

July 12, 2012

Who's in Charge Here? Recent Decision May Cause Headaches for California Franchisors

By Christopher Cobey and Adam Rosenthal

California is the birthplace of the franchise business model. Today, there are approximately 62,000 independent franchisees operating in California, employing more than 1.1 million state residents.

Historically, franchisors have not been liable for employment claims brought by a franchisee's employees. However, a recent decision by a California Court of Appeal may encourage disgruntled employees who work for a franchisee to sue both the franchisee as well as the "deep pockets" franchisor as co-defendants in employment lawsuits. In *Patterson v. Domino's Pizza, LLC*, 2012 Cal. App. LEXIS 753 (June 27, 2012), a California Court of Appeal reversed summary judgment in favor of the defendant franchisor on the grounds that triable issues of material fact existed as to whether the franchisor had sufficient "control" over the franchisee to find the franchisor liable in a sexual harassment lawsuit brought by a franchisee's former employee. *Patterson* offers several important lessons to companies that operate through independent franchisees in the Golden State.

The Trial Court's Decision

The lawsuit was filed by a then-16-year-old girl who worked for a Domino's Pizza franchisee (the "franchisee") and claimed that she was sexually harassed and assaulted by the franchisee's assistant manager. After resigning from her job, she filed a lawsuit against the assistant manager, the franchisee, and Domino's Pizza, LLC (the "franchisor") in its capacity as the franchisor. Early in the course of litigation, the franchisee filed for bankruptcy protection, leaving the franchisor as the only solvent defendant.

During discovery, the owner of the franchisee testified that an employee working for the franchisor as the "area leader" instructed the franchisee to terminate the assistant manager and at least one other employee. The owner also testified that he had to comply with the area leader's demands on personnel matters, or risk being "out of business very quickly."

The franchisor filed a motion for summary judgment, arguing that it could not be liable to the plaintiff because: (1) the franchisee was an independent contractor pursuant to the written franchisee agreement; and (2) there was no principal-agent relationship between itself and the franchisee. The trial court held that the franchisee was an independent contractor, and thus the franchisor could not be vicariously liable for plaintiff's wrongful termination claims.

The Court of Appeal's Ruling

A California Court of Appeal reversed the trial court's order in its entirety. The court held that, for the purpose of summary judgment, there was sufficient evidence that the franchisor exercised "substantial control" over the franchisee, and thus could be vicariously liable on the plaintiff's employment claims. In reaching this conclusion, the court relied on two sets of facts: (1) the franchisor's day-to-day control over the franchisee as set forth in the franchise agreement; and (2) the franchisor's significant involvement in the franchisee's personnel decisions.

Day-to-Day Control over the Franchisee's Employees and Business

The franchisor argued that, pursuant to the franchise agreement, it could not be deemed the "employer" of the franchisee's employees. According to the franchise agreement, the franchisee was "responsible for recruiting, hiring, training, scheduling for work, supervising and paying the persons who work in the Store and those personnel [were the franchisee's] employees and not [the franchisor's] agents or employees."

The appellate court dismissed the franchisor's argument, noting that, "for the purpose of a summary judgment motion, a franchisor's actions speak louder than words in the franchise agreement." In concluding that the franchise agreement was not dispositive, the court relied on the following "evidence" that the franchisor exerted "complete or substantial control" over its franchisees' employees, including that the franchisor:

- Establishes the "qualifications" and "demeanor" required of a franchisee's employees, including grooming standards and the specific types of jewelry and undergarments that could be worn by a franchisee's employees.
- Mandates that before a franchisee's employee is permitted to run a store, the franchisee must disclose the employee's identity to the franchisor.
- Dictates the types of training in which a franchisee's employee must participate.
- Establishes specific hiring requirements and mandates the types of documents that must be included in a personnel file.

The court also questioned the franchisor's assertion that, under the franchise agreement, the franchisee has the freedom to conduct its "own independent business." The court cited what it considered evidence of "control," finding that the franchisor:

- Maintains "independent access" to a franchisee's financial data and has the right to audit a franchisee's tax returns and financial statements.
- Sets the franchisee's store hours, advertising, handling of customer complaints, signage, equipment, décor, and the "method and manner of payment" by customers.
- Regulates the pricing of items at the counter and for home delivery and establishes standards for liability insurance.
- Determines the book and record keeping methods.
- Sends inspectors to monitor operations.
- Controls whether the franchisee may be engaged in other business activities.
- Requires weekly sales reports.
- Establishes "minimum guidelines" for the operation of the unit (e.g., bank deposit procedures, closing procedures, security, delivery staffing, and literature allowed in the store).

Based on the above evidence, the court found a "reasonable inference" supporting the plaintiff's claim that the franchisee was not an independent contractor.

Involvement in Personnel Decisions

The court aptly held that, under California law, to find that a franchisor is vicariously liable for a franchisee's actions, courts must "look to the totality of the circumstances to determine who actually exercises the ultimate control."

Addressing that test, the franchisor argued that the evidence supported affirming summary judgment because: (1) the franchisee made all of the employment decisions for the unit; (2) the franchisor did not discipline employees; and (3) the owner of the franchisee made the independent decision to terminate the assistant manager. In response, the plaintiff argued that the evidence created a material dispute as to whether: (1) the franchisor exercised extensive control over the franchisee; (2) the franchisor controlled employee conduct and discipline; and (3) the franchisor's area leader made personnel decisions, including the order to terminate the unit's assistant manager.

In siding with the plaintiff, the court relied on the testimony of the owner of the now-bankrupt franchisee, who testified that he had virtually no independent control over his business. In addition, the court relied heavily on the testimony that the franchisor's area leader ordered the franchisee to terminate certain employees or, in the franchisee's opinion, risk losing the right to operate the franchise. While the court acknowledged the franchisor's contrary evidence, for the purpose of summary judgment, the court held that there was a triable issue of fact with regard to whether or not the franchisee lacked local control over its operations.

Five Steps Franchisors Can Take to Help Prevent Claims by a Franchisee's Employees

Although the court in *Patterson* departed from many decisions that have considered the relationship between franchisors and franchisees and found that the franchisor was *not* vicariously liable for the franchisee's employment claims.¹ *Patterson* is a cautionary reminder to franchisors that want to avoid claims by their franchisee's employees.

1. Revise the franchise agreement

While franchise agreements typically specify that the franchisee is responsible for all personnel decisions, if there is any ambiguity on this issue, it is important to rectify it immediately, by including text such as, "Franchisee will have sole responsibility for the hiring, day-to-day management, evaluation, discipline, and termination of its employees."

2. Do not interfere with a franchisee's personnel decisions and policies

No matter how tempting it may be, franchisors should refrain from involving themselves with a franchisee's personnel decisions. Franchisors should remind their employees who are in regular contact with franchisees (e.g., area managers) that they are not to consult with or comment on personnel decisions. If during a routine visit a franchisor's representative observes conduct by a franchisee's employees that raises concerns (e.g., theft, harassment, etc.), instead of reprimanding the employee directly, the franchisor's representative should merely report what is observed, but refrain from making comments or suggestions about how to handle the situation.

3. Build a "wall" between the franchisor and the services offered to franchisees

Franchisors often either require or provide franchisees with the option of using certain shared business services at a reduced price (e.g., payroll, point of sale software, ordering, etc.). *Patterson* appears to suggest that some of these services may be considered, at least cumulatively, as evidence of a franchisor's "control." To prevent such a finding, franchisors may want to consolidate all of these ministerial services into a separate entity that directly markets to and/or manages for the franchisees. If such an arrangement is not feasible, franchisors should, at the very least, notify franchisees who use a common payroll service that any discrepancy or concerns they have with payroll calculations should be immediately brought to the franchisor's attention, with a reminder that the franchisor is not responsible for determining the validity or accuracy of the payroll information provided by the franchisee.

4. Review policies and practices to avoid evidence of control over personnel decisions

In addition to reviewing the franchise agreement, franchisors should also review their policies and practices to avoid inferences of "control" over a franchisee's employees. For example, if the franchisor maintains a telephone hotline for franchisee employees to lodge complaints against a franchisee, it may be wise to either discontinue the hotline, or at least remind callers that the franchisor takes no responsibility over any employment issues within the individual franchise, and that the purpose of the hotline is to pass on complaints directly to the owner of the franchisee.

¹ See, e.g., *Laird v. Capital Cities/ABC Inc.*, 68 Cal. App. 4th 727 (1998), *Singh v. 7-Eleven, Inc.*, 2007 U.S. Dist. LEXIS 16677 (N.D. Cal. Mar. 8, 2007); and *Ruiz v. Sysco Corp.*, 2011 U.S. Dist. LEXIS 84502 (S.D. Cal. July 29, 2011).

5. Stay on top of this issue

Patterson is an important reminder that some courts may be inclined to bring a franchisor into a lawsuit, especially where – as in Patterson – the franchisor is the only defendant with the resources to provide a remedy to an injured employee. To forestall this result, franchisors must train their employees to avoid situations that would suggest day-to-day involvement in local personnel decisions.

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