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Threats to Franchise Model: Where is Labor Law Taking Us?

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Threats to Franchise Model: Where is Labor Law Taking Us?¹

I. The Intersection Between Labor Law and Franchising

The hot button question of whether a franchisor can be deemed the employer of its franchisees and/or the joint employer of its franchisees' employees has come to a boiling point, with the National Labor Relations Board's (the "NLRB") recent publication of its final rule establishing a new "joint employment" standard under the National Labor Relations Act (the "NLRA") and the Department of Labor's (the "DOL") promulgation of new regulations addressing how to assess whether a worker is an employee or an independent contractor under the Fair Labor Standards Act (the "FLSA").

The Federal Trade Commission's Franchise Rule defines a "franchise" as "any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

- (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
- (2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
- (3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate."²

Nothing in this definition indicates that the Federal Trade Commission (the "FTC" or the "Commission") ever intended for the franchisor-franchisee relationship to be deemed an employer-employee relationship.

In fact, the very essence of the franchise model is one of an independent contractual relationship between the franchisor and franchisee. Under this model, the franchisor grants franchisees the right (and the franchisees undertake the obligation) to develop (at the franchisee's own expense) a franchised outlet operating under the franchisor's trade names and marks and in accordance with the standards of the franchisor's proprietary system. In this regard, the franchise model is nothing more than a form of a trademark license transaction. To maintain the validity of the license, trademark law requires that licensors (such as franchisors) impose certain standards upon its licensees (i.e., franchisees) when operating under the licensor's marks. Without the imposition of these standards, which exemplify the quality of the products and/or

¹ *Chris Nickels extends sincere gratitude to Harrison Rayment, Associate Attorney at Quarles and Brady, LLP, for his invaluable research assistance and contributions in the preparation of this paper.*

² 16 C.F.R. § 436.1(h).

services associated with the licensor's brand, it can be held that the licensor abandoned its marks.

Despite franchisees being contractually obligated to comply with the franchisor's standards, the franchise relationship gives franchisees a certain level of autonomy over the day-to-day operations of their franchised businesses (including the hiring and firing of its employees). But for some, this "autonomy" is nothing more than smoke and mirrors. Over the last decade, the fundamental principle of the franchise business model has come under intense scrutiny by an increased number of joint employer liability and/or wage and hour litigations and the recent promulgation of state and federal employment laws whose application (intentionally or incidentally) extends into the franchising arena. It is this recent intersectionality of employment and franchise law that has challenged the franchise business model as we know it.

Before we examine the recent federal legislation that has placed franchisors in the crosshairs of labor and employment law, we must first understand how we got here.

A. Understanding the Basics

Answering the question of whether a franchisee is an employee or independent contractor initially starts with the courts turning to the law to see how an "employee" and "independent contractor" are defined. Two laws that courts typically refer to in making these decisions are the National Labor Relations Act and the Fair Labor Standards Act.

1. Definition of Misclassification

The misclassification of workers is a pervasive problem in the United States. When a worker is treated as an employee, he/she is entitled to a host of worker protections under federal and state law. For example, employees are entitled to minimum wage and overtime pay protections under the Fair Labor Standards Act (the "FLSA"), but the same protections are not afforded to independent contractors. Under the FLSA, employers are charged with determining whether a worker is an employee or an independent contractor. "A worker who performs services for an individual or entity ... as an independent contractor, however, is not that person's employee under the Act. Thus, the FLSA does not require such person to pay an independent contractor either the minimum wage or overtime pay..."³ When an employer treats a worker who is deemed an employee under the FLSA as an independent contractor, the employer is liable for misclassification.⁴

2. Definition of Joint Employment

Under Section 103.40 of the NLRA, "an employer as defined by Section 2(2) of the National Labor Relations Act (the Act), may be considered a joint employer of a separate employer's employees only if the two employers share or codetermine the employees'

³ Independent Contractor Status Under the Fair Labor Standards Act, Executive Summary, 86 FR 1168

⁴ Department of Labor: Wage and Hour Division, Wages and the Fair Labor Standards Act – Misclassification of Employees as Independent Contractors Under the Fair Labor Standards Act, <https://www.dol.gov/agencies/whd/flsa/misclassification>

essential terms and conditions of employment.”⁵ Section 152(3) of the NLRA defines the term “employee” as including “any employee, and shall not be limited to employees of a particular employer, unless the Act explicitly states otherwise...”⁶ Remarkably, the NLRA does not actually define the term “employer.” Instead, Section 152 of the NLRA states that an “employer” merely includes “any person acting directly or indirectly in the interest of an employer in relation to an employee...”⁷

B. The Tests Used to Establish Whether An Employment Relationship Exists

In deciding whether a worker qualifies as an employee or an independent contractor, federal and state courts and government agencies will first look to the laws under which a claim is being brought. To the extent that the labor or employment law at issue clearly defines what constitutes an employment relationship, the language of that law will ultimately control. However, labor and employment laws like the NLRA and FLSA divine what the legislatures intended.

To establish if an employment relationship exists under the FLSA and NLRA, courts will look to the statutes’ definitions. Under the FLSA, an employee is defined as “any individual employed by an employer”⁸, an “employer” is defined to include “any person acting directly or indirectly in the interest of an employer in relation to an employee”,⁹ and the term “employ” means “to suffer or permit to work.”¹⁰ On the other hand, the NLRA defines an “employer” to include “any person acting as an agent of an employer, directly or indirectly”, and an “employee” to “include any employee and shall not be limited to the employees of a particular employer.” Interestingly, neither the FLSA nor the NLRA defines an independent contractor.

These ambiguous (and at times completely circular) definitions have caused courts to develop the following three tests to determine if an employment relationship exists between a worker and hiring entity: (i) the common law test, commonly referred to as the “the right to control” test; (ii) the “economic reality” test; and (iii) the “ABC” test (a hybrid of the “right to control” and the “economic reality” tests). Regardless of the test being applied, the determination as to whether an employment relationship exists is a fact-based analysis that courts use to analyze the totality of the circumstances surrounding the relationship between the worker and the hiring entity.

Right to Control Test

The “right to control” test, which is rooted in the principles of agency, examines the underlying facts to assess the level of control the franchisor is granted under the franchise. In determining whether a franchisee is an employee or independent contractor,

⁵ 29 C.F.R. § 103.40.

⁶ 29 U.S.C. § 152(3).

⁷ 29 U.S.C. § 152(2).

⁸ 29 U.S. Code § 203(e)(1).

⁹ 29 U.S. Code § 203(d).

¹⁰ 29 U.S. Code § 203(g).

“[t]he general rule is where a franchise agreement gives the franchisor the right of complete or substantial control over the franchisee, an agency relationship exists It is the right to control the means and manner in which the result is achieved that is significant in determining whether a principal-agency relationship exists.”¹¹ The “right of control” test follows the Restatement (Second) of Agency § 220(2) and considers the following ten factors when determining if a worker (in this case a franchisee) is an employee or an independent contractor:

- (1) The extent of control which, by the agreement, the employer may exercise over the details of the work;
- (2) Whether or not the worker is engaged in a distinct occupation or business;
- (3) The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;
- (4) The skill required in the particular occupation;
- (5) Whether the employer or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;
- (6) The length of time for which the person is employed;
- (7) The method of payment, whether by the time or by the job;
- (8) Whether or not the work is a part of the regular business of the employer;
- (9) Whether or not the parties believe they are creating the relation of an employer and employee; and
- (10) Whether the principal is or is not in business.”¹²

A vast majority of federal and state courts (and approximately twenty-three states)¹³ apply the “right to control” test when trying to determine whether a worker is an employee or independent contractor. On the federal level, courts generally rely on this test in determining whether an employment relationship exists under the NLRA, and other federal statutes such as, the Federal Unemployment Tax Act, the Immigration Reform and Control Act and the Federal Insurance Contributions Act, to name a few.

In *Community for Creative Non Violence v. Reid*, the United States Supreme Court stated that:

“In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished. Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the

¹¹ *Cislaw v. Southland Corp.*, 6 Cal.Rptr.2d 386, 388 (Cal. Ct. App. 1992).

¹² Restatement (Second) of Agency § 220(2) (1958). See also, *FedEx Home Delivery v. NLRB*, 563 F.3d 492 (D.C. Cir. 2009).

¹³

hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.”¹⁴

Federal agencies, like the Internal Revenue Service, expanded the “right to control” test and created a 20-factor test which the IRS initially used to assess whether an employment relationship existed. Some states have adopted this test, which takes the following twenty (20) factors into consideration:

1. **“Instructions:** If the person for whom the services are performed has the right to require compliance with instructions, this indicates employee status.
2. **Training:** Worker training (e.g., by requiring attendance at training sessions) indicates that the person for whom services are performed wants the services performed in a particular manner (which indicates employee status).
3. **Integration:** Integration of the worker’s services into the business operations of the person for whom services are performed is an indication of employee status.
4. **Services rendered personally:** If the services are required to be performed personally, this is an indication that the person for whom services are performed is interested in the methods used to accomplish the work (which indicates employee status).
5. **Hiring, supervision, and paying assistants:** If the person for whom services are performed hires, supervises or pays assistants, this generally indicates employee status. However, if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status.
6. **Continuing relationship:** A continuing relationship between the worker and the person for whom the services are performed indicates employee status.
7. **Set hours of work:** The establishment of set hours for the worker indicates employee status.
8. **Full time required:** If the worker must devote substantially full time to the business of the person for whom services are performed, this indicates employee status. An independent contractor is free to work when and for whom he or she chooses.
9. **Doing work on employer’s premises:** If the work is performed on the premises of the person for whom the services are performed, this indicates employee status, especially if the work could be done elsewhere.
10. **Order or sequence test:** If a worker must perform services in the order or sequence set by the person for whom services are performed, that shows the worker is not free to follow his or her own pattern of work, and indicates employee status.
11. **Oral or written reports:** A requirement that the worker submit regular reports indicates employee status.

¹⁴ Community for Creative Non-Violence v. Reid, 490 U.S. 730 (1989).

12. **Payment by the hour, week, or month:** Payment by the hour, week, or month generally points to employment status; payment by the job or a commission indicates independent contractor status.
13. **Payment of business and/or traveling expenses:** If the person for whom the services are performed pays expenses, this indicates employee status. An employer, to control expenses, generally retains the right to direct the worker.
14. **Furnishing tools and materials:** The provision of significant tools and materials to the worker indicates employee status.
15. **Significant investment:** Investment in facilities used by the worker indicates independent contractor status.
16. **Realization of profit or loss:** A worker who can realize a profit or suffer a loss as a result of the services (in addition to profit or loss ordinarily realized by employees) is generally an independent contractor.
17. **Working for more than one firm at a time:** If a worker performs more than de minimis services for multiple firms at the same time, that generally indicates independent contractor status.
18. **Making service available to the general public:** If a worker makes his or her services available to the public on a regular and consistent basis, that indicates independent contractor status.
19. **Right to discharge:** The right to discharge a worker is a factor indicating that the worker is an employee.
20. **Right to terminate:** If a worker has the right to terminate the relationship with the person for whom services are performed at any time he or she wishes without incurring liability, that indicates employee status.”

However, due to its complexity, the IRS simplified its 20-factor test by grouping the factors into the following three categories of evidence that it deemed relevant in determining whether the requisite control exists under the common law right to control test: (1) behavioral control; (2) financial control; and (3) relationship of the parties.

- **Behavioral Control.** In assessing whether the hiring entity has behavioral control over the worker, there must be evidence that the hiring entity has the “right to direct or control how the worker performs the specific task for which he or she is engaged”¹⁵. That is, the hiring entity must have the right to direct or control the details and means by which the worker performs the required services.
- **Financial Control.** To establish that the hiring entity has financial control over the worker, there must be evidence that “there is a right to direct or control how the business aspects of the worker’s activities are conducted.”¹⁶ Specifically, the test considers if, among other things: (i) the worker made a significant investment; (ii) the worker is reimbursed for its work related expenses; (iii) the method by which the worker is paid; and (iv) the opportunity for profit or loss.
- **Relationship of the Parties.** The IRS’s simplified test for determining whether a hiring entity exercises the requisite control to establish that a worker should be

¹⁵ Department of the Treasury, Internal Revenue Service, Independent Contractor or Employee? Training Materials, Training 3320-102 (10-96) TPDS 84238I, at 2-7. This document is publicly available at the IRS’ website at: <https://www.irs.gov/pub/irs-utl/emporind.pdf>.

¹⁶ *Id.*

classified as an employee examines the relationship between the worker and the hiring entity. In particular, this component of the IRS' test evaluates "how the parties perceive their relationship."¹⁷ Particularly, the test considers the parties' intent (i.e., the terms of the written contract, the employee benefits the worker received, the hiring entity's ability to discharge or terminate the worker and the nature of the hiring entity's regular business activity).

Economic Reality Test

The "economic realities" test focuses on the economic relationship between the worker and the hiring entity in evaluating whether an employment relationship exists. Under this test, a worker is an employee if

"the worker is economically dependent upon the employer for continued employment. The test examines the nature of the relationship in light of the fact that independent contractors would typically not rely on a sole employer for continued employment at any one time, but would work for, and be compensated by, many different employers, whereas most employees hold a single job and rely on that one employer for continued employment and for their primary source of income. The economic reality test is generally applied to laws whose purpose is to protect or benefit a worker, because courts view the protection of a worker who is financially dependent on a particular employer as important."¹⁸

In *Bartels v. Birmingham*,^{332 U.S. 126 (1947)}, the United States Supreme Court noted that the pivotal question that should be asked when applying the "economic reality" test is whether "as a matter of economic reality" the worker is "dependent upon the business to which they render service."¹⁹ Simply put, the "ultimate inquiry is whether, as a matter of economic reality, the worker is dependent on a particular individual, business, or organization for work (and is thus an employee) or is in business for him- or herself (and is thus an independent contractor)."²⁰ In applying the "economic reality" test, the Supreme Court identified five factors that should be considered when determining whether a worker is an employee or independent contractor under the "economic reality" test. But the Court was clear that no one factor is dispositive, nor is this an exhaustive list of the factors that courts should take into account.²¹ The five primary factors²² that should be considered under the "economic reality" test include:

- (1) The worker's degree of control over the work to be performed;
- (2) The worker's opportunities for profit or loss;

¹⁷ *Id.*

¹⁸ Bureau of Labor Statistics, Monthly Labor Review, *What is an employee? The answer depends on the Federal law*, Charles J. Muhl, p. 7 (January 2002), available at <https://www.bls.gov/opub/mlr/2002/01/art1full.pdf>.

¹⁹ *Bartels v. Birmingham*, 332 U.S. 126, 130 (1947).

²⁰ Independent Contractor Status Under the Fair Labor Standards Act, Final Rule issued by the Department of Labor Wage and Hour Division, 86 FR 1168 (January 7, 2021).

²¹ *United States v. Silk*, 331 U.S. 704, 716 (1947).

²² *Id.*

- (3) The investment that the worker will make in facilities;
- (4) The permanency of the worker's relation to the employer; and
- (5) The skill required in the claimed independent operation.

The “economic reality” test is generally applied in determining whether a worker is an employee under federal statutes, like the FLSA. In its fifteen-page Administrator’s Interpretation issued on January 21, 2016 by the DOL’s Wage and Hour Division, Administrator David Weil noted that “[u]nlike the common law control test, which analyzes whether a worker is an employee based on the employer’s control over the worker and not the broader economic realities of the working relationship, the “suffer or permit” standard broadens the scope of employment relationships covered by the FLSA.”²³

The “ABC” Test

A third test that courts and several states²⁴ use to determine whether a worker is an employee or independent contractor is the “ABC” test. The test combines elements of the “right to control” and “economic reality” tests and “considers the economic realities of the work relationship as a critical factor in the determination, but focuses on the employer’s right to control the work process as a determinative factor.”²⁵ Unlike the “right to control” and “economic reality” tests, the “ABC” test creates a presumption that a worker is an employee unless the hiring entity can establish the following three criteria, which the Supreme Court of California best enunciated in *Dynamex Operations W v. Superior Court*:

- (A) “That the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact;
- (B)²⁶That the worker performs work that is outside the usual course of the hiring entity’s business; and

²³ United States Department of Labor: Wage and Hour Division, Administrator’s Interpretation No. 2016-1, Administrator David Weil (January 20, 2016). This interpretive guidance is no longer on the Department of Labor’s website, but is available at: https://www.hallrender.com/wp-content/uploads/2016/01/DOL_Joint_Employment_1_20_16.pdf.

²⁴ According to a report published by the Congressional Research Service, at least twenty states and the District of Columbia have adopted the “ABC Test”. Congressional Research Service, CRS Report No. R46765 *Worker Classification: Employee Status Under the National Labor Relations Act, the Fair Labor Standards Act and the ABC Test*, Jon O. Shimabukuro (April 20, 2021).

²⁵ Bureau of Labor Statistics, Monthly Labor Review, *What is an employee? The answer depends on the Federal law*, Charles J. Muhl, p. 9 (January 2002), available at <https://www.bls.gov/opub/mlr/2002/01/art1full.pdf>.

²⁶ Approximately twenty-seven states use some version of the ABC test to determine whether a worker is an employee or independent. These states include: Alaska, Arizona, California, Connecticut, Delaware, Georgia, Hawaii, Illinois, Indiana, Kansas, Louisiana, Massachusetts, Maryland, Maine, Nebraska, New Hampshire, New Jersey, New Mexico, Nevada, Ohio, Oregon, Rhode Island, Tennessee, Utah, Vermont, Washington and West Virginia (See American Bar Association: Practice Point, *Employment Classification in an App-Based Nation*, Jennifer D. Thayer, Amye M. Melton, and David R. Grimm (August 24, 2020), available at: https://www.americanbar.org/groups/taxation/publications/abataxtimes_home/20aug/20aug-pp-thayer-employment-classification/?login). Of those twenty-seven aforementioned states only California and Massachusetts use the formulation of prong B.

(C) That the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.”²⁷

If the employer can establish that the employee satisfies all three prongs of the “ABC Test”, then the worker will be deemed an independent contractor and not an employee.

II. Historical Treatment of These Issues

A. Brief overview of prior litigation

1. Misclassification (largely confined to janitorial franchising)

Franchise agreements commonly refer to the franchisor-franchisee relationship as that of a franchisor-independent contractor relationship. And decades’ long judicial precedent virtually unanimously held that the franchisor-franchisee relationship was not an employment relationship but rather an independent contractor relationship. A case that best articulated this once universal judicial view was *Cislaw v. Southland Corp.* In entering summary judgment in favor of the franchisor of California 7-Eleven stores, the Court of Appeal ruled that the franchisor could not be held vicariously liable in a wrongful death case where the plaintiffs alleged that the franchisees sold clove cigarettes to their underage son resulting in his death. There the Court reasoned that “the franchise agreement withheld from the franchisor control over decisions relating to employment, inventory and day-to-day operations of the 7–Eleven store. For this reason, the agreement could not, in and of itself, provide a basis for finding the existence of an agency relationship between the [franchisee] and [the franchisor].”²⁸ The Court acknowledged that “franchisor’s interest in the reputation of its entire system allows it to exercise certain controls over the enterprise without running the risk of transforming its independent contractor franchisee into an agent.”²⁹

However, the principles enunciated in *Cislaw* have not been applied to franchisors universally. Courts have ruled in some cases that franchisors of janitorial franchisees are the employers of its franchisees. The most notable example of such case is *Awuah, et. al v. Coverall North America, Inc.* There, the franchisees of Coverall of North America, Inc., a janitorial franchisor, filed suit against Coverall alleging that Coverall, among other things, misclassified its franchisees as independent contractors. In partially granting the plaintiffs’ motion for summary judgment, the United States District Court for the District of Massachusetts agreed with plaintiffs finding they were misclassified as independent contractors. Applying Massachusetts law, the Court noted that Coverall bore the burden of proving that (i) the individual is free from control and direction in connection with the performance of the service; (ii) the service is performed outside the usual course of the business of the employer; and (iii) the individual is customarily engaged in an

²⁷ *Dynamex Operations W. v. Superior Court*, 232 Cal.Rptr.3d 1,8 (Ca. Sup. Ct. 2018)

²⁸ *Cislaw v. Southland Corp.*, 4 Cal. App. 4th 1284, 1296 (1992).

²⁹ *Id.* at 1292.

independently established trade, occupation, profession, or business of the same nature as that involved in the service performed.

While the Court noted that Coverall had to establish each of the foregoing elements, it placed special emphasis on the second prong asserting that it was dispositive. While Coverall argued that it and its franchisees were engaged in separate and distinct businesses - - the franchisees being engaged in performing services and Coverall being engaged in selling franchises and training and supporting its franchisees - - the Court dismissed that argument, finding that “[d]escribing franchising as a business in itself, as Coverall seeks to do, sounds vaguely like a description for a modified Ponzi scheme—a company that does not earn money from the sale of goods or services, but from taking in money from unwitting franchisees to make payments to previous franchisees.”³⁰

2. Joint Employer

As with cases alleging misclassification, the courts had historically been reluctant to deem a franchisor the joint employer of its franchisees’ employees. For example, in *Patterson v. Domino’s Pizza, LLC*, the Supreme Court of California held that Domino’s was not liable for sexual harassment claims brought by one of its franchisee’s employees. In reversing the Court of Appeal’s decision overturning lower court’s grant of summary judgment in favor of Domino’s, the California Supreme Court reasoned that:

“The “means and manner” test generally used by the Courts of Appeal cannot stand for the proposition that a comprehensive operating system alone constitutes the “control” needed to support vicarious liability claims like those raised here. As noted, a franchise contract consists of standards, procedures, and requirements that regulate each store for the benefit of both parties. This approach minimizes chain-wide variations that can affect product quality, customer service, trade name, business methods, public reputation, and commercial image.

More to the point, there are sound and legitimate reasons for business format contracts like the present one to allocate local personnel issues almost exclusively to the franchisee... A franchisor enters this arena, and becomes potentially liable for actions of the franchisee's 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. Any other guiding principle would disrupt the franchise relationship.”³¹

Although courts almost universally held that franchisors are not the joint employers of their franchisees’ employees, courts almost never reached this conclusion upon a franchisor’s motion to dismiss at the pleading stage. As long as the plaintiff sufficiently

³⁰ *Awuah v. Coverall North America, Inc.*, 707 F.Supp.2d 80, 84 (D. Mass. 2010).

³¹ *Patterson v. Domino’s Pizza, LLC*, 333 P.3d 723, 738-739 (Cal. 2014).

alleged a joint employer claim, the courts would allow the case to proceed to discovery. Typically, courts would wait for discovery to be concluded and a record established before dismissing the case on a post-discovery motion for summary judgment.

For example, in *Cordova et al. v. SCCF, Inc.*, the franchisor of Sophie's Cuban Cuisine Restaurants moved to dismiss a complaint alleging that it was the joint employer or a single integrated employer of its franchisees' employees in a putative class action asserting Fair Labor Standards Act and New York State Labor Law violations. The franchisor moved to dismiss the plaintiffs' second amended complaint. However, the Southern District Court of New York denied the franchisor's motion to dismiss, reasoning that:

"The Second Circuit has not yet considered whether a franchisor can qualify as a joint employer, but (the franchisor) cites decisions from other circuits, in which courts, using versions of the economic reality test established by the Supreme Court, have generally concluded that franchisors are not employers within the meaning of the FLSA (citations omitted)... The decisions that (franchisor) cite, however, were all issued on motions for summary judgment after the parties had completed discovery; and the courts found that full records did not support plaintiffs' arguments that the franchisor defendants were Plaintiffs' employers. ... Here, however, there has not been any discovery and the question on this motion practice is whether the allegations pleaded in the (complaint) are sufficient plausibly to state a claim for relief... While it is not far from this juncture that Plaintiffs will need to show that (the franchisor) qualifies as a joint employer, taking the facts in the light most favorable to Plaintiffs, the Court finds that Plaintiffs have plausibly pleaded facts."³²

At summary judgment, franchisors were almost universally successfully in defeating such claims.

III. Things Start to Change.

A. *Browning-Ferris*

As noted above, by the mid-2010's, a fair body of case-law had developed on whether (and under what circumstances) franchisors could be deemed joint employers for purposes of the Fair Labor Standards Act. And that case-law largely rejected attempts to make franchisors liable for their franchisees' wage and hour violations.

But cases claiming that franchisors could be deemed joint employers for purposes of the National Labor Relations Act were outliers. The few cases that addressed such claims seemed to consistently reject the notion that franchisors were joint employers—even where the franchisor allegedly controlled in detail virtually everything the franchisee

³² *Cordova et al. v. SCCF, Inc. et al.*, 2014 WL 3512838 (S.D.N.Y. 2014).

had to do in operating its franchise.³³ The NLRB seemed to recognize that a franchisor has a legitimate need in setting uniform standards to maintain quality and protect the goodwill of the franchise system, and that the mere establishment of these standards would not make a franchisor a joint employer.³⁴ A franchisor crossed the line only if it exercised control over labor relations.³⁵

Why things changed is unclear. When they did is not. Browning-Ferris Industries of California, Inc. (“Browning-Ferris”) operates a recycling plant. Although it has some of its own employees, Browning-Ferris contracts with a third-party (Leadpoint Business Services) to provide the workers that sort through the incoming material and keep the sorting areas clean.

Leadpoint was, by contract, the sole employer of these workers. It had the sole responsibility for hiring, disciplining, reviewing, paying and firing these employees. It also provided their benefits and uninsured payments. Browning-Ferris, however, was not entirely divorced from these activities. Among other things, Browning-Ferris: required that Leadpoint’s workers pass drug tests; limited the number of continuous months they could work at its facility; reserved the right to reject a worker for any reason; required that Leadpoint not pay its employees more than Browning-Ferris paid its own employees for doing the same job; set both the number and length of shifts; and, on occasion, interacted with, supervised, and provided instructions directly to Leadpoint’s workers.

In 2013, a local union filed a petition to represent these workers which claimed that Browning-Ferris was the “joint employer” of Leadpoint’s employees. And some would argue that this level of control supported a finding of joint employment—even under the

³³ See, e.g., *The Southland Corp. d/b/a Speedee 7-Eleven*, 170 NLRB 1332, 1333 (Apr. 12, 1968) (franchisor was not a joint employer despite a policy manual that described “in meticulous detail virtually every action to be taken by the franchisee in the conduct of his store”).

³⁴ See, e.g., *Love’s Barbeque Restaurant*, 245 NLRB 78, 120 (Sept. 20 1979) (franchisor was not a joint employer where franchisees were required to prepare and cook food a certain way because, among other things, the franchisor established these requirements to “keep the quality and good will of [the franchisor’s] name from being eroded”) (internal quotations and citations omitted), *enforcement granted in part and denied in part by Kallmann v. N.L.R.B.*, 640 F.2d 1094 (9th Cir. 1981). The NLRB’s General Counsel continued to adhere to this view—even after *Browning-Ferris Industries of California, Inc. d/b/a BFI Newby Island Recyclery* (“Browning-Ferris”) came out. For example, in his Amicus Brief in *Browning-Ferris*, the NLRB’s General Counsel made clear that “[t]he Board should continue to exempt franchisors from joint-employer status to the extent that their indirect control over employee working conditions is related to their legitimate interest in protecting the quality of their product or brand.” *Amicus Brief of the Gen. Counsel in Browning-Ferris Indus. Of Cal., Inc.*, Case 32-RC-109684. More recently, the NLRB’s General Counsel observed that where a franchisor’s “control over [a franchisee’s] operations are limited to ensuring a standardized product and customer experience,” such “factors clearly do not evince sharing or codetermining matters governing essential terms and conditions of employment.” *Advice Mem. of the NLRB in Nutritionality, Inc. d/b/a Freshii*, Cases 13-CA-134294 *et al.* (April 28, 2015).

³⁵ See *Tilden, S. G., Inc.*, 172 NLRB 752 (1968) (franchisor was not a joint employer even though the franchise agreement dictated “many elements of the business relationship,” because the franchisor did not “exercise direct control over the labor relations of [the franchisee]”).

more restrictive standard that governed at that time.³⁶ But after conducting an evidentiary hearing, the NLRB's Acting Regional Director concluded otherwise. The evidence was insufficient, the Director concluded, "to establish that Browning-Ferris controlled or co-determined those matters governing the essential terms and conditions of the workers' employment, such as wages, benefits, hiring, discipline, termination, daily work responsibilities, and shift schedules."³⁷

The union filed a petition for review. Shortly afterwards, the Board solicited briefing from the parties and interested amici on whether its joint-employer test should be updated.

In 2015, the Board issued its decision, expanding dramatically the circumstances under which an entity could be deemed a joint employer under the NLRA.³⁸ In *Browning-Ferris*, "the Board majority held that, even when two entities have never exercised joint control over essential terms and conditions of employment, and even when any joint control is not direct and immediate, the two entities will still be joint employers based on the mere existence of reserved" joint control, or based on indirect control or control that is limited and routine."³⁹ Although the current Board has argued that these requirements were always part of the joint employer test and rooted in the common-law, that has not always been the NLRB's view. In fact, in 2017 the Board took the position that, prior to *Browning-Ferris*, a determination that an entity was a joint employer could not be made unless that entity: (i) actually "exercised joint control over essential employment terms"—"evidence that an entity had 'reserved' the right to exercise such control would not result in joint employer status"; (ii) exercised control that was "direct and immediate"; and (iii) exercised control that was not limited and routine.⁴⁰

³⁶ The NLRB's General Counsel recently made this point, arguing (in the Statement of Position he filed on February 6, 2023) that the "Board should conclude that BFI's exercise of direct control over Leadpoint employees' essential terms and conditions of employment (supervision, direction of work, hours, and wages), together with the strong evidence of BFI's indirect and reserved control over those and other essential terms and condition of employment (hiring, firing, and discipline), is clearly sufficient to find joint-employer status even under" its prior standards. (A copy of this Statement of Position is available at <file:///C:/Users/leonn/Downloads/Position%20Statement%20to%20the%20Board-BrowningFerris%20Industries%20of.pdf>.)

³⁷ *Browning-Ferris Indus. of Cal., Inc. v. NLRB*, 911 F.3d 1195, 1205 (D.C. Cir. 2018).

³⁸ *Browning-Ferris Indus. of Cal., Inc.*, 362 N.L.R.B. No. 186, at 2 (Aug. 27, 2015).

³⁹ *Hy-Brand Industrial Contractors, Ltd.* 365 NLRB No. 156 (Dec. 14, 2017), *vacated on other grounds*, 366 NLRB No. 26 (Feb. 26, 2018).

⁴⁰ *Hy-Brand*, 365 NLRB No. 156 at nn. 4-6. See also *AT&T v. NLRB*, 67 F.3d 446 (2d Cir. 1995) ("Limited and routine supervision, without an ability to hire, fire, or discipline, cannot justify a finding of joint employer status."); *AM Property Holding Corp.*, 350 N.L.R.B. 998, 1000 (2007) (the Board "does not rely merely on the existence of . . . contractual provisions" to determine whether a joint-employer relationship exists, but "rather looks to the actual practice of the parties").

This expansion of the concept of joint employment had significant repercussions on franchising in particular. According to a study commissioned by the International Franchise Association:⁴¹

- In the four years following the issuance of *Browning-Ferris*, “more than 200 unfair labor practice charges were filed ... alleging a joint employment relationship between a franchisor and its franchisee”—a nearly 50% increase over the number of such charges that were filed in the four years before *Browning-Ferris*.
- Many franchisors withdrew or materially circumscribed the assistance they were providing to their franchisees based on the concern that certain forms of assistance (like training and operational advice) could be deemed indicia of joint employment.
- Litigation claiming that franchisors were joint employers increased exponentially, as many plaintiffs relied on *Browning-Ferris* in pressing the notion that a franchisor should be deemed a joint employer for purposes of the FLSA and state wage and hour laws. This was true even though the NLRB’s joint employment standard is supposed to be “rooted in common-law agency principles, not the economic-realities test used to interpret “employer” for purposes of the Fair Labor Standards Act.”⁴²

B. It’s Alive! – The Various Failed Attempts to Kill *Browning-Ferris*

One of Congress’ primary objectives in enacting the NLRA was to promote stability in labor relations.⁴³ As it concerns the Board’s view on joint employment, it would be difficult to imagine a set of outcomes more inconsistent with that avowed purpose. In fact, the only consistent thing that can be drawn from the NLRB’s approach to joint employment over the last decade is that it has been consistently inconsistent.

1. The *Hy-Brand* Decision

Shortly after the Board issued its decision concluding that *Browning-Ferris* was a joint employer, *Browning-Ferris* filed a petition with the D.C. Circuit Court of Appeals seeking review of that decision. While that petition was pending, the NLRB—newly constituted by the Trump administration—decided to again revisit the joint-employer

⁴¹ See The Economic Impact of an Expanded Joint Employer Standard, available at <https://www.franchise.org/sites/default/files/2019-05/JE%20Econ%20Impact%200128.pdf>.

⁴² See Standard for Determining Joint Employer Status, 88 Fed. Reg. 73946, at 73977 (Oct. 27, 2023) (codified at 29 C.F.R. part 103).

⁴³ See *Colgate-Palmolive-Peet Co. v. NLRB*, 338 U.S. 355, 362–363 (1949) (“To achieve stability of labor relations was the primary objective of Congress in enacting the National Labor Relations Act.”); *NLRB v. Appleton Elec. Co.*, 296 F.2d 202, 206 (7th Cir. 1961) (A “basic policy of the Act [is] to achieve stability of labor relations.”).

question. In *Hy-Brand Industrial Contractors, Ltd.*,⁴⁴ the Board expressly overruled *Browning-Ferris*, concluding that the standard adopted in *Browning-Ferris* “impermissibly exceeded the Board’s statutory authority, misread and departed from prior case law, and subverted traditional common law agency principles.”⁴⁵ According to *Hy-Brand*, “a finding of joint-employer status” would require “proof that the alleged joint-employer entities have actually exercised joint control over essential employment terms (rather than merely having ‘reserved’ the right to exercise control)” and that the control exercised “be ‘direct and immediate’ (rather than indirect).”⁴⁶ Moreover, “joint-employer status will not result from control that is ‘limited and routine.’”⁴⁷ *Id.*

Hy-Brand was welcome news for franchisors. However, it was also short-lived. After *Hy-Brand* came down, the Board asked the Circuit Court of Appeals to remand *Browning-Ferris*'s case to the NLRB for further consideration in light of the new standard. Shortly after remand, the NLRB’s Inspector General determined that one of the members of the *Hy-Brand* panel was a shareholder in one of the law firms involved in *Browning-Ferris*. According to the Inspector General, this fact should have led this member to recuse himself, as “the practical effect of the *Hy-Brand* deliberative process was a ‘do over’ for the *Browning-Ferris* parties.”⁴⁸

Based on the Inspector’s report, the NLRB vacated the *Hy-Brand* decision and announced that “the overruling of the *Browning-Ferris* decision is of no force or effect.”⁴⁹ The NLRB subsequently asked the Circuit Court to recall its remand mandate and resolve *Browning-Ferris*'s petition for review on the merits.

2. The *Browning-Ferris* Review Petition

On May 9, 2018, the NLRB announced it was going to go through a rulemaking process to address the proper standard for joint-employer status. A few months later, on September 14, 2018, the NLRB published its notice of proposed rulemaking which suggested reinstating its prior “direct and immediate control” test for joint-employer status: “[T]o be deemed a joint employer under the proposed regulation, an employer must possess and actually exercise substantial direct and immediate control over the employees’ essential terms and conditions of employment of another employer’s employees in a manner that is not limited and routine.”⁵⁰

⁴⁴ 365 N.L.R.B. No. 156 (Dec. 14, 2017), *vacated by Hy-Brand Industrial Contractors, Ltd.*, 366 N.L.R.B. No. 26 (Feb. 26 2018).

⁴⁵ *Id.*

⁴⁶ *Id.* at 35.

⁴⁷ *Id.*

⁴⁸ See Memorandum of NLRB Inspector General David P. Berry, at 2, 5 (Feb. 9, 2018), available at <https://www.nlr.gov/who-we-are/inspector-general>.

⁴⁹ *Hy-Brand Industrial Contractors, Ltd.*, 366 N.L.R.B. No. 26 (Feb. 26, 2018).

⁵⁰ 83 Fed. Reg. 46681, 46686 (Sept. 14, 2018).

This impending rulemaking process was not, however, a silver bullet for Browning-Ferris. Because it had made clear that any new rule would apply prospectively only, the Board asked the Circuit Court to resolve Browning-Ferris' petitions for review.

Ultimately, on December 28, 2018, the D.C. Circuit Court issued an opinion “affirm[ing] the Board’s articulation of the joint-employer test as including consideration of both an employer’s reserved right to control and its indirect control over employees’ terms and conditions of employment.”⁵¹ However, “[i]n applying the indirect-control factor . . . the Board failed to confine it to indirect control over the essential terms and conditions of the workers’ employment.”⁵² “To inform the joint-employer analysis, the relevant forms of indirect control must be those that share or co-determine those matters governing essential terms and conditions of employment.”⁵³ Because the Board did not confine its consideration of indirect control consistently with common-law limitations, the Court remanded the matter for further proceedings consistent with its opinion.

But that did not happen. Rather, after remand, the Board held it would be “manifestly unjust” to apply the new standard laid out in *Browning-Ferris* to the parties, affirmed the original determination (before full Board review) that Browning-Ferris was *not* a joint employer, and dismissed the General Counsel’s unfair labor practice complaint against Browning-Ferris.⁵⁴ The union petitioned the D.C. Circuit for review of this decision and, on July 29, 2022, the D.C. Circuit again reversed. The court concluded that it would not be “manifestly unjust” for the NLRB to apply the new test for joint-employment to Browning-Ferris because, in its view, “the Board’s precedent on the joint-employer standard was anything but static”—a fact that the NLRB itself recognized when, in 2020, it noted that the Board has “never actually ceased considering indirect and reserved control . . .” The court therefore vacated the Board’s rulings and (again) remanded the matter for further proceeding consistent with its opinion.⁵⁵

3. The 2020 Final Rule

On February 26, 2020, the NLRB issued a new final rule (the “2020 Rule”) that largely rejected the nebulous joint employment test set forth in *Browning-Ferris*. First proposed in 2018, the 2020 Rule—which generated nearly 30,000 comments during the rulemaking process—states that joint-employer status can be found only if an entity exercises “substantial direct and immediate control” over the essential terms and conditions of another company’s employees. A practical ability to exercise that control will not suffice, nor will a contract provision that remains unused. Likewise, the requisite control will not be present if it is exercised only on a sporadic, isolated, or de minimis

⁵¹ *Browning-Ferris Industries of California, Inc. v. National Labor Relations Board*, 911 F.3d 1195, 120 (D.C. Cir. 2018).

⁵² *Id.* at 1209.

⁵³ *Id.* at 1219-20 (internal quotations omitted).

⁵⁴ *Browning-Ferris Indus. of Cal., Inc.*, 369 NLRB No. 139, at *6 (2020).

⁵⁵ *Sanitary Truck Drivers v. NLRB*, 45 F.4th 38, 48 (D.C. Cir. 2022)

basis. And indirect control, while relevant, will not alone support a finding of joint employment.

More importantly, the 2020 Rule provides clear guidance on how the joint employment test is to be applied—which is something the NLRB had never done before, and which it expressly refused to do in enacting its most recent rule.⁵⁶ This guidance is particularly essential for franchise businesses, as it addresses both the risks associated with contract provisions that are commonplace in franchise agreements and with practices that are commonplace in franchising. For example, the 2020 Rule:

- defines what constitutes the “essential terms and conditions of employment” and limits those terms and conditions to eight factors (“wages, benefits, hours of work, hiring, discharge, discipline, supervision, and direction”);
- defines the phrase “substantial control” as “direct and immediate control that has a regular or continuous consequential effect on an essential term or condition of employment”;
- notes that discipline refers to actually making the disciplinary decision, not merely advising the franchisee of an employee’s substandard performance;
- notes that discharge means making the decision to terminate the employment of someone else’s employee;
- provides that control over wages means setting the wage rates;
- provides that control over hours of work means actually determining work schedules, not merely setting operating hours; and
- provides that direction means “assigning particular employees their individual work schedules, positions, and tasks,” not just explaining what type of work needs to be done.

The clarity of this new rule was hailed by the business community in general. But like the *Hy-Brand* decision, the 2020 Rule may be short lived.

IV. The Current Legal Landscape Under the NLRB.

Proving the accuracy of the adage that everything old is new again, the NLRB recently adopted another new joint employment standard that both revives and expands the test laid out in *Browning-Ferris*. Before addressing the impact and status of this new standard, it is important to address the impetus behind its adoption, as doing so is

⁵⁶ Various commenters to the new rule asked the Board to identify specifically the principles it would look to in applying the “common law” principles of agency. It refused to do so, stating that “common-law agency principles [are] sufficiently familiar and tractable to assist parties in interpreting and complying with other labor and employment statutes that use these terms.” 88 Fed. Reg. 73946, at 73958.

essential to understanding why businesses have been (and likely will continue to be) subjected to these alternating inconsistent tests.

A. Understanding the Purpose and Composition of the NLRB

As noted above, the National Labor Relations Act has a limited but significant purpose: to eliminate obstructions to commerce caused by “strikes and other forms of industrial strife or unrest”⁵⁷ by “encouraging the practice and procedure of collective bargaining and by protecting the exercise by workers of full freedom of association, self-organization, and designation of representatives of their own choosing, for the purpose of negotiating the terms and conditions of their employment or other mutual aid or protection.”⁵⁸ In other words, the purpose of the NLRA is to protect workers’ rights to join or form a union.

The NLRB has a similarly limited but significant purpose: “to enforce the National Labor Relations Act.”⁵⁹ Specifically, the NLRB “is an independent federal agency vested with the power to safeguard employees’ rights to organize and to determine whether to have unions as their bargaining representative. The agency also acts to prevent and remedy unfair labor practices committed by private sector employers and unions.”⁶⁰

Of course, how the NLRB goes about accomplishing this purpose and exercising its power depends on the composition of the NLRB itself. The NLRB consists of five members, all of whom are “appointed by the President by and with the advice and consent of the Senate.”⁶¹ Each Board member serves for five years (unless they are filling a vacancy, in which case their term is limited to the unexpired term of the member they are replacing), and may only “be removed [as a member] by the President, upon notice and hearing, for neglect of duty or malfeasance in office, but for no other cause.”⁶²

The effect of this structure is to create an agency whose views are often driven by the party that currently occupies the White House. As administrations change, so does the composition of the NLRB, leading to differing views and approaches on how the NLRA should be interpreted and enforced.

Viewed in this context, the re-incarnation of *Browning-Ferris* is not surprising. President Biden has stated that he considers himself the most pro-union President in U.S. history. In fact, President Biden made his views on *Browning-Ferris* clear before he was elected. This is what then-candidate Biden’s website said in a section entitled “Ensure workers can bargain with the employer that actually holds the power, including

⁵⁷ 29 U.S.C. § 151.

⁵⁸ *Id.*

⁵⁹ See <https://www.nlr.gov/resources/faq/nlr> (last visited on March 1, 2024).

⁶⁰ See <https://www.nlr.gov/about-nlr/what-we-do> (last visited on March 1, 2024).

⁶¹ 29 U.S.C. § 153.

⁶² *Id.*

franchisors, and ensure those employers are accountable for guaranteeing workplace protections”:

During the Obama-Biden Administration, the NLRB issued the landmark *Browning-Ferris Industries* decision. If allowed to stand, this decision would allow unions to collectively bargain with the employer that actually controls their wages, benefits and working conditions — which is often not the staffing agency or the franchisee, but a large corporation or franchisor like McDonald’s. The Trump Administration and Trump’s handpicked NLRB majority proposed reversing this decision. *As president, Biden will enact legislation codifying the Browning-Ferris Industries joint employer definition into law, as called for in the PRO Act, and restoring the broad definition of joint employment to wage and hour law.*⁶³

B. The NLRB’s New Standard—*Browning-Ferris Plus*

Although the PRO Act has not become legislation, the NLRB has sought to implement the *Browning-Ferris* standard (with some significant modifications) through a rule change. On September 6, 2022, the NLRB released a Notice of Proposed Rulemaking (“NPRM”) regarding the standard for determining joint-employer status under the NLRA. According to the NLRB, “[t]he NPRM proposes to rescind and replace the joint-employer rule that took effect on April 27, 2020” (i.e., the 2020 Rule) with a rule that, in the NLRB’s view, is “intended to explicitly ground the joint-employer standard in established common-law agency principles, consistent with Board precedent and guidance that the Board has received from the U.S. Court of Appeals for the DC Circuit.”⁶⁴

Under the proposed rule, two or more employers would be deemed joint employers if they “‘share or codetermine those matters governing employees’ essential terms and conditions of employment,’ such as wages, benefits and other compensation, work and scheduling, hiring and discharge, discipline, workplace health and safety, supervision, assignment, and work rules.”⁶⁵ The NPRM made clear that the NLRB intended to consider “both direct evidence of control and evidence of reserved and/or indirect control over

⁶³ See <https://www.democracyinaction.us/2020/biden/bidenpolicy102519labor.html> ((last visited on March 1, 2024) (emphasis added). The PRO Act, also known as the Protecting the Right to Organize Act of 2021 (H.R.842), is a wide-ranging bill that, among other things, would change the test for worker classification (adopting the ABC test), change the test for joint employment (adopting the *Browning-Ferris* standard) and effectively repeal state right-to-work laws. See <https://www.congress.gov/bill/117th-congress/house-bill/842/committees>. It passed in the House in 2021, largely along party lines, and was referred to the Senate Committee on Health, Education, Labor, and Pensions. It died in Committee. It was reintroduced on February 28, 2023, by Rep. Bobby Scott (D-VA-03) as the Protecting the Right to Organize Act of 2023. It has not passed out of committee.

⁶⁴ See <https://www.nlr.gov/news-outreach/news-story/nlr-issues-notice-of-proposed-rulemaking-on-joint-employer-standard> (last visited on March 1, 2024).

⁶⁵ *Id.*

these essential terms and conditions of employment when analyzing joint-employer status.”⁶⁶

The NPRM generated over 13,000 comments. None, however, seem to have produced any material changes in the NLRB’s intended approach.

On October 26, 2023, the NLRB published its final rule. The new rule replaces (and formally rescinds) the “substantial direct and immediate control” standard that was implemented during the Trump administration and replaces it with a test under which a finding of joint employment hinges on whether the putative joint employer has the power to control “**one or more**” of the employees’ essential terms and conditions of employment.⁶⁷ Under the new rule, the essential terms and conditions of employment are defined as: (1) wages, benefits, and other compensation; (2) hours of work and scheduling; (3) the assignment of duties to be performed; (4) the supervision of the performance of duties; (5) work rules and directions governing the manner, means, and methods of the performance of duties and the grounds for discipline; (6) the tenure of employment, including hiring and discharge; and (7) working conditions related to the safety and health of employees.¹

There are several key takeaways from the new rule:

- The rule permits a finding of joint employment if control exists over just one item from the broad list of essential terms and conditions of employment. In other words, the factor that previously considered the “extent” of control has largely been neutered.
- Joint employment may be found regardless of whether control is actually exercised. What matters to the Board is “the putative employer’s authority to control, without regard to whether or in what manner that control has been exercised.”⁶⁸ Accordingly, if your agreement gives you the authority to control a term and condition of employment, joint employment may be found, even if you did not exercise (and have *never* exercised) that power.
- A finding of joint employment can be predicated on indirect control. Relying on the District of Columbia Circuit’s ruling in *Browning-Ferris Industries v. NLRB*, the Board concluded that the definition of “employer” (as set forth in Section 2(2) of the NLRA) “textually indicates that the statute looks at all probative indicia of employer status, whether exercised `directly or indirectly’” and therefore that the Act “expressly recognizes that agents acting `indirectly’ on behalf of an employer could also count as

⁶⁶ *Id.*

⁶⁷ See Standard for Determining Joint Employer Status, 88 Fed. Reg. 73946 (Oct. 27, 2023) (to be codified at 29 C.F.R. part 103).

⁶⁸ See Standard for Determining Joint Employer Status, 88 Fed. Reg. 73946, at 73950.

employers.”⁶⁹ The Board concluded that this change was needed to address those situations where an entity attempted to avoid being deemed joint employer by using an intermediary to control the essential terms and conditions of employment.

Board Member Kaplan’s dissent to the Final Rule summarized the impact of these changes and why they represent not merely a reincarnation of *Browning-Ferris*, but a significant expansion of the principles set forth in that decision:

“The final rule the majority issues today, concerningly, goes beyond BFI [*Browning-Ferris*] in several ways. BFI went no further than to assert that the “direct and immediate control” standard of pre-BFI precedent is not compelled by the National Labor Relations Act (NLRA or the Act); the majority now claims that it is statutorily impermissible. BFI held that contractually reserved but unexercised control and indirect control are probative of joint-employer status; the majority now makes them dispositive of that status. BFI recognized that “of course,” the “existence, extent, and object of a putative joint employer’s control . . . all may present material issues” in a joint-employer determination; the majority removes the term “extent.” Under their final rule, joint-employer status is established if control exists (even if only potentially or indirectly) and if the object of control is an essential term and condition of employment of another entity’s employees, regardless of the extent of that control. Put differently, the final rule eliminates the second step of the BFI standard, which required the Board to determine whether the extent of a putative joint-employer’s control over the terms and conditions of employment of another business’s employees was sufficient “to permit meaningful collective bargaining.”⁷⁰

C. The Interests of Franchising – Do they Matter?

The final rule offers precious little in terms of guidance for franchisors. In response to comments that the rule failed to “pay adequate heed to franchisors’ need to protect their brands and their trade or service marks,” the NLRB stated only that it was “mindful of franchisors’ need to protect their brands and their trade or service marks,” but “view[ed] the likelihood of conflict [between the rule and these obligations] as minimal under the standard adopted in th[e] final rule”:

Many common steps franchisors take to protect their brands have no connection to essential terms and conditions of employment and therefore are immaterial to the existence of a common-law employment relationship. While we are not inclined to categorically state that all forms of control aimed at protecting a brand are immaterial to the existence of a common-law employment relationship, we stress that many forms of control that franchisors reserve to protect their brands or trade or service marks (like

⁶⁹ *Id.* at 73954.

⁷⁰ *Id.* at 73987 (citations omitted) (Kaplan, M., dissenting).

those dealing with logos, store design or décor, or product uniformity) will typically not be indicative of a common-law employment relationship.

The NLRB gave no guidance on whether other controls inherent in many franchise relationships would be indicative of control over an essential term or condition of employment. This includes, for example, provisions: establishing standardized hours of operation; specifying minimum staffing levels; recommending delivery/service times; requiring and/or providing certain types of training; establishing cleanliness standards; and requiring that employees undergo background checks or drug tests. Likewise, the Board did not address whether such controls would be deemed controls needed to protect a franchisor's brand.

Many in franchising believe that, if this rule becomes effective, it will have the same detrimental impacts on franchising and franchisees as did *Browning-Ferris*.⁷¹ In fact, several constituents raised that issue during the comment period, noting that an expanded and amorphous joint employer stand could cause franchisors either to withdraw support or, alternatively, micro-manage their franchisees' operations.⁷² The International Franchise Association (citing the study it had commissioned) specifically raised the concerns that were incurred in the wake of *Browning-Ferris*.⁷³ The NLRB deemed such concerns irrelevant:

We do not believe that the study provides an appropriate or sufficient basis to abandon our effort to rescind the 2020 rule and promulgate a new joint-employer standard. There is no suggestion in the Act's text or legislative history that the Board has the authority to depart from common-law agency principles in adopting and applying a joint-employer standard because of its predicted effect on a particular industry or industries, irrespective of statutory policy or Congressional intent.⁷⁴

Summing up its view on the issue, the NLRB stated that “[t]he final rule is not based on the Board's assessment of the new standard's effect—negative or positive—on franchise businesses, as that consideration has no clear basis in the Act.”⁷⁵

⁷¹ See, e.g., Franchise Community Urges Action on Joint Employer Rule, Franchise Times (Nov. 3, 2023), available at https://www.franchisetimes.com/franchise_news/franchise-community-urges-action-on-joint-employer-rule/article_209a5050-7a8f-11ee-9285-2f4355a0f353.html; The New Joint Employer Rule Will Crush Franchising As We Know It. Here's What You Can Do to Protect Your Business, Entrepreneur, (Nov. 16, 2023), available at <https://www.entrepreneur.com/franchises/joint-employer-rule-will-crush-franchising-heres-how-to/465517>

⁷² *Id.* at 73978-73979.

⁷³ *Id.* at 73979.

⁷⁴ *Id.*

⁷⁵ *Id.*

D. Where Things Stand Now

If any ray of sunshine may be gleaned from the new rule, it is that whether (and when) the new rule takes effect remains an open issue. The final rule was originally set to take effect on December 26, 2023, but the Board extended the effective date to February 26, 2024.⁷⁶

In anticipation of that date, two different lawsuits were filed challenging the rule—for entirely different reasons. On November 9, 2023, a coalition of organizations including the IFA and the U.S. Chamber of Commerce filed suit against the NLRB and its Commissioners in the United States District Court for the Eastern District of Texas. Claiming that the new rule “displaces widely accepted common-law standards governing the scope of employment relationships, establishes entirely new tests of employer liability, reconfigures relationships among legally separate entities, erases distinctions between contractors and employers, and threatens billions of dollars in liability and costs,” the Texas suit seeks to enjoin the new rule on the ground that it violates the Administrative Procedure Act in that it contravenes the common law and is arbitrary and capricious.⁷⁷

Three days earlier, on November 6, 2023, the Service Employees International Union (“SEIU”) filed a Petition for Review of the Final Rule in the United States Court of Appeals for the D.C. Circuit (Case No. 23-1309) claiming, in substance, that the new rule did not go far enough.⁷⁸ According to the SEIU’s Petition, the NLRB violated the NLRA by failing to include in its list of the essential terms and conditions of employment “all mandatory subjects of collective bargaining.”

A substantial amount of jockeying for position ensued. Right after the D.C. suit was filed, all the plaintiffs in the Texas suit filed a motion to intervene in the that proceeding and, shortly afterwards, a motion to dismiss the Petition for lack of subject matter jurisdiction. The motion claimed the SEIU lacked standing to file the Petition (as it suffered no injury) and that challenges to the NLRB’s rulemaking had to first be heard in the district courts. That motion remains pending.

In Texas meanwhile, the NLRB contended that the court should transfer the suit to the D.C. Circuit because, in its view, challenges to its rulemaking needed to first be heard in the Circuit Courts, not the district courts. The district court denied that motion and proceeded to consider on an expedited basis the parties’ cross-motions for summary judgment.

⁷⁶ The Board extended the effective date after the Government Accountability Office, in response to a Congressional Review Act (“CRA”) resolution, notified the NLRB that it had not followed the CRA required waiting period before implementing the new rule.

⁷⁷ *Chamber of Commerce of the United States of America, et al. v. National Labor Relations Board, et al.*, Case No. 6:23-00553, Dkt. 1 ¶ 2 (U.S. District Court for the Eastern District of Texas).

⁷⁸ *Service Employees International Union v. National Labor Relations Board*, Case No. 23-1309 (D.C. Circuit).

On February 22, 2024, the district court issued an order staying the effective date of the rescission of the 2020 Rule and the date of implementation of the new rule until March 11, 2024. Then, on March 8, 2024, the district court entered a ruling that vacated the NLRB's New Rule. The court held that the NLRB's New Rule was unlawfully overbroad because it "would treat virtually every entity that contracts for labor as a joint employer because virtually every contract for third-party labor has terms that impact, at least indirectly ... essential terms and conditions of employment."

The effect of this ruling is profound. Not only did the court invalidate the New Rule, but it also invalidated the NLRB's rescission of the Trump-era joint employer rule. Whether this ruling holds remains to be seen, as the NLRB has already indicated it plans to appeal the ruling. Further, it remains to be seen whether the D.C. Circuit will address the SEIU's challenge to the New Rule and, if so, the impact (if any) of the district court's ruling..

There is also significant activity on the legislative front. The U.S. House of Representatives recently passed a Congressional Review Act (CRA) resolution overturning the NLRB's expanded joint employer rule. That CRA now heads to the Senate. President Biden has vowed to veto the CRA if it passes the Senate.

V. Misclassification and Joint Employment under the FLSA

Although the developments under the NLRA are significant for franchising, the federal statute that most directly impacts franchisors is the Fair Labor Standards Act. There are two distinct concepts under that statute that can create liability for franchisors: misclassification and joint employment. While these concepts are somewhat related, they address different relationships and have different consequences.

Misclassification within the franchise framework specifically refers to the nature of the relationship between the franchisor and the franchisee. The franchise business model fundamentally asserts that franchisees operate as independent contractors, not employees. This distinction is routinely underscored in franchise agreements, which typically state that the franchisee acts as an independent contractor and that there is no fiduciary, employment, or agency relationship between the franchisee and franchisor. A claim of misclassification seeks to upend these acknowledgements by pressing the notion that the franchisee is not an independent contractor, but an employee. Outside of jurisdictions that employ the ABC test, allegations of misclassification usually revolve around the degree of control exerted by the franchisor over its franchisees.

Conversely, as with the NLRA, a joint employment claim under the FLSA focuses on the connection between the franchisor and the employees of the franchisee, particularly regarding the franchisor's influence over these employees. Under the FLSA, a joint employer scenario exists when each entity alleged to be an employer has authority over the employees' working conditions.

A. The Department of Labor’s Historical Approach to Misclassification

The FLSA does not provide a definition of an independent contractor, and prior to the Trump Administration, the Department of Labor (“DOL” or “the Department”) had not engaged in formal rulemaking to distinguish between employees and independent contractors. Nevertheless, federal judges took the initiative to formulate standards for determining whether a worker is an employee or independent contractor.

Since the 1940s, the standard used in making that determination has focused on the “economic reality” of the relationship between the hiring entity and the worker.⁷⁹ And in analyzing the economic reality of the parties’ relationship for purposes of the FLSA, federal courts have historically looked at six non-exclusive factors. These include: 1) opportunity for profit or loss depending on managerial skill; 2) investments by the worker and the potential employer; 3) degree of permanence of the work relationship; 4) nature and degree of control; 5) extent to which the work performed is an integral part of the potential employer’s business; and 6) skill and initiative.

While courts and the DOL have applied these factors for more than 70 years, they did so inconsistently and disagreed on the relevant weight of certain factors. For this reason, the Trump Administration’s DOL sought to standardize the independent contractor inquiry by adopting a formal rule in 2021 (“2021 IC Rule”).⁸⁰ In January 2021, the DOL adopted a test to determine whether an individual was an employee or independent contractor that prioritized the value of two specific factors when evaluating the relationship between the hiring entity and the worker. These two factors were: 1) the nature and degree of the individual’s control over the work; and 2) the individual’s opportunity for profit or loss.⁸¹ The DOL prioritized these factors as they were historically the “most probative” of a worker’s proper classification.⁸²

Almost immediately after assuming office, the Biden Administration sought to delay the implementation of the 2021 IC Rule.⁸³ The Biden Administration did so based on its belief that the 2021 IC Rule was inconsistent with how courts had, for decades, applied the economic realities test.⁸⁴ Despite the Biden Administration’s efforts to delay the implementation of the 2021 IC Rule, a federal court in Texas ruled that the Biden Administration’s delay in implementing the rule, as well as a total withdrawal of the rule,

⁷⁹ *Bartels v. Birmingham*, 332 U.S. 126, 130 (1947); *United States v. Silk*, 331 U.S. 704, 713 (1947).

⁸⁰ 86 Fed. Reg. 1168.

⁸¹ *Id.* at 1246 (§ 795.105(c)).

⁸² *Id.*

⁸³ 86 Fed. Reg. 12535.

⁸⁴ 87 Fed. Reg. 62218.

were unlawful.⁸⁵ As a result, the 2021 IC Rule remained in effect as the Biden Administration engaged in formal rulemaking to create its own independent contractor distinction. On January 10, 2024, the DOL published its final rule that became effective on March 11, 2024.⁸⁶

B. The Department of Labor’s New Misclassification Standards

1. RIN 1235-AA43: Employee or Independent Contractor Classification under the Fair Labor Standards Act

First and foremost, the DOL’s new rule explicitly replaced the Trump Administration’s independent contractor rule. The DOL did so by concluding that the 2021 IC Rule and its “core factors” approach did not comply with the FLSA’s text and statutory purpose.⁸⁷ Among other things, the DOL contended that the 2021 IC Rule barred courts from considering whether the work performed by the individual was central or important to the employer’s business.⁸⁸

Under the DOL’s new rule, the ultimate inquiry is focused on the worker’s economic dependence on its putative employer.⁸⁹ The DOL has stressed that the FLSA’s definition of “employee” and “employer” were meant to protect all workers who, as a matter of economic reality, are economically dependent on an employer for work.⁹⁰ An independent contractor, on the other hand, is in business for themselves.⁹¹ And the DOL concluded that determining whether a worker is economically dependent on its putative employer depends on evaluating the same six factors federal circuit courts have historically analyzed the FLSA under.⁹² Under the new rule, no single factor is given greater weight or priority over another.

The first factor to consider is whether the worker has an opportunity for profit or loss depending on managerial skill. This inquiry examines whether a worker has opportunities for profit or loss based on managerial skill that affect the worker’s economic success or failure in performing the work.⁹³ The DOL listed relevant facts to consider in

⁸⁵ *Coal. for Workforce Innovation v. Walsh*, No. 1:21–CV–130, 2022 WL 1073346 (E.D. Tex. Mar. 14, 2022), appeal filed, No. 22–40316 (5th Cir. May 13, 2022).

⁸⁶ 89 Fed. Reg. 1638.

⁸⁷ *Id.* at 1639.

⁸⁸ *Id.*

⁸⁹ *Id.* at 1742 (§ 795.105(b)).

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.* at § 795.110(a)(1).

⁹³ *Id.* at § 795.110(b)(1).

addressing this factor, including but not limited to whether: 1) the worker determines or can meaningfully negotiate the charge or pay for the work provided; 2) the worker accepts or declines jobs or chooses the order and/or time in which jobs are performed; or 3) the worker engages in marketing, advertising, or other efforts to expand their business or secure additional work.⁹⁴ If a worker has no opportunity for a profit or a loss, then this factor suggests that the worker is an employee.⁹⁵

The second factor considers investments by the worker and the potential employer. This factor examines whether any investments by a worker are capital or entrepreneurial in nature.⁹⁶ Investments that are capital or entrepreneurial in nature and indicate independent contractor status generally support an independent business and serve a business-like function.⁹⁷ The DOL states that the focus of this comparison should be on comparing the investments of the worker and the hirer to determine whether the worker is making similar types of investments as the potential employer. This would suggest that the worker is operating independently, which would indicate independent contractor status.⁹⁸

The third factor looks at the degree of permanence of the work relationship. This factor weighs in favor of the worker being an employee when the work relationship is indefinite in duration, continuous, or exclusive of work for other employers.⁹⁹ In contrast, this factor weighs in favor of the worker being an independent contractor when the work relationship is definite in duration, non-exclusive, project based, or sporadic based on the worker being in business for themselves and marketing their services or labor to multiple entities.¹⁰⁰

The fourth factor examines an employer's nature and degree of control over the worker.¹⁰¹ Facts relevant to the putative employer's control over the worker include whether the potential employer sets the worker's schedule, supervises the performance of the work, or explicitly limits the worker's ability to work for others.¹⁰² Additional facts relevant to the potential employer's control over the worker include whether the potential

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.* at § 795.110(b)(2).

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.* at § 795.110(b)(3).

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at § 795.110(b)(4).

¹⁰² *Id.*

employer uses technological means to supervise the performance of the work (such as by means of a device or electronically), reserves the right to supervise or discipline workers, or places demands or restrictions on workers that do not allow them to work for others or work when they choose.¹⁰³ Whether the potential employer controls economic aspects of the working relationship should also be considered, including control over prices or rates for services and the marketing of the services or products provided by the worker.¹⁰⁴

The fifth factor considers the extent to which the work performed is an integral part of the potential employer's business.¹⁰⁵ This factor does not depend on whether any individual worker in particular is an integral part of the business. Instead, the focus is on whether the function they perform is an integral part of the business.¹⁰⁶ This factor weighs in favor of the worker being an employee when the work they perform is critical, necessary, or central to the potential employer's principal business.¹⁰⁷ On the other hand, this factor weighs in favor of the worker being an independent contractor when the work they perform is not critical, necessary, or central to the potential employer's principal business.¹⁰⁸

The sixth factor examines the skill and initiative of the worker.¹⁰⁹ This factor indicates employee status where the worker does not use specialized skills in performing the work or where the worker is dependent on training from the potential employer to perform the work.¹¹⁰ The fact that a worker brings specialized skills to the work relationship is not itself indicative of independent contractor status because both employees and independent contractors may be skilled workers.¹¹¹ It is the worker's use of those specialized skills in connection with business-like initiative that indicates that the worker is an independent contractor.¹¹²

Finally, the DOL's new rule opens up the analysis to include "additional factors." The DOL recognized that additional factors may be relevant in determining whether the

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at § 795.110(b)(5).

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at § 795.110(b)(6).

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

worker is an employee or independent contractor if the factors in some way indicate whether the worker is in business for themselves, as opposed to being economically dependent on the potential employer for work.¹¹³

The DOL's new rule states that all factors are to be applied equally, with no single factor to be given predetermined weight over the others. No single factor or group of factors are to be dispositive. The DOL contends that this approach offers required flexibility when applying the FLSA.¹¹⁴

2. The Significance of Not Adopting the ABC Test

In returning to a test that evaluates all six economic reality factors, the DOL explicitly stated in its FAQs that the new rule does not adopt an "ABC test".¹¹⁵ That is significant, because out of the plethora of tests to determine whether a worker is an employee or independent contractor, the ABC test is the most stringent on employers.

Though the prongs of the ABC test may have slightly different phrases depending on the statute or jurisdiction, the ABC test typically provides that a worker is presumptively considered an employee and not an independent contractor unless all three conditions are met: 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 nature that involved the work performed.¹¹⁶

This test makes it incredibly challenging for a company to classify workers as independent contractors. If an employer fails to satisfy even one of the three prongs, the worker will be classified as an employee. As such, the ABC test is problematic for the franchisee and franchisor relationship. Prong B of the ABC test presents the largest challenge to the franchisor-franchisee relationship. To be considered an independent contractor, the entity must perform work that is outside the course of the hiring entity's business. Because franchisors license their trademarks to franchisees, both entities may be determined to be in the same line of business.¹¹⁷ Prong A, which requires independent

¹¹³ *Id.* at § 795.110(b)(7).

¹¹⁴ *Id.* at § 795.110(a)(1).

¹¹⁵ *Frequently Asked Questions - Final Rule: Employee or Independent Contractor Classification Under the FLSA*, DEPT. LABOR <https://www.dol.gov/agencies/whd/flsa/misclassification/rulemaking/faqs> (last visited Feb. 20, 2024)

¹¹⁶ *Dynamex Operations West, Inc. v. Superior Court*, 4 Cal. 5th 903, 955-56 (2018).

¹¹⁷ *See Awuah v. Coverall N. Am., Inc.*, 707 F. Supp. 2d 80, 82-84 (D. Mass. Mar. 23, 2010). The court concluded that Coverall's franchisees were not independent contractors because both entities were engaged in the same course of business – the cleaning business. The court rejected Coverall's attempt to distinguish itself from its franchisees by arguing that it was in the "franchising business" not the cleaning

contractors be free from control and direction from the hiring entity, could also prove problematic. This is because franchisors rely on exerting control and direction over franchisees to ensure consistency in operations and maintain the quality of services provided. As a result, ABC tests make it very challenging for franchisors to prove that franchisees are independent contractors, and the application of a nationwide ABC test could dispose of the historical independent contractor relationship between the two entities.

During the rulemaking process, the DOL considered adopting an ABC style test. However, the Department decided against doing so. The DOL explained that the United State Supreme Court had held that the economic reality test was the applicable standard for determining workers' classification under the FLSA, and the existence of employment relationships under the FLSA does not depend on such isolated factors as the three independently determinative factors in the ABC test.¹¹⁸ The DOL therefore concluded that the ABC test is inconsistent with U.S. Supreme Court precedent and that it could only adopt the ABC test if the Supreme Court revisited its precedent or if Congress passed legislation that altered the applicable analysis under the FLSA.¹¹⁹

The implications of the DOL's decision not to implement the ABC test are significant. Had the DOL adopted an ABC test, franchisors could have been vulnerable to a nationwide standard that could open them up to possible misclassification lawsuits by their own franchisees.

1. Implications of the DOL's New Test for Franchising

The DOL's decision not to implement an ABC test to determine independent contractor status is a win for franchising. Instead of taking a step that could jeopardize the entire makeup of the franchising system, the DOL adhered to the totality of the circumstances test that has historically been applied by federal courts. However, this does not mean that it would be impossible for a court to determine that a franchisee is an employee of a franchisor. Franchisors should analyze their relationships with their franchisees to ensure that the relationship complies with the factors outlined in the DOL's new rule.

Making the wrong choice could have significant ramifications. Entities that incorrectly categorize workers may face penalties and damages for failing to compensate franchisees with minimum wages and overtime. Under the FLSA, misclassified employees might also recover the unpaid wages as liquidated damages, in addition to attorneys' fees. In addition to the FLSA, entities could face damages under state wage-hour laws for neglecting to provide meal and rest breaks, and failing to keep or issue detailed records of work hours and itemized pay statements. It is important to remember

business. Rather, the court determined that Coverall sold cleaning services, which were the same services provided by the franchisees, and thus Coverall failed to satisfy Prong B of the ABC test.

¹¹⁸ *Supra* note 8, at 1660-61.

¹¹⁹ *Id.* at 1661.

that the absence of precise records of hours worked does not preclude a determination of liability. Franchisees could estimate their weekly work hours and claim compensation for missed meal or rest periods. Moreover, franchisees could be eligible for waiting time penalties due to delayed payments.

Furthermore, a franchisee may contend that the franchisor should reimburse them for operational expenses incurred while managing the franchise. For instance, under California Labor Code Section 2802, employees are entitled to reimbursement from their employer for all necessary expenses or losses sustained as a direct result of performing their duties or following the employer's instructions. Utilizing this provision's expansive scope, a franchisee could argue it is entitled to compensation from the franchisor for various expenses, such as office space, supplies, marketing, and payroll.¹²⁰

C. Circuit Court Tests under the FLSA

The true significance of the DOL's new rule remains to be seen. Most federal circuits already have their own legal tests for determining a worker's independent contractor status. Further, the Supreme Court has taken up a case this session where it will reconsider the "Chevron" Doctrine. Thus, the level of deference courts will grant to the DOL's new rule is far from certain. As a result, it is important for franchisors to be mindful of federal circuit court precedent in the states in which they do business.

All the federal circuits that have ruled on the classification of independent contractors have done so under some version of the "economic reality" test. The majority of Circuits conduct this test by analyzing the same six enumerated factors in the DOL's new rule.¹²¹ However, some federal circuits have explicitly excluded from their analysis certain factors. For example, the Fifth and Second Circuits have applied a five-factor test that does not consider the factor of whether the worker has made investments into equipment or materials to perform the specific job.¹²² Ultimately, because federal courts have been dealing with independent contractor classification through their own tests for decades, and given the Supreme Court's signaling that it will part ways, or at very least

¹²⁰ See e.g. *Haitayan v. 7-Eleven, Inc.*, CV 17-7454 DSF (ASx), 2020 WL 1290613, at *5 (C.D. Cal. Feb. 19, 2020) (plaintiff franchisees claimed that defendant 7-Eleven violated Cal. Lab. Code § 2802 by failing to reimburse, among other things, the salaries plaintiffs paid to employees, the costs of maintaining their stores, and "expenses associated with store operational supplies."); *Fleming v. Matco Tools Corp.*, Case No. 19-cv-00463-WHO, 2021 WL 673445, at *13 (N.D. Cal. Feb. 21, 2021) (plaintiff franchisee sought reimbursement from their franchisor under Cal. Lab. Code § 2802 for various expenses including internet service, cell phones, insurance, and franchise fees).

¹²¹ *Martin v. Selker Bros., Inc.*, 949 F.2d 1286, 1293 (3rd Cir. 1991); *Schultz v. Capital Int'l Sec., Inc.*, 466 F.3d 298, 304-05 (4th Cir. 2006); *Keller v. Miri Microsystems LLC*, 781 F.3d 799, 807 (6th Cir. 2015); *Sec'y of Labor v. Lauritzen*, 835 F.2d 1529, 1535 (7th Cir. 1987); *Walsh v. Alpha & Omega USA, Inc.*, 39 F.4th 1078, 1082 (8th Cir. 2022); *Donovan v. Sureway Cleaners*, 656 F.2d 1368, 1370 (9th Cir. 1981); *Baker v. Flint Eng'g & Constr. Co.*, 137 F.3d 1436, 1440 (10th Cir. 1998); *Scantland v. Jeffry Knight, Inc.*, 721 F.3d 1308, 1312 (11th Cir. 2013).

¹²² *Barfield v. N.Y.C. Health & Hosps. Corp.*, 537 F.3d 132, 142 (2d Cir. 2008); *Hopkins v. Cornerstone Am.*, 545 F.3d 338, 343 (5th Cir. 2008).

limit Chevron Deference, federal courts may simply continue to apply their multifactor tests they have already articulated and pay little deference to the DOL's new rule.

VI. SEC Human Capital Management Rule

A. Background on the SEC's Approach to Human Capital Management

In recent years, discourse in support of the relevance of human capital management has increased. Proponents of investments in human capital management argue that companies with effective human capital management perform better than those who poorly manage their human capital, and investing in human capital management can lead to greater measures of profitability such as higher risk-adjusted returns, return on assets, and return on invested capital.¹²³ Following this continued interest in human capital resource disclosures, the United States Securities and Exchange Commission (the "SEC" or "the Commission") has been in the process of modernizing disclosure requirements of publicly traded companies.

On August 26, 2020, the SEC adopted amendments to Regulation S-K ("2020 Amendments"). Specifically, after its August 2020 amendments, the SEC required public companies to include, as a disclosure topic, a description of the registrant's human capital resources to the extent such disclosures would be material to an understanding of the registrant's business.¹²⁴

Despite the efforts of the SEC to modernize disclosure requirements, the 2020 Amendments were not without controversy. The 2020 Amendments were criticized for offering virtually no guidance about what information should be disclosed.¹²⁵ The 2020 Amendments also failed to provide a definition of "human capital."¹²⁶ Thus, the 2020 Amendments were criticized for giving companies vast discretion to determine for themselves what factors could be material to an investor.

Due to what some see as shortcomings in the 2020 Amendments, the SEC has continued to receive pressure from stakeholders to further modernize its disclosure requirements regarding human capital management. Proponents of further rulemaking have pushed for more expansive disclosure requirements. Some stakeholders have asked that the SEC's proposal on human capital management require the disclosure of a company's use of temporary and contract workers, employee turnover data, information

¹²³ Aaron Bernstein and Larry Beferman, *The Materiality of Human Capital to Corporate Financial Performance*, President and Fellows of Harvard College (April 2015); https://lwp.law.harvard.edu/files/lwp/files/final_human_capital_materiality_april_23_2015.pdf

¹²⁴ 85 Fed. Reg. 63726, at 63755.

¹²⁵ Sec. Exch. Comm'n Inv. Advisory Comm., *Recommendation of the SEC Investor Advisory Committee's Investor-as-Owner Subcommittee regarding Human Capital Management Disclosure*, 1 <https://www.sec.gov/files/spotlight/iac/20230921-recommendation-regarding-hcm.pdf>.

¹²⁶ *Id.*

on employee compensation and benefits, workforce health and safety information, and demographic data. Stakeholders argue that this information is necessary to help investors “understand how companies treat their most critical asset – the workers.”¹²⁷

Opponents of increased disclosure requirements of human capital management have perceived the SEC’s efforts to modernize disclosure rules as an effort to influence employment law policy in the United States.¹²⁸ Opponents believe that a potential rule on human capital management disclosures could require publicly traded companies to disclose the number of independent contractors the company uses, which could lead to the SEC’s own independent contractor interpretation.¹²⁹

B. Proposed Human Capital Management Rule

Despite indications that the SEC would be proposing rules on human capital management disclosure in 2023, the SEC’s fall 2023 regulatory agenda indicated that the proposed rule would be delayed until April 2024. Although a proposed rule has been delayed, should the SEC propose a rule on human capital management disclosure, it will undoubtedly require greater disclosure from publicly traded companies.

Hints of greater disclosure requirements can be seen within the SEC’s Investor Advisory Committee (“IAC”). The IAC advises the SEC on a vast number of issues including regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, and on initiatives to protect investor interests and promote investor confidence and the integrity of the securities marketplace.¹³⁰ On September 21, 2023, the IAC approved subcommittee recommendations to expand required human capital management disclosures.

The IAC requested that the SEC strengthen the disclosure requirements under current Item 101(c) under Regulation S-K by requiring the disclosure of four separate human capital metrics. First, the IAC recommended that the SEC require employers to disclose the number of people employed by the company, broken down by whether the employees are full-time, part-time, or contingent workers.¹³¹ Second, the IAC

¹²⁷ Press Release, U.S. Senator Sherrod Brown and U.S. Senator Mark Warner, Brown, Warner Press Sec To Act On Workforce Management Disclosure (Dec. 14, 2023) <https://www.brown.senate.gov/newsroom/press/release/brown-warner-press-sec-to-act-on-workforce-management-disclosure>.

¹²⁸ Letter from Senator Pat Toomy & Senator Richard Burr & Senator Mike Crapo & Senator Mike Braun, to Gary Gensler (Feb. 28, 2022) https://www.braun.senate.gov/wp-content/uploads/files/2022-03/SEC_Employment_%20FINAL_2282022.pdf.

¹²⁹ *Id.*

¹³⁰ Investor Advisory Committee, SEC. EXCH. COMM’N <https://www.sec.gov/about/advisory-committees/investor-advisory-committee>.

¹³¹ *Supra* note 46, at 9.

recommended that the SEC require employers to disclose turnover or comparable workforce stability metrics.¹³²

Third, the IAC recommended that the SEC require companies to disclose the total cost of their workforce, broken down into major components of compensation.¹³³ Finally, the IAC recommended that the SEC require companies to disclose workforce demographic data sufficient to allow investors to understand the company's efforts to access and develop new sources of talent, and to evaluate the effectiveness of these efforts.¹³⁴ While certainly not the final rule, the IAC recommendations provide a window into the mind of the SEC and could likely play a prominent framework in the SEC's proposed rule.

C. Impact on Publicly Traded Franchisors

To the extent they are not already doing so, publicly traded franchisors should prepare to disclose greater information about their human capital. Should the SEC adopt a rule similar to the recommendations proposed by the IAC, publicly traded franchisors will have to expand their disclosure areas. Franchisors should review the current human capital disclosures they are making pursuant to their obligations after the SEC's 2020 Amendments in light of the newly proposed IAC recommendations.

VII. Where Are Things Going

If the inconsistent approaches to misclassification and joint employment taken by the past three administrations teach us anything, it is that it is impossible to know what the law in these areas will look like even a year from now. In fact, just a few weeks before the final version of this paper went to publication, the same federal court in Texas discussed above declared that the test for joint employment set forth in the NLRB's new 2023 joint employer rule was contrary to the NLRA. In *Chamber of Commerce et. al. v. National Labor Relations Board, et. al.*, the district court held that those provisions of the rule which made indirect or reserved control over working conditions sufficient to establish joint employer status violated the NLRA, as they were broader than the common-law test for employment codified in the Act. The court also had issued with the second part of the test under the new rule—which looks at whether an entity controls various working conditions—because it was likely broader than the first part of the test. The court concluded that because this part of the test failed to articulate a comprehensible standard, it was likely arbitrary and capricious. Finally, the court vacated the NLRB's vacatur of the 2020 rule, which now remains in effect.

¹³² *Id.* at 10.

¹³³ *Id.* at 11.

¹³⁴ *Id.* at 12.

More recently, on April 7, 2024, the Senate approved a Congressional Review Act resolution, which blocked the NLRB's new rule.

Where things go next-is anyone's guess. President Biden has promised to veto the CRA, and the NLRB has vowed to appeal the ruling striking down its new rule. And as mentioned above, there is parallel litigation right now in the District of Columbia Circuit Court which challenges the same rule that has now twice been struck down.
