to the meaning of the “hiring entity.”

### **B. Damages Exposure in ABC Misclassification Claims**

In franchise relationships, the parties generally allocate rights and duties by contract. Typically, the franchisee is responsible for the cost of operation of the franchised business, including the cost of employees, leases, equipment, products and other operational expenses. The franchisor is typically paid a franchise fee and royalties. Based on the terms of the agreement, the parties enter into long term relationships in accordance with their contracts.

In a misclassification claim, the putative employer may be forced to pay some of the expenses the franchisee had contractually agreed to pay. In California, Labor Code §2802 provides:

(a) An employer shall indemnify his or her employee for all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her duties, or of his or her obedience to the directions of the employer, even though unlawful, unless the employee, at the time of obeying the directions, believed them to be unlawful. . . .

(c) For purposes of this section, the term “necessary expenditures or losses” shall include all reasonable costs, including, but not limited to, attorney’s fees incurred by the employee enforcing the rights granted by this section.

If a franchisor is an employer, does the employee have the right to indemnification for all necessary expenditures or losses in “obedience” to the directions of the franchisor?

In *Fleming v. Matco Tools Corp.*, 2021 WL 673445 (N.D. Cal. Feb. 21, 2021), the franchisor argued that if there was a finding of misclassification, the franchisees would have to return years of profits to Matco. The court disagreed, stating that if “franchisees are reclassified as employees, any profits they have earned would likely be considered ‘wages’ that are not recoverable by employers once paid.” *Id.* at \*16.

The court next addressed the critical issue of damages under Labor Code § 2802. The plaintiffs were seeking reimbursement of the following expenses: fuel, maintenance,

registration, the cost of computers, printers and the software system, Internet service, cell phones, uniforms, insurance, the cost of unsold and returned tools and franchise fees. Matco argued that awarding such damages would be unjust enrichment for the franchisees. The court rejected that argument:

“Matco offers no explanation why it would be unjust for franchisees who earned revenues in excess of their expenses to also receive reimbursements. If franchisees are in fact employees under California law, then § 2802 requires that Matco reimburse them for certain expenses. These obligations are on top of obligations Matco would owe to its employees to pay them minimum wage and otherwise comply with California Labor law.” *Id.* at \*14.

*Mujo v. Jani-King Int'l, Inc.*, 307 F. Supp. 3d 38, 47-52 (D. Conn. 2018), addresses a similar damages issue. The case was decided under Connecticut’s version of the ABC test. The case is, nonetheless, significant because it addresses the mechanics of imposing an employment relationship over a pre-existing commercial franchise relationship. Jani-King franchisees argued that they were misclassified employees. Jani-King argued that the plaintiff’s theories were fundamentally at odds with the protections afforded to franchise agreements under the Connecticut Franchise Act and would have “catastrophic consequences for the franchise business model in its entirety.” *Id.* at 44.

The court found nothing in the text or purpose of the Minimum Wage Act or the Franchise Act that would preclude applying the ABC test to a franchise relationship. *Id.* at 46. The Legislature had not exempted franchise relationships and no exemption could be implied, because there were numerous other express exemptions from coverage in the statute. The court held that Connecticut law did not foreclose the possibility that a franchisee could also be an employee. The court, therefore, refused to dismiss the franchisees’ employment claims.

The plaintiffs argued that Jani-King had taken deductions from their wages for royalty fees, advertising fees, finder’s fees, accounting fees, technology fees, complaint fees, services fees, business fees, client sales tax, and lease deductions. Jani-King argued that these deductions were not wages and the court agreed. The court was required to enforce the contract by its terms and could not relieve the plaintiffs from difficulties undertaken pursuant to the contract.

The court held that the formula for calculating an employee’s wages was determined by the agreement between the putative employer and the employee. All of the claimed wage deductions, except the “down payment” were provided for in the agreement and, therefore, the deductions were not “wages.” The “down payment” (otherwise known as a franchise fee) could be shown to be a payment for the right to initial or continued employment, which would be void as a matter of law if an employment relationship was established because requiring a party to buy a job would violate Connecticut law. The court dismissed claims that ongoing royalty payments fell into the same category.

The *Haitayan v. 7-Eleven* claims that were tried in March of this year were for reimbursement of business expenses under Labor Code §2802.

### **C. Potential Employment Claims by Corporate Entities**

Although *Acosta v. Jani-King of Okla., Inc.*, 905 F.3d 1156 (10th Cir. 2018), was an FLSA action brought by the Secretary of Labor for the alleged failure to maintain employee records, the case suggests the range of claims that may be brought against franchisors. The Secretary alleged that Jani-King of Oklahoma had required franchisees to form corporations.

Jani-King asserted that the corporations formed by franchisees could not have employment claims. The court held that the economic realities of the working relationship determined employment status, not the “label or structure overlaying the relationship.” The court ruled that “the fact that these individuals are franchisees or have formed corporations does not end the inquiry.” *Acosta*, 905 F.3d at 1159. The Secretary of Labor had made allegations that were sufficient to proceed on as to franchisees, including corporate franchisees, at least at the pleading stage.

### **D. Is There Light at the End of the Tunnel?**

*Patel v. 7-Eleven, Inc.*, 485 F. Supp. 3d 299 (D. Mass. 2020), was a misclassification claim brought by franchisees against 7-Eleven under the Massachusetts ABC test. On cross-motions for summary judgment, the court granted summary judgment in favor of 7-Eleven. The FTC Franchise Rule requires franchisors to exercise “significant control” over franchisees “or risk not being in compliance with the FTC Franchise Rule.” Although the FTC Franchise Rule does not compel a party to exercise control, it defines a relationship resulting from the exercise of such control as a franchise.

The court dismissed the case, stating: “It cannot be the case, as plaintiffs suggest, that, in qualifying as a franchisee pursuant to the FTC’s definition, an individual necessarily becomes an employee. In effect, such a ruling by this Court would eviscerate the franchise business model, rendering those who are regulated by the FTC Franchise Rule criminally liable for failing to classify their franchisees as employees.” *Id.* at 310.

When the *Vazquez* court remanded the case to the district court, it did so with observations and guidance. The court instructed the district court to consider authorities from other jurisdictions that apply the ABC test. The district court in *Vazquez* would be following the Ninth Circuit’s directive if it adopted the reasoning in the *Patel* case.

## **VI. ABC Test Legislation**

### **A. California**

Despite lobbying attempts, California has steadfastly declined to adopt any form of exclusion from the ABC test for franchising.

## **B. The Changing Federal Employment Standards**

The Protecting the Right to Organize Act of 2021, commonly referred to as the PRO Act, imposes the ABC test on a federal level by amending the National Labor Relations Act to expand the workers who qualify for collective bargaining. The Act passed the House of Representatives by a vote of 225-206. It is widely believed the PRO Act will not pass the Senate.

Employee status under the FLSA is governed by the regulations of the Department of Labor and the standard is currently in flux. Historically, the economic realities test had been used to distinguish independent contractors from employees, but the Trump administration issued a new rule on January 6, 2021 clarifying the standard under the FLSA, entitled “Independent Contractor Status under the Fair Labor Standards Act.” See 86 FR 1168. The new rule would broaden the definition of independent contractor for purposes of FLSA liability.

The discussion of the new rule noted, “After highlighting some of the reports of adverse consequences experienced by workers and businesses in California following the passage A.B. 5, the Department concluded that adopting the ABC test as the FLSA’s generally applicable standard for distinguishing employees from independent contractors would be unduly restrictive and disruptive to the economy. Finally, as a matter of law, the Department asserted that adoption of California’s ABC test would be inconsistent with the more flexible economic reality test adopted by the Supreme Court, as it would cover workers who have been held by the Supreme Court to be independent contractors under the economic reality test.”

The final rule was originally scheduled to take effect on March 8, 2021, but the Biden administration asked federal agencies to freeze pending regulations to allow further time for review. The Department issued a notice on March 4, 2021, delaying the Independent Contractor Rule’s effective date until May 7, 2021. See 86 FR 12535. Then, on March 11, 2021, the Department announced a notice of proposed rulemaking, proposing to rescind the new independent contractor rule. See 86 FR 14027.

### **Disclosures**

Jonathan Solish or his firm were counsel on *Cislaw v. 7-Eleven* and *Ambrose v. Avis*, filed *amicus* briefs on *Juarez v. Jani-King* and *Vazquez v. Jan-Pro* and are co-counsel for the IFA in its suit against the State of California challenging AB-5.

International Franchise Association  
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# 2021 Judicial Update Selected Termination and Bankruptcy Cases

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**Elizabeth M. Weldon**  
Snell & Wilmer L.L.P.

## **IFA Judicial Update – Selected Termination and Bankruptcy Cases – 2021**

### **1. Termination Cases**

#### **(a) Choice of Law Issues Impacting Termination**

##### **(i) *Crest Furniture, Inc. v. Ashley Homestores, Ltd.*, No 1:20-cv-01383-NLH-AMD, 2020 WL 6375808 (D.N.J. Oct. 30., 2020)**

Franchisee Crest Furniture, Inc., and its 95 year old chairman, Simon Kaplan (collectively “Crest”), sold Ashley brand furniture for decades and entered into a variety of trademark usage agreements with Ashley between 2004 and 2019 to operate eleven Ashley HomeStores in Pennsylvania and New Jersey. Crest’s headquarters and warehouse were in New Jersey.

Crest claimed that Ashley announced in November 2019 that Ashley would not renew the trademark usage agreements for four of Crest’s Pennsylvania stores. Crest also claimed Ashley previously told Kaplan that he was too old to run the stores and it wanted him “out” and that the closure of these four stores would ruin its overall business and that Ashley plotted with Crest’s competitors to take over Crest’s stores. Subsequently, Crest sued franchisor parties Ashley HomeStores, LTD and Ashley Furniture Industries, Inc. (collectively “Ashley”) for a variety of New Jersey statutory and common law claims, including breach of the New Jersey Franchise Practices Act, common law franchise rights, equitable estoppel, unfair competition, fraud, violation of the New Jersey Law Against Discrimination, and for declaratory judgment.

Ashley filed a motion to dismiss Crest’s claims, arguing, among other things, that the trademark usage agreements contained forum selection clauses requiring litigation to occur in Wisconsin state court, not New Jersey federal court, and that the claims under the NJFPA and New Jersey Law Against Discrimination failed because Ashley’s alleged conduct was directed only to Pennsylvania and stores in Pennsylvania. Crest claimed the NJFPA applied even though the four stores terminated were in Pennsylvania because it maintained a “unified multi-state franchise with Ashley” and it could not be parsed out into separate franchises. Crest based its argument in part on the facts that its headquarters and main warehouse were both in New Jersey. For purposes of the motion to dismiss, the court agreed with Crest.

The court focused its analysis on the NJFPA claim, and agreed that the issue was whether the Crest was part of a unified multi-state franchise that included all of Crest’s HomeStores operating out its New Jersey headquarters or whether the claims are instead about four individual franchises in Pennsylvania. As this was a motion to dismiss, the court focused on Crest’s allegations in the complaint, which included allegations that both Crest and Ashley treated the stores as “bundled.” Crest alleged that Ashley required furniture orders to go through Crest’s New Jersey warehouse and that it serviced the Pennsylvania stores through New Jersey. Crest utilized single purchase orders from Ashley that did not indicate which store would get which furniture. Additionally, Crest alleged that renewals of the trademark usage agreements required Crest to generally release Ashley, and this release covered all stores, not just the trademark usage

agreement and store under renewal. While Ashley argued that this multi-state franchise argument violated the NJFPA’s definition of “place of business,” the court found that Ashley’s arguments all went to the substance of the claims and not to what Crest pleaded in its complaint. Plus the court viewed Crest’s claims as broader than just about four stores.

This case shows us that choice of law and forum issues may not be cut and dried in the case of multi-unit franchisees, and especially those with operations in multiple states. Crest asserted creative arguments to obtain its preferred forum and law, which worked—at least for the motion to dismiss stage—and caused the court to view the allegations holistically and broadly. While Ashley did not have much choice but to try to enforce its contractual forum selection clause, it is important to remember that forum selection and choice of law decision can be fact-bound and fact-specific. This author wonders if the same result will occur at a later stage when evidence can be utilized, instead of allegations only.

(ii) ***ACD Distribution, LLC v. Wizards of the Coast, LLC, No. C18-1517JLR, 2020 WL 3266196 (W.D. Wash. June 17, 2020)***

Choice of law controlled the outcome on a claim for violation of Wisconsin’s Fair Dealership Law. Plaintiff ACD Distribution, LLC (“ACD”) was a Wisconsin-based distributor for defendant Wizards of the Coast, LLC (“Wizards”) since 1993 and alleged that a large part of its business was based on distributing Wizard’s products—science fiction and fantasy games, such as “Magic: The Gathering.” In 2018, Wizards informed ACD that it was not going to renew the parties’ distribution agreement, without reason and even though ACD had been a good business partner. ACD alleged that its business would have to close without the Wizards distribution agreement. ACD filed suit in Wisconsin, alleging violation of Wisconsin’s Fair Dealership Law, and the case eventually was transferred to the United States District Court, Western District of Washington.

Wizards filed a partial motion for judgment on the pleadings, based on its choice of law clause, calling for application of Washington law and thus the dismissal of the claim under Wisconsin’s Fair Dealership Law. The court agreed with Wizards. It found there was an actual conflict of laws because Wisconsin law prohibited failure to renew a dealership agreement without good cause, while Washington law did not have a good cause requirement for failure to renew a dealership agreement. ACD even conceded that Washington law would not protect it. The court found there was no reason to not apply the parties’ choice of law clause, and thus the claim under the Wisconsin statute failed. This case demonstrates the importance of focusing on where the parties are and what law applies and was agreed to before a claim is made.

(b) **Having the Ability to Terminate – At Will and Other Reasons**

(i) ***Servpro Industries, Inc v. Woloski, No. 3:17-cv-01433, 2020 WL 5629452 (M.D. Tenn. Sept. 21, 2020)***

A history of customer complaints led to termination of a Servpro franchisee, and the court considered what kind of factual support the franchisor did and did not need for

that termination. Franchisor Servpro Industries, Inc. (“Servpro”) filed a complaint against former franchisee defendants Tammy Woloski, Paul Woloski, and Delta Dawgs Construction Company d/b/a Servpro of Rosemead/South El Monte ( “Defendants”) for trademark infringement and breach of contract. Defendants filed a counterclaim against Servpro and others for breach of the franchise agreement by wrongful termination, among other claims. Servpro and Defendants sought summary judgment on a variety of claims, but we focus on the court’s decision to grant summary judgment for Servpro on Defendants’ wrongful termination claims.

Servpro based the termination of the franchise agreement on multiple customer and insurance company complaints lodged against Defendants in their operation of their franchising—including complaints like price gouging, excessive work, wrongful charges, and intimidation. Servpro claimed it received more than nine customer complaints, including from national account customers affecting the entire brand, during Defendants’ 22 month tenure as a franchisee. These complaints caused Defendants to be in breach of the franchise agreement provision that prohibited “conduct that reflects materially and unfavorably upon OPERATOR and the reputation of the system.” Defendants argued that some of the complaints were untrue, but the court found that Servpro was not required to determine that every complaint was correct and had shown reputational damage due to both the consistency and egregious nature of the complaints, customer threats of lawsuits, and damage to key accounts. “[D]amage to a company’s reputation does not always depend on the ultimate validity of the complaint. . . . Thus, a franchisee’s failure to promptly resolve complaints, even when the customer is in the wrong, may result in damage to the franchisor’s reputation. In other words, at some point, the consistent and serious nature of unresolved consumer complaints can be a legitimate basis for termination if the franchisor can show the complaints resulted in damage to its reputation.” Because Defendants did not provide any evidence to show Servpro’s reputational concerns were not valid, summary judgment was properly in favor of Servpro.

(ii) ***Compania Embotelladora Del Pacifico, S.A. v. Pepsi Cola Company, 976 F.3d 239 (2d Cir. 2020)***

Compania Embotelladora Del Pacifico, S.A. (“CEPSA”), a Pepsi bottler in Peru, sued Pepsi Cola for breach of contract, alleging, among other things, breach of its exclusive bottling agreement when Pepsi terminated the agreement in 1999 after CEPSA stopped paying its debts to Pepsi. The case had a very lengthy history—the original complaint was filed in 2000 and this appellate decision was filed in 2020. In the district court, Pepsi moved to dismiss the wrongful termination claim on the grounds that under New York law the contract was terminable at will as it was a contract of indefinite duration and the contract did not explicitly state that the parties intended to be bound perpetually.

Despite New York law that provided a contract of indefinite duration is terminable at will, CEPSA appealed and argued that the contract did express the intent to be bound perpetually unless one of five stated termination events occurred that would allow Pepsi to terminate. The court of appeal affirmed the district court’s decision. CEPSA argued that the court’s decision would make the five termination events, which gave Pepsi the right but not the obligation to terminate, meaningless and against New York’s law against

surplusage. The court rejected this argument, relying on law that stated such listings of termination events were not surplus, but rather important cautionary listings that could cause a party to terminate. Additionally, the court found that the termination events paragraph had another purpose—to allow Pepsi the ability to terminate without having to wait for a reasonable duration since New York law provided a requirement that distribution agreements that are terminable at will have a reasonable duration before termination.

(iii) ***KJ Appliance Center, LLC v. BSH Home Appliances Corporation*, No. 2:19-cv-795-RMG, 2020 WL 4352380 (D.S.C. July 29, 2020)**

Wrongful termination claims are inherently fact-specific but this case is an example of how low the floor can be for dealer termination protections. In March 2018, plaintiffs KJ Appliance Center, LLC (“KJ”), Kenneth Johnson, and Jim Brantley (“Plaintiffs”) entered into two dealer agreements with Defendant BSH Home Appliances Corporation’s (“BSH”), to sell BSH products from a brick-and-mortar location, which Plaintiffs rented. Just eighty-six days later, BSH terminated the dealer agreements on the basis that “[a]s part of BSH’s strategy to remain competitive in the future, we are compelled to reorganize our authorized dealer relationships.” The dealer agreements allowed both parties to terminate them on thirty days’ written notice.

Plaintiffs sued BSH for wrongful termination and breach of the covenant of good faith and fair dealing, among other things. BSH sought summary judgment on these claims, and Plaintiffs then sought to voluntarily dismiss the case so they could litigate it in state court instead. The court quickly denied the motion to voluntarily dismiss, on the basis that it already denied a motion to amend and Plaintiffs were dilatory—the motion was filed after the close of discovery and dispositive motions and BSH’s motion for summary judgment—and did not have a good reason to move to state court. The court then granted BSH’s motion for summary judgment, disposing of the case.

Under the applicable law in North Carolina, a supplier can terminate a distributor at will, and is only limited by contractual restrictions and a “reasonable time” restriction—in which “a distributor who has made substantial investments in his business is entitled to operate the distributorship for a ‘reasonable time.’” The law interpreted “reasonable time” as being a “fair opportunity to recoup expenditures.” Here, the evidence showed that Plaintiffs made a net profit in the time they operated, the dealer entity repaid all startup costs that one of the individual founders advanced, and Plaintiffs were released from their lease obligations for a one-time payment of just over \$7,000 to the landlord. The wrongful termination claim failed as a matter of law and it was permitted by the agreements. Query would the outcome of this case be different if Plaintiffs could not have exited long-term lease obligations?

(iv) ***Gertz v. Vantel International/Pearls in the Oyster Inc.*, No. 19-12036-FDS, 2020 WL 3977404 (D. Mass. July 14, 2020)**

While at-will termination is not typical in franchising, it is not shocking in the multi-level marketing realm. Plaintiffs became distributors for the Vantel Pearls system in 2016 and later entered into Leader Agreements with defendant Vantel Pearls. The Leader Agreements permitted either party to terminate the agreement at will, and in 2019 Vantel

Pearls did just that, originally under the provision that allowed for termination without cause and later also on the grounds that plaintiffs violated a non-solicitation provision. Plaintiffs sued Vantel Pearls and its owner and chief executive officer for a variety of claims, including, among others, for breach of contract, misrepresentation, and declaratory relief that the termination provision was unconscionable.

Defendants filed a motion to dismiss the complaint. Relevant to our focus in this section, the court granted defendants' motion as to the claim for declaratory relief that the termination provision was unconscionable. The court readily dismissed plaintiffs' argument that the termination provision was procedurally unconscionable, as it was not forced on them and was not hidden from them. The court also found that the termination provision was not substantively unconscionable. The fact that the contract allowed termination after plaintiffs incurred investment expenses was not enough to be unconscionable, especially considering the fact that Vantel Pearls paid plaintiffs periodically on their agreements until termination. The court also rejected plaintiffs' argument that the termination provision was substantively unconscionable because it allegedly deviated from industry standards and differed from a policy called the "MLM Promise." There was no legal support for the idea that a contract is unconscionable just because it differs from industry standard and the MLM Promise was irrelevant because the agreements were integrated.

(v) ***M30 Brands, LLC v. Riceland Foods, Inc., No. 18-1371 (PG), 2020 WL 6084138 (D.P.R. Oct. 15, 2020)***

Puerto Rico's Dealer Protection Act calls for termination with just cause, and here the court found that failure to make sales or advertise product could be just cause. Plaintiff distributor M30 Brands, LLC, a Puerto Rico corporation, sued defendant supplier Riceland Foods, Inc. claiming Riceland wrongfully terminated and impaired the parties' distribution agreement. The parties brought cross motions for summary judgment. The court denied M30's motion and granted Riceland's motion in part.

In January 2016, the parties entered into a distribution agreement for M30 to sell Riceland's branded rice product, but two years later, Riceland unilaterally terminated this agreement. M30 claimed that Riceland did not have just cause to terminate the agreement, while Riceland argued that it did because M30 only sold a minimal amount of rice in Puerto Rico—\$31,000 worth in two years, to only two clients, and did not market the Riceland products in Puerto Rico. The Dealer Protection Act identified just cause for termination as the "[n]onperformance of any of the essential obligations of the dealer's contract, on the part of the dealer, or any action or omission on [their] part that adversely and substantially affects the interests of the principal or grantor in promoting the marketing or distribution of the merchandise or service." 10 L.P.R.A. § 278.

The court initially addressed M30's argument that the Dealer Protection Act applies to sales outside Puerto Rico. This was significant here because M30 made 90% of its sales in the Virgin Islands, while its sales in Puerto Rico were anemic. The court found the Dealer Protection Act did not apply to those Virgin Island sales because the Dealer Protection Act only applied when a dealer developed a market in Puerto Rico.

After it was clear that only Puerto Rico sales were at issue, the court proceeded to agree with Riceland that the termination was justified and that M30's significant breach could not be interpreted as "minor." The poor sales, combined with M30's failure to market or promote the product, gave Riceland just cause for the termination. That said, another claim by M30—that Riceland impaired M30 with delayed shipments—continued on.

(vi) ***Casco, Inc. v. John Deere Construction & Forestry Company***, Nos. 17-1570 & 17-1571, 2021 WL 791608 (1st Cir. Mar. 2, 2021)

The same Dealer Protection Act was at issue in this case as in the M30 case, above, but had very different results as to the termination. The First Circuit affirmed a finding that Deere did not have just cause to terminate a dealer under the Dealer Protection Act, even though the dealer admitted it had a past due balance of almost \$150,000 at termination.

Plaintiff Casco, Inc. ("Casco") and John Deere Construction & Forestry Company ("Deere") were in a long-time dealer agreement under which Casco sold Deere's construction equipment in Puerto Rico. Casco and Deere began working together in 1986, but by 2013, after some earlier conflicts between the parties, Casco had fallen behind in payments to Deere and owed it \$150,000 and then Deere cancelled a large order for a piece of equipment Casco sold to a customer. On the basis of the overdue sums, Deere terminated the dealer agreement. The parties both sued each other, with Casco suing Deere for wrongful termination of the dealer agreement and for wrongful order cancellation under the Dealer Protection Act, among other things, and Deere suing Casco for monies it owed. The jury granted Casco relief on both of its Dealer Protection Act claims (including damages of over \$1.4 million on the wrongful termination claim), but also the district court granted Deere relief on its counterclaim against Casco for over \$200,000. The First Circuit affirmed these findings.

The court affirmed the finding in favor of Casco on the wrongful order cancellation, finding the cancellation unjustified under the Dealer Protection Act and a breach of the dealer agreement. Deere had based its cancellation on Casco's failure to meet certain training requirements, but there was conflicting evidence that Deere knew Casco could not access the online platform for this training and that Deere did not follow internal policy to allow a grace period for training after a dealer purchased equipment requiring the training.

Likewise, the court affirmed the finding in favor of Casco on the wrongful termination claim. Deere argued that just cause existed for the termination because Casco admittedly owed a past-due sum of almost \$150,000 at termination. Deere additionally pointed to Casco's other lesser failings under the contract, such as failing to meet inventory, marketing, and service standards, but the court noted the agreement did not require certain amounts or have details of these standards. More significantly, while the court agreed that timely payment for goods normally is a basic obligation under a dealer agreement, parties can present "special circumstances" to show that a termination was not justified on this basis. Casco showed this conflicting evidence of special circumstances—including that its agreement listing "Essential Obligations" did not include

timely payment and that Deere really terminated Casco because Casco had a relationship with Deere's competitor, Volvo, not because of its overdue balance. Casco's evidence included showing that Deere tried to change the dealer agreement to prohibit competition, which Casco rejected; Deere threatened to withdraw support if Casco did business with Volvo and revoked some funding due to Casco's tie to Volvo; Deere was disgruntled about Casco seeking financing for its rental operation from others after Deere refused to provide that financing; and Deere singled-out Casco to exclude it from annual dealer conferences. Once all the evidence was combined, the court did not find the jury's findings in favor of Casco to be unreasonable. The court also affirmed the damages award to Casco of over \$1.4 million, as well as the award to Deere for its overdue balance.

(vii) ***Keen Edge Company, Inc. v. Wright Manufacturing, Inc., No. 19-CV-1673-JPS, 2020 WL 4926664 (E.D. Wis. Aug. 21, 2020)***

In this case, the court issued a temporary restraining order against termination under the Wisconsin Dealer Law. Plaintiff Keen Edge Company, Inc. ("Keen Edge") was an engine and parts supplier, distributing lawn mower products made by defendant Wright Manufacturing, Inc. ("Wright") since the 1980's. Keen Edge and Wright did not have a written dealer agreement, but had agreed that Keen Edge would be the exclusive distributor of these products in Wisconsin and all or parts of some surrounding states and areas, in exchange for meeting certain sales growth, marketing, and rebate requirements. In April and May 2019, Wright asserted that Keen Edge was in default of its distributor requirements and listed 16 areas of improvement and stated that it would visit Keen Edge for a progress visit, which never occurred. The parties communicated about the asserted defaults, but did not come to agreement. Thereafter, Keen Edge continued to act as a distributor and attended distributor meetings and submitted budgets and terms to Wright for 2020 that Wright accepted in August 2019. In October 2019, however, Wright gave notice that it would terminate Keen Edge as a distributor in 30 days without reason or opportunity to cure, though it referenced the default communications.

Keen Edge filed a complaint for breach of contract and violation of the Wisconsin Fair Dealership Law and sought a temporary restraining order and a preliminary injunction, which the court granted. Wright argued that the Wisconsin Fair Dealership Law did not apply because the dealership was not "situated" in Wisconsin. To make this determination, courts are to consider:

- 1) percent of total sales in Wisconsin (and/or percent of total revenue or profits derived from Wisconsin); 2) how long the parties have dealt with each other in Wisconsin; 3) the extent and nature of the obligations imposed on the dealer regarding operations in Wisconsin; 4) the extent and nature of the grant of territory in this state; 5) the extent and nature of the use of the grantor's proprietary marks in this state; 6) the extent and nature of the dealer's financial investment in inventory, facilities, and good will of the dealership in this state; 7) the personnel devoted to the Wisconsin market; 8) the level of advertising and/or promotional expenditures in Wisconsin; and 9) the extent and nature of any supplementary services provided in Wisconsin.

The court analyzed Keen Edge's situation and found that it had a significant, and not de minimus, presence in Wisconsin so that the Wisconsin Fair Dealership Law applied. Keen Edge alleged that Wright products made up about 95% of its total sales. Keen Edge had a distribution facility in Wisconsin, where its president also worked full-time, though its primary facility was in Illinois. Among other things, the court found most of Keen Edge's inventory was in its Wisconsin facility, its Wisconsin sales were 20-25% of its sales efforts and 20% of its resources in advertising and promotion, and its most visible employee was in Wisconsin. Wright countered that the Wisconsin Fair Dealership Law was only meant to apply when a dealer's investment was not fully recoverable and that Keen Edge could sell the product still. The court rejected this idea because Keen Edge would stop being in business and its inventory would decrease in value once it did not have Wright's replacement parts, training, warranties, and the like.

The court also analyzed whether Wright gave Keen Edge 90 days' written notice of the termination and 60 days to cure, required under the Wisconsin Fair Dealership Law. The court recognized that Wright send a letter itemizing defaults in May 2019, but found it could not be the required notice as Wright acted as if it would willing to continue the dealership—no visits, no further statements of underperformance, accepting the budget, hosting Keen Edge's employees at meetings, and approving another Keen Edge proposed dealer agreement. The court then turned to the October 2019 termination letter (with its 30 day notice without cure) and found it could not be the required notice due to the time required by the Wisconsin Fair Dealership Law. Perhaps more importantly the court found there was no evidence of good cause for the termination and that the reasons given in the May 2019 notice were pretextual due to lack of any follow up and disparate treatment from other dealers; Wright really wanted Keen Edge to sell the business to a competitor. The termination was prevented by the temporary restraining order in the territory that was the subject of the action.

(c) **Interesting Challenges in the Termination Context**

(i) **Covid-19 Related Claims**

(1) ***KFC Corporation v. Kamal*, No. 3:20-cv-279-DJH-CHL, 2020 WL 7634590 (W.D. Ky. Dec. 22, 2020)**

While the underlying case was about termination and post-termination standards, this opinion focused on forum selection arguments and arguments about the Covid-related dangers of litigating out of a franchisee's home state. Plaintiffs KFC Corporation and KFC US, LLC (collectively "KFC") sued KFC franchisees Gas Investments Corporation and Liberty Gas, LLC and the franchisees' owner, Syed Kamal, for breach of their franchise agreements and guaranty, trademark infringement, and unfair competition, after the franchise agreements were terminated for non-payment of royalties and fees due to KFC. After KFC filed a motion for preliminary injunction to enjoin operation of the stores, the Texas-based defendants filed a motion to dismiss for lack of jurisdiction and improper venue.

The franchise agreements contained a Kentucky choice of law clause and called for venue in Louisville, Kentucky. The court rejected defendants' argument that the clause was ambiguous and did not cover the scope of the dispute. But defendants did not give up there and also argued that enforcing the venue selection clause would be "unfair or unreasonable" based on the Covid-19 pandemic due to the franchisee owner's age and health issues. The court focused on the protections it has put in place to guard against the pandemic-related risks—such as phone and video conferences—that made it so the defendant would not need to travel to Kentucky during the pandemic. While the defendants' arguments about pandemic risks were rejected, this author expects similar arguments are being made around the country, at least for the next few months while more of the population is being vaccinated.

(2) ***Gus's Franchisor, LLC v. Terrapin Restaurant Partners, LLC, No. 2:20-cv-2372-JPM-cgc, 2020 WL 5121364 (W.D. Tenn. Aug. 31, 2020)***

Covid-19 concerns were also presented by the franchisee in this case, but again these arguments were unsuccessful with the court. Here, Plaintiff Gus's Franchisor, LLC's ("Gus's") sued former franchisee defendants Mark Dawejko and Terrapin Restaurant Partners, LLC ("Terrapin") for trademark and trade secret infringement after Gus's terminated the parties' franchise agreement. Later, the court granted Gus's motion for temporary restraining order to prevent Terrapin from using the franchisor's marks and from operating the restaurant as if it was associated with Gus's, and later the court entered a Consent Permanent Injunction on these issues. Gus's alleged that Terrapin failed to comply with the temporary restraining order or the injunction, and filed a motion for contempt.

The court found that Gus's provided evidence of Terrapin's violation of the order and injunction. Terrapin argued that their lawyers advised them to continue operating the store as is because it was in the best interest of the store and its employees to continue operating during the pandemic shutdowns. The court rejected these arguments and found their non-compliance was not justified and set a hearing to determine the amount of sanctions to be awarded against Terrapin.

(ii) **Discrimination Claim**

(1) ***Elsayed v. Family Fare LLC, No. 1:18-cv-1045, 2020 WL 4586788 (M.D.N.C. Aug. 10, 2020)***

In this case, the franchisee plaintiffs tried to challenge termination of their franchise agreement based on joint employer and racial discrimination claims. The court rejected these claims, but practitioners should consider whether some or all of these claims could go differently in another court.

Plaintiffs Lola Salamah and Amro Elsayed ("franchisees"), a married couple, operated a Family Fare gas station and convenience store, via their company Almy, LLC ("Almy"). Originally they entered into a contract operator agreement with defendant M.M. Fowler, Inc., ("M.M. Fowler"), who owned certain rights in the brand of stores, but eventually they entered into a franchise agreement with defendant Family Fare, LLC

("Family Fare") to operate the same store and M.M. Fowler acted as their landlord. During the operation of the store, a store employee stole a large amount of lottery tickets. The franchisees normally needed to declare the items as stolen and pay the amount of these tickets back to the franchisor immediately, but a business consultant of M.M. Fowler, who acted as the franchisees' liaison with the franchisor, told the franchisees to mark the tickets as sold and pay back losses over time instead. Eventually, the franchisees had a difficult time paying off full amount and called franchisor for help. The following month the franchisor terminated the franchise agreement due to the amounts owed on the lottery tickets. At termination, the same franchisee liaison showed up at store, called the police, and had the locks on the store changed to prevent the franchisees from further access to store.

Plaintiff franchisees sued Family Fare, M.M. Fowler, and related individuals ("Defendants") for a variety of claims, but this decision focused on the franchisees' wage and hour claims under the Fair Labor Standards Act, wrongful termination and discrimination claims based on the franchisor liaison's alleged prejudice against Arab Americans, and unlawful eviction claims. Defendants filed motions for summary judgment as to all of these claims.

Defendants sought summary judgment on the FLSA claims (for failure to pay overtime) on the basis that they were not employers or joint employers of plaintiffs. The court found Defendants were not joint employers—they did not assert control beyond brand standard enforcement, did not have power to hire and fire workers, and did not perform normal employer responsibilities like payroll and taxes. It is notable that the court found certain factors of the joint employer test did not carry weight in the franchise context, such as whether there was a long term relationship or ownership of the location. The court also found that franchisee wife was not an employee of Defendants either—she controlled her own work, she could make a profit or loss on her own skill, her job required skill, and she hired people for her store.

Then the court turned to franchisee husband's racial discrimination claim under Title VII. He asserted that Defendants fired him because of their animus against Arab Americans, but this claim also failed because court found Defendants were not his joint employers either, based on similar facts as—though a different test than—the court applied to his wife's claim.

The franchisees also claimed the franchise agreement was terminated as a pretext for their discrimination against Arab Americans, under 42 U.S.C § 1981. The court rejected this claim and related claims because there was no evidence the actual franchisor was prejudiced against Arab Americans and only franchisor terminated the agreement. Plaintiffs' evidence that franchisor's liaison was prejudiced was not sufficient.

Finally, the court also ruled on the franchisees' Unfair and Deceptive Trade Practices Act ("UDTPA") based on wrongful self-help eviction. Plaintiffs had more traction with this claim, and presented evidence that the franchisor's liaison had them locked out of the store and pushed one of their employees when he took possession of the store's cash register. The franchisees claimed they suffered injury as the franchisee husband

alleged he was physically harmed by the eviction process. While the court seemed uncertain whether the injury allegation would ultimately carry the day, the court allowed this claim to move forward.

(iii) **Waiver Claim**

(1) ***Little Caesar Enterprises, Inc. v. Little Caesars ASF Corporation*, No. 19-2335, 2021 WL 37544 (6th Cir. Jan. 5, 2021)**

Little Caesar Enterprises (“Little Caesars”) sued Rollie and Beverly Knox and others (the “Knoxes”), its former franchisees, for amounts due under the franchise agreement and to enforce termination of that agreement. The Knoxes or their entities owned 20 Little Caesars locations across six states. In 2017, the Knoxes failed to make certain royalty payments, failed to pay for supplies, and failed to produce business records to Little Caesars. After they failed to cure these defaults after notice, Little Caesars terminated their franchise agreements, but clarified that if they continued to operate the restaurants, it would accept payments but not waive its claims against them.

Little Caesars filed a complaint against the Knoxes for breach of contract, among other things. The Knoxes filed a counterclaim and continued to operate the restaurants until Little Caesars obtained a preliminary injunction—and eventually a contempt order—against them after they stopped making any payments on the stores. Eventually, Little Caesars obtained summary judgment on all claims and the court ordered the Knoxes to pay more than \$2.6 million in both liquidated and additional damages to Little Caesars.

The Knoxes appealed, arguing that application of the liquidated damages provision was premature, which the court rejected. The Knoxes also argued that Little Caesars waived its right to terminate when it supplied ingredients to them during the litigation. The court also rejected this argument based on the fact that the Knoxes would have to show the high bar of a knowing waiver, and Little Caesars stated in the termination letter that continued dealings to operate the store after termination would not be a waiver of their rights to enforce the franchise agreements. A message here for franchisors is to continue asserting non-waiver statements in termination communications.

(iv) **Restrictive Covenant Enforcement**

(1) ***ComForCare Franchise Systems, LLC v. ComForCare Hillsboro McMinnville Corporation*, 815 Fed. Appx. 80 (6th Cir. 2020)**

Franchisor ComForCare Franchise Systems, LLC (“CFS”) appealed a 2019 order granting in part and denying in part CFS’s motion for preliminary injunction that CFS sought against its franchisee (referred to as the “Larmangers” in the opinion or the “franchisee” here) after its franchisee announced it was terminating its franchise agreement and would continue to serve the franchisee’s patients. CFS sought a preliminary injunction under the non-competition clauses of the franchise agreement to stop the franchisee from serving any patients. The district court mostly granted the preliminary injunction, but interestingly denied it as to the franchisee’s provision of services to franchisee’s 79 existing patients. The district court reasoned that the injunction

would cause the franchisee to go out of business and people would need to find new caregivers, which is difficult.

CFS appealed the decision on the ground that the district court “re-wrote” the parties’ agreement. But the Sixth Circuit affirmed the district court’s decision. “The district court wisely applied [preliminary injunction factors from caselaw] by recognizing that health-care providers are not commodities, and found that the Larmangers’ existing patients would suffer if the Larmangers were enjoined from serving them. We find no abuse of discretion.”

(2) ***Mainstream Fashions Franchising, Inc. v. All These Things, LLC*, 453 F.Supp.3d 1167 (D. Minn. 2020)**

After termination several franchisees, the franchisor filed motion for preliminary injunction to enforce post-termination obligations, but the court only sparingly enforced them to protect the mark and not to prevent franchisee’s ongoing business. Mainstream Fashions Franchising, Inc.—a franchisor of a women’s clothing brand—terminated its franchisees for two locations in North Carolina for refusing to change to a new point-of-sale system and on allegations the franchisees abandoned or showed intent to abandon the stores. The franchisees argued that Mainstream committed a variety of failures itself under the franchise agreements, related to the POS system and otherwise.

When Mainstream learned that the franchisees were continuing to operate their stores after termination, it sued the franchisees for breach of the franchise agreements, violation of post-termination obligations, and related claims. The parties then filed dueling motions: Mainstream filed a motion for preliminary injunction to stop the franchisees from operating their businesses and the franchisees filed a motion to dismiss the complaint. The court denied the franchisees’ motion to dismiss the complaint because, among other things, there were factual disputes and evidence was necessary to resolve the defenses. The court turned to Mainstream’s motion for preliminary injunction, and found that Mainstream showed a threat of irreparable harm in relation to the franchisees’ use of Mainstream’s marks and products, but it did not show such a threat in relation to the general operation of the franchisees’ continuing businesses. Other than the claims to prevent the franchisees from using the marks and products, the court found Mainstream did not show it had “any more or less of a chance than Defendants at succeeding on its claims” and referenced its findings that the lack of an evidentiary record prevented it from finding the post-termination noncompetition provisions were enforceable or not or whether the businesses were actually competing. Finally, the court examined the balance of the harms—finding it to be in Mainstream’s favor as to stopping franchisees’ use of Mainstream’s marks and products, but finding it to be in franchisees’ favor as to continuing to operate the businesses. The court focused on the fact that the stores were the franchisees’ sole livelihood, which would be ended if the injunction was granted to shut down the stores. In denying the injunction to stop the operation of the stores or other post-termination obligations (aside from the trademark and product issues), the court again iterated the lack of a factual record in the case.

(3) ***Delivery.com Franchising, LLC v. Moore, No. 20-20766-CIV-COOKE/GOODMAN, 2020 WL 3410347 (S.D. Fla. June 19, 2020)***

Many termination cases involve terminations commenced by the franchisor, but this case involved a franchisee that purported to terminate its franchise agreement right before its work under the franchise agreement was scheduled to commence and also right about the time COVID-19 concerns arose. Defendant Pooler Takeout, LLC (“PTO”) was a food delivery business in Pooler, Georgia and it signed up to change its business to operate as a Mr. Delivery franchisee (later Mr. Delivery was purchased by Delivery.com). Right before PTO was scheduled to onboard to the Delivery.com takeout and delivery platform, PTO’s counsel wrote to Delivery.com to halt the onboarding efforts and stated that PTO considered the franchise agreement null and void, and also alleged the franchise agreement was not legally binding and was breached by Mr. Delivery for not furthering the agreement for the 14 month period between signing and planned onboarding.

Delivery.com sued Patrick Moore, the principal of PTO, for breach of the franchise agreement, injunctive relief, and related claims. Delivery.com also sought a preliminary injunction—importantly, a mandatory injunction—seeking to enforce the franchise agreement and require PTO to onboard as a Mr. Delivery franchisee, which the magistrate judge recommend should be denied. The court recognized that Delivery.com would likely succeed on its breach of contract claim and that Moore’s claims about delays and problems with the onboarding process did not justify termination of the franchise agreement, but the court also found that Delivery.com had not met any of the higher standards necessary for a mandatory injunction.

The court found that Delivery.com did not prove that its restrictive covenants—which would prevent PTO from competing—were enforceable because it did not show that it had a legitimate business interest in enforcing those covenants. Delivery.com did not provide PTO with any specialized training; Delivery.com had not done business in Pooler, Georgia and had no goodwill or trademark usage there; and PTO had never used Delivery.com’s platform for business in Pooler, Georgia. Similarly, Delivery.com did not show any risk of irreparable harm, as all of its harms were monetary and could be remedied by damages—again the court found it was critical that Delivery.com had not done any business at all in Pooler, Georgia. The balance of the harms favored Moore, actually, because PTO was a family-operated business, had 20 drivers, and had over 21,000 customer accounts, compared to Delivery.com which had not done any business in that market.

Relevant to our current times, Moore tried to argue COVID-19-related interests merited against the motion, but the court rejected this line of argument. Moore claimed that the public interest would be harmed by the injunction because the restaurants PTO worked with relied on PTO for food delivery and making PTO move to a new platform could cause loss of customers—including many who are elderly or disabled—and failure of the businesses using the delivery service. Moore also argued that this injunction could cause customers to not use delivery, but rather leave home to pick-up food or dine-in at restaurants, both of which are dangerous in these pandemic times. The court was

unmoved and found these COVID-19-relate arguments speculative and without evidence (such as evidence from PTO customers).

## 2. **Bankruptcy**

### (a) **Covid-19 Impacts and Arguments**

#### (i) ***In re Sanam Conyers Lodging, LLC, 619 B.R. 784 (Bankr. N.D. Ga. 2020)***

In this case, the bankruptcy court approved a Chapter 11 reorganization plan for a franchised business mid-pandemic. While this is not an unusual situation generally, this case is interesting because it shows the court's commitment to allowing reorganization—even during a pandemic—and the court's use of a high level of detail mixed with geographic consideration and some speculation about Covid-19 recovery.

Debtor was Janam Madison Lodging, LLC, a Red Roof Inn and Suites franchisee. The hotel was damaged by a fire in early 2019 and was closed for repair through April 2019, but the debtor filed for Chapter 11 relief in March 2019. After the pandemic started, the debtor filed an amended plan of reorganization in May 2020. The court held an evidentiary hearing on the amended plan, under which the debtor would continue to own and manage the hotel and would pay all claims over time. Much of the opinion focused on whether the amended plan met the feasibility standard under the bankruptcy code—whether the plan would require liquidation or further reorganization, other than as proposed in the plan. The plan required immediate payments, which the court found the debtor could pay, and the court analyzed the debtor's ability to pay future payments.

The court recognized there was little case law helpful in determining how to factor a global pandemic into to a hotel reorganization, but that the pandemic did have to factor into the analysis and that reorganization must still occur despite these circumstances. The court also recognized there was no certainty on when “normal” life would emerge, but that the five-year payout plan benefited the feasibility finding here as the parties expected the pandemic to subside sometime in 2021. The court's analysis was detailed and rooted in current events—considering items such as the debtor's ability to find other sources of customers despite the pandemic, the Georgia governor's resistance to closing businesses, the likelihood of universities coming back to campus and football season, the debtor's more rural location (with less mobility restrictions than Atlanta), the likelihood of the Masters Golf Tournament occurring, and the debtor's pivot in marketing to be a longer-stay hotel additionally. The court noted “that feasibility is not a crystal ball, and nothing is certain,” but found the plan feasible and approved it. It seems likely that this kind of detailed analysis, taking into consideration of uncertainties and realities of pandemic-life and post-pandemic recovery, may be seen in future cases.

#### (ii) ***In re Pier 1 Imports, Inc., 615 B.R. 196 (Bankr. E.D. Va. 2020)***

While this is not a franchise case, I note *In re Pier 1 Imports, Inc., 615 B.R. 196 (Bankr.E.D.Va. 2020)* because it is unusual and should be noted for potential application

in the franchise realm. Here, the debtors, Pier 1 Imports, Inc. and its affiliates, sought Chapter 11 reorganization and this opinion dealt with their emergency motion to relieve them from having to pay rent for a limited time when the stores were closed due to the Covid-19 pandemic. Somewhat surprisingly the court granted this relief.

Due to Covid-19 related mandatory shut-downs, Pier 1 requested that it be permitted to only pay “critical expenses” for a limited period of time, which meant only certain and not all landlords would receive rent payments during this time, though related insurance, utility, and security payments would continue. As one can imagine, some of the landlords objected to this motion, but the court granted the motion.

The court specified that Pier 1 was not proposing to rid itself of these rent obligations, and they would still accrue and be owed. Also, the court highlighted that while Pier 1 had contemplated supply disruptions earlier in the case, no one contemplated the complete shuttering of non-essential businesses, like Pier 1. Moreover, the court recognized that Pier 1 had tried alternate mechanisms to preserve its liquidity, such as furloughing employees—more than half of them; closing stores; decreasing salaries—by 20 to 50 percent; reaching out to their landlords to negotiate a consensual rent deferral; and delaying payment to vendors and suppliers for non-essential items. The court also specified what it was not deciding by this motion—it was not deciding the amount of rent due or whether the rent was not due because of the government-mandated closures or some other defense like impossibility, impracticability, or frustration of purpose.

The affected landlords now had an administrative expense claim that must be paid in full before the plan was confirmed. The court reasoned that to do otherwise in this case would give the landlords “super-priority” status over other administrative expense claims. It also found that Pier 1’s payment of the related amounts (insurance and the like) was sufficient protection for the affected landlords.

In the end, the court focused on the fact that there was no real alternative in this unusual situation of complete store shut-downs. Pier 1 could not produce money to pay rent because its stores were closed by government order. And liquidated efforts would be wasteful of assets that could be better used in the case for all creditors. “COVID-19 presents a temporary, unforeseen, and unforeseeable glitch in the administration of the Debtors’ Bankruptcy Cases.”

(b) **Termination in Bankruptcy**

(i) ***In re Jonesboro Tractor Sales, Inc.*, 619 B.R. 223 (Bankr. E.D. Ark. 2020)**

The dealer debtor, Jonesboro Tractor Sales, Inc., filed a motion in its Chapter 11 proceeding for a determination that contracts and agreements between the debtor and Kubota Tractor Corporation were assumable executory contracts, which Kubota contested. Kubota asserted that the parties’ dealer agreement was not assumable under section 365(c)(2) of the Bankruptcy Code because it was “a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the [D]ebtor” and sought relief from the stay to terminate the dealer agreement. The court

heavily referenced testimony from the debtor's primary owner, who testified that debtor had never been default under the dealer agreements and was not notified of any such default. And it was undisputed that the debtor was not in monetary default of the dealer agreement at the time it filed for bankruptcy.

The court's and the parties' focuses were on (1) whether the debtor's ability to purchase products from Kubota on credit made the dealer agreements non-assumable contracts and (2) whether the debtor's possible failure to maintain a minimum level of inventory put the debtor in breach of the agreements.

As to the credit option, the court found that under the contract Kubota was not required to give the debtor financing to purchase products, though it could. The contract also allowed Kubota to require the debtor to pay in cash or on COD. The debtor's principal testified that she believed she was not permitted to purchase products on credit with Kubota after declaring bankruptcy. While there was some conflicting evidence on whether Kubota would extend credit or not, the court's focus was on Kubota's *ability* to not extend credit. Because Kubota had a choice about credit, the court found the dealership agreement was "not a contract to extend financial accommodations within the meaning of Section 365(c)(2)" and was not otherwise a contract to make a loan or other debt financing, and thus was assumable.

The court also examined whether Kubota should be granted relief from the stay to terminate the dealer agreement and stop the debtor from acting as a Kubota dealer. The court rejected the idea that Kubota could terminate the dealer agreement for the sole reason that the debtor declared bankruptcy and so examined whether it could do so due to the debtor's alleged failure to maintain a minimum level of inventory under the terms of the dealer agreement. Kubota's argument failed as speculation. The debtor historically carried high levels of inventory, the current inventory (even after not being replenished) was not far off the minimum, and Kubota had never notified debtor of a breach of this minimum provision.