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Employer Update

Claims Against Franchisors As Alleged "Employers"

By Jeffrey S. Klein, Nicholas J. Pappas, and Sarah Martin

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Government agencies increasingly are prosecuting enforcement actions against franchisors under federal labor and employment laws, claiming that they are employers of their franchisees' employees.[1] For example, in July 2014 the National Labor Relations Board ("NLRB") announced that it had authorized forty-three cases against franchisor McDonald's USA, LLC for alleged labor violations by its franchisees, including alleged failure to pay overtime, failure to provide required breaks and layoffs related to union organizing activity.[2] In a press release, the NLRB stated that if it cannot reach a settlement with McDonald's, it will issue complaints and name McDonald's as a so-called "joint-employer" of employees of its franchisees. A "joint-employer" relationship may exist where two companies are in a contractual relationship, and one company (e.g., the franchisor) has retained control over the terms and conditions of employment for employees of the other company (e.g., the franchisee).[3]

Separately, in an amicus brief filed with the NLRB, the NLRB's general counsel recently has advocated a return to the NLRB's pre-1984 interpretation of the National Labor Relations Act ("NLRA").[4] Under the pre-1984 interpretation of the NLRA, a franchisor qualifies as an employer even if it exercised only "indirect control" over working conditions. Under the "indirect-control" standard, the NLRB found relatively minimal control, such as making recommendations to a supplier firm during the collective bargaining process or retaining the contractual right to engage in "general supervision" of employees, to be indicative of joint employer status.[5] Although the NLRB has adhered to a more franchisor-friendly standard over the past twenty years, the general counsel's brief now argues that the NLRB must return to its previous approach in order to effectuate the purposes of the NLRA, including the facilitation of collective bargaining.[6] The NLRB's new position indicates that franchisors should prepare to defend themselves against union organizing claims alleged by their franchisees' employees.

In addition to the suits that the NLRB may pursue, McDonald's faces private suits in seven actions pending in three states. In these cases, twenty-seven named plaintiffs, who purport to represent tens of thousands of McDonald's employees, argue that courts should hold McDonald's responsible for its franchisees' alleged wage and hour violations.[7]

In this article, we analyze franchisors' defenses to claims by franchisee employees under the Fair Labor Standards Act ("FLSA").[8] We will analyze some recent cases which illustrate the steps franchisors may take to protect themselves against claims by franchisee employees.

Test For Employer Status

Under the FLSA, an "employer" includes "any person acting directly or indirectly in the interest of an employer in relation to an employee." When an employee sues a franchisor under the FLSA, the court must determine whether the franchisor falls within the statutory definition of an "employer."

Courts and administrative agencies have adopted a number of legal theories to determine whether a franchisor qualifies as an "employer" of the franchisees' employees. Courts use labels such as "joint employer," "single employer," or other names when analyzing claims against franchisors.[9] Each test for employer status differs slightly from the others,[10] and courts frequently apply several theories or blur the distinctions between them.[11] However, courts frequently focus upon the extent to which the franchisor controls the terms and conditions of employment of the franchisees' employees as the primary factor which determines whether a franchisor will be amenable to suit.[12]

In this article, we focus on the "joint-employer" test. As discussed above, a so-called "joint-employer" relationship exists, notwithstanding that the franchisor and the franchisee are two separate legal entities, in circumstances where the franchisor has "retained for itself sufficient control of the terms and conditions of employment of the employees who are employed by the [franchisee]."[13] Courts focus on the degree of control a franchisor exercises over employment policies, and the extent to which it supervises employees' day-to-day activities. Courts also cite a franchisor's authority to hire and fire employees and to administer employee training programs as evidence of a franchisor's joint-employer status.

FLSA Suits Against Franchisors

Two opinions from this year illustrate the manner in which courts have assessed whether an employee can sue a franchisor as an "employer" under the FLSA. In *Olvera v. Bareburger Group, LLC*, 2014 WL 3388649, at *6 (S.D.N.Y. July 10, 2014), a federal district court in New York denied a motion to dismiss by franchisors of FLSA claims brought by franchisee employees. The plaintiffs in *Olvera* alleged that Bareburger Group, LLC and three related franchisor defendants guided their franchisees on how to hire and train employees, set and enforced operational requirements, and monitored employee performance. The Bareburger employees also claimed that the franchisors specified methods and procedures for preparing food, exercised control over the work of employees, required franchisees to keep records of hours and wages, and exercised control over timekeeping and payroll practices. The court determined that if the plaintiffs could prove these practices, the franchisors would constitute employers under the FLSA. Similarly, in *Cordova v. SCCF, Inc.*, 2014 WL 3512838 (S.D.N.Y. July 16, 2014) the same court held that franchisees' employees could sue a franchisor for alleged wage and hour violations if the franchisor created management and operation policies and practices, provided materials for monitoring employee performance, and had authority to exercise control over employee records.

A federal circuit court case decided this year illustrates that employees will not succeed in FLSA claims against franchisors when they are unable to show that the franchisor actually controlled terms and conditions of employment. In *Orozco v. Plackis*, 757 F.3d 445, 452 (5th Cir. 2014), a restaurant cook, Benjamin Orozco, working at a franchisee restaurant (Craig O's) sued the franchisor's owner Craig Plackis, claiming that he had not been paid minimum wage or overtime to which he was entitled under the FLSA. Plackis gave the franchisee advice regarding general operations, including profitability, menu changes, vendor contracts and advertising. The record contained evidence showing that after meeting with Plackis, the franchisee made changes to employee work schedules or conditions of employment.

The case proceeded to trial, where the jury returned a verdict in favor of the cook. Plackis moved for judgment as a matter of law under Rule 50 of the Federal Rules of Civil Procedure, arguing that the cook had not submitted sufficient evidence from which the jury could reasonably have found that Plackis was the cook's employer. On appeal from the denial of the Rule 50 motion, the appeals court reversed. The court held that the jury could not reasonably have concluded that Plackis actually had authority over key elements of the employment relationship, including hiring and firing decisions, supervision, work schedules, conditions of employment, or the rate and method of payment.

Franchisors wishing to minimize exposure to joint employer claims from employees should look carefully at both their franchise agreements and their daily practices, with the objective of maximizing franchisee control over terms and conditions of employment.

The court did not consider Plackis's advice to the franchisee to be evidence of control over working conditions. Plackis's advice, followed by the franchisee's implementation of his suggested changes, did not establish that Plackis actually had the right to require the franchisee to abide by his recommendations. Similarly, Plackis's review of employee schedules did not establish that he had control over scheduling.

Practical Considerations

Franchisors wishing to minimize exposure to joint employer claims from employees should look carefully at both their franchise agreements and their daily practices, with the objective of maximizing franchisee control over terms and conditions of employment. For example, franchisors may consider giving franchisees full control over hiring decisions, employee benefits, wages and scheduling. Franchisors also may wish to confirm that franchisees retain the responsibility for training their employees, particularly if such training relates to employee relations and compliance with anti-discrimination laws.

Some franchisors may nevertheless negotiate the right to exercise more control over their franchisees. Franchisors who retain such control or influence over terms and conditions of employment—such as employee training, hiring, scheduling or payroll—should understand that they are thereby increasing the risk that a court might find that they have become "joint employers," and, therefore, may face claims based on alleged violations of the various employment laws.

Another way for franchisors to reduce the risk of being found to be joint employers is to include a provision in their franchise agreements stating that franchising decisions are based solely on the franchisees' conformity to specified quality standards. Franchise agreements may be re-written to establish that all suggestions made by the franchisor which are not related to such standards are entirely optional.

Franchisors can reduce their exposure to financial loss by requiring franchisees to maintain insurance policies covering employment discrimination claims, and by including both broad and specific indemnification provisions in their franchise agreements. Indemnification provisions may cover all claims of third parties (including employees) arising out of the operation of the franchise. While courts in many states may not enforce indemnification provisions if there is a judicial finding that the indemnitee actually engaged in intentional discrimination, franchisors may rely on indemnification provisions for payment of their defense costs and/or payment of judgments for claims of vicarious liability, unintentional discrimination or non-meritorious claims of intentional discrimination.[14] Franchise agreements also may state that a franchisee may not interpret any policy as preventing it from complying with federal, state or local law.

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1. Steven Greenhouse, *McDonalds Ruling Could Open Door for Unions*, N.Y. Times, July 29, 2014, available at

http://www.nytimes.com/2014/07/30/business/nlrb-holds-mcdonalds-not-just-franchisees-liable-for-worker-treatment.html?_r=1; Julie Jargon, *McDonalds Ruling Sets Ominous Tone for Franchisers*, Wall Street Journal, July 29, 2014, available at http://online.wsj.com/articles/nlrb-decision-could-make-mcdonalds-liable-for-labor-practices-of-franchisees-1406660591.

2. Nat'l Labor Relations Bd. Office of Public Affairs, *NLRB Office of the General Counsel Authorizes Complaints Against McDonald's Franchisees and Determines McDonald's, USA, LLC is a Joint Employer*, July 29, 2014, available at http://www.nlrb.gov/news-outreach/news-story/nlrb-office-general-counsel-authorizes-complaints-against-mcdonalds; Jargon, *supra* note 1.

3. *Myers v. Garfield & Johnson Enterprises, Inc.*, 679 F. Supp. 2d 598, 607 (E.D. Pa. 2010) (quoting *N.L.R.B. v. Browning-Ferris Indus. of Pennsylvania, Inc.*, 691 F.2d 1117, 1123 (3d Cir. 1982)).

4. Amicus Brief of the General Counsel, Browning-Ferris Industries of Cal., Case No. 32-RC-109684, slip op. at 17 (N.L.R.B. June 26, 2014).

5. *Id.* at 6-7 (citing *U.S. Pipe & Foundry Co.*, 247 NLRB 139, 140 (1980); *Jewel Tea Co.*, 162 NLRB 508, 509-10 (1966)).

6. *Id.* at 22-23.

7. Jargon, *supra* note 1; Steven Greenhouse, *McDonald's Workers File Wage Suits in 3 States*, N.Y. Times, Mar. 13, 2014, available at http://www.nytimes.com/2014/03/14/business/mcdonalds-workers-in-three-states-file-suits-claiming-underpayment.html?_r=0.

8. 29 U.S.C. §201, et.seq.

9. *See, e.g., Myers v. Garfield & Johnson Enterprises, Inc.*, 679 F. Supp. 2d 598, 605 (E.D. Pa. 2010) (discussing single-employer and joint-employer liability); *Latuga v. Hooters*, 1996 WL 164427, at *7 (N.D. Ill. Mar. 29, 1996) (holding that various Hooters franchisor and franchisee entities were so inter-related as to be a single employer for purposes of Title VII).

10. While some courts use traditional common law agency theories others apply the "instrumentality test," which looks at whether the franchisor controls the specific instrumentality of the harm alleged. *See, e.g., Papa John's Int'l, Inc. v. McCoy*, 244 S.W.3d 44, 47 (Ky. 2008); *Wendy Hong Wu v. Dunkin' Donuts, Inc.*, F. Supp. 2d 83, 93-94 (E.D.N.Y. 2000) *aff'd sub nom. Wu v. Dunkin' Donuts, Inc.*, 4 F. App'x 82 (2d Cir. 2001).

11. *See, e.g., Hatcher v. Augustus*, 956 F. Supp. 387, 390 (E.D.N.Y. 1997) (employing a "hybrid test" that relies on a list of nine non-exhaustive factors); *McLaurin v. Fusco*, 629 F. Supp. 2d 657, 659-60 (S.D. Miss. 2009) (explaining the "hybrid test").

12. *See, e.g., Patterson v. Domino's Pizza, LLC*, S204543, 2014 WL 4236175, at *17-19 (Cal. Aug. 28, 2014) (holding that franchisor was not liable for sexual harassment by franchisee's employee when the franchisee was solely responsible for hiring and training employees and lacked contractual authority to manage the behavior of the franchisee's employees); *Singh v. 7-Eleven, Inc.*, 2007 WL 715488, at *4-6 (N.D. Cal. Mar. 8, 2007) (holding that franchisor was not liable for alleged FLSA violations when it did not have the power to hire and fire employees or to determine work schedules or rates and methods of payment).

13. *Myers v. Garfield & Johnson Enterprises, Inc.*, 679 F. Supp. 2d 598, 607 (E.D. Pa. 2010) (quoting *N.L.R.B. v. Browning-Ferris Indus. of Pennsylvania, Inc.*, 691 F.2d 1117, 1123 (3d Cir. 1982)).

14. Jeffrey S. Klein and Nicholas J. Pappas, *Insuring Against Job Discrimination Claims*, N.Y. L. J., Apr. 1, 1996, at 1.

Post-Contractual Non-Compete Covenants Under German Law

By Stephan Grauke, Mareike Pfeiffer and Johannes Allmendinger

Many companies negotiate post-contractual non-compete clauses with their management and other key personnel in order to protect their business interests. This is an issue that is also of relevance in the context of M&A. Compared to the U.S. and a number of other European countries, the legal requirements in Germany for such covenants are rather strict. In particular, employers must be aware that compensation amounting to at least 50% of an individual's most recent total remuneration must be agreed upon for the term of the post-contractual non-compete restriction and that the term of such restrictions must not extend beyond a period of two years. As employers run the risk that the non-compete agreements will not be enforceable if these requirements are not met, restrictive covenants must be carefully drafted. Furthermore, given the remarkable costs of a post-contractual non-compete covenant, employers should evaluate in every case whether non-compete restrictions are necessary to safeguard the interests of the firm.

Under German law, the legitimate scope of non-compete covenants varies slightly depending on the individual who is to be restricted by the covenant. If the restrictions apply to employees (including executive employees), the statutory requirements set forth by Sec. 74 *et seq* German Commercial Code (*Handelsgesetzbuch*) apply. In contrast, these provisions do not apply to board members and managing directors, as those individuals are generally not considered to be "employees."

Non-Compete Agreements With Employees

The requirements for non-compete agreements with employees are essentially as follows:

- The agreement must be made in writing.
- Non-compete clauses must reflect legitimate business interests of the company (*e.g.*, protection of company know-how, customer details and other sensitive information), and these clauses must not unreasonably hinder the employee in his or her professional advancement.
- The prohibition may not be extended beyond a period of two years following the termination of the employment relationship.
- The covenant must not extend beyond the geographic area in which the employee is active.
- The employer needs to provide compensation equivalent to at least 50% of the employee's most recent overall remuneration (including fixed salary, variable compensation and fringe benefits) to be paid during the term of the covenant.

For practical reasons, non-compete covenants should be negotiated by the parties when entering into the respective employment relationship, *e.g.*, by including a corresponding clause in the employment agreement. Although it is legally possible to negotiate post-contractual restrictions during an ongoing employment relationship, it is often difficult to obtain the employee's consent once it becomes important for the company to have the employee sign a non-compete clause.

Compared to the U.S. and a number of other European countries, the legal requirements in Germany for post-contractual non-competition covenants are rather strict.

Regarding the scope of the covenant, there is – unfortunately – no "one-size-fits-all" solution. Instead, each covenant, in particular its factual and geographical scope, must be tailored to the circumstances of the individual case at hand. As a general rule, a close link between an employee's position and professional activities, and the scope of the post-contractual non-compete restriction is required. Therefore, if an employee only serves a certain part or division of a company or only within a certain territory, it may be unlawful to extend the scope of the non-compete clause to the entire business of the firm or to competing activities worldwide, while in the case of executive employees, the legitimate scope may be broader. Similarly, a term less than two years must be agreed upon if the maximum period of two years is not necessary to protect legitimate business interests or if the maximum term would unreasonably impede the employee's professional career and ability to earn a living. Employers should note that the scope of any covenant is only binding and enforceable against the employee to the extent the statutory requirements are met. If non-compete restrictions exceed the permitted scope, the scope of the covenant, by operation of law, is, in general, automatically reduced to the scope permitted by law in maximum.

Under German law, non-compete compensation for employees must be at least 50% of the employee's most recent overall remuneration and the term of the post-contractual non-compete restriction must not extend beyond two years.

When calculating the compensation, all elements of the employee's remuneration, including bonus payments, allowances and non-cash benefits (*e.g.*, a company car available for private use), must be taken into account, not just the most recent fixed salary amounts. On the other hand, the mere reimbursement of expenses or payments made with respect to employee inventions do not have to be considered. Where the contractual remuneration consists of variable payments, the average of such remuneration received over the last three years shall be the basis of the calculation of the non-compete compensation. However, the employee must allow any sums that he or she earns through capitalization of his or her work capacity elsewhere or that he or she maliciously fails to earn to be deducted from the compensation due if the non-compete compensation plus these earnings would exceed the most recent contractual remuneration by more than 10% (or more than 25% if the employee was forced to change his or her residence to find work). In case the amount of compensation agreed by the parties is too low, the covenant will be non-binding for the employee. As a consequence, in this case, the employee may choose to adhere to the covenant and claim the compensation (it is controversial whether the amount illegally agreed upon between the parties or the statutory minimum amount can be claimed) or to compete. In any case, the employer is bound by the decision of the employee and can, in particular, not enforce the post-contractual non-compete obligation against the will of the employee.

Should the company wish to withdraw from the covenant, it may agree with the employee to annul the mutual obligations under the non-compete clause. In practice, such an agreement may be part of a termination agreement or a court settlement for instance. Alternatively, if an agreement with the employee cannot be reached, the employer, prior to the end of the employment relationship, may also unilaterally waive the prohibition in writing. The downside of a waiver, however, is that the employer will only be released from the obligation to compensate the employee as of one year following the date of the declaration, while the employee will be free to engage in competing activities immediately(however, not before the end of the employment relationship). As a consequence, in case an employer realizes that post-contractual competition by the employee is not likely to harm the company's interests, the non-compete covenant should be waived as soon as possible.

In case of non-compliance with the non-compete restrictions, the employer may seek injunctive relief. In addition, damages that arise from any violation of the covenant may be claimed. However, since in practice it is often difficult to provide evidence for the occurrence of specific damage, non-compete covenants should generally be backed up by a contractual penalty. Like the non-compete covenant itself, a penalty clause should be drafted carefully to avoid the risk that the clause cannot be enforced against the employee. There is the potential, for instance, that a court may consider contractual penalties equal to more than three months' salary invalid (in practice, penalties in the amount of one month's salary are often agreed upon). In addition, according to the German Federal Labor Court, penalty clauses must clearly define the circumstances under which a (new) breach of the non-compete clause occurs (which is particularly relevant in the context of repeated and permanent breaches of the covenant).

Non-Compete Restrictions for Board Members and Managing Directors

Unless a board member or managing director expressly agrees with the company on the applicability of the statutory provisions for employees, the following differences in comparison to non-compete covenants with employees should be observed:

- While it is still recommended to agree on non-compete restrictions in writing, there is no legal requirement to do so.
- The term of the non-compete restriction is typically restricted to two years. Under special circumstances, however, non-compete restrictions may be even longer.
- Whether companies may compensate managers with the equivalent of 50% or less of the manager's fixed salary only is controversial. However, given that there is no (uniform) case law so far, companies should agree with managers (especially with managers whose variable remuneration is rather high) on compensation in the amount of at least 50% of the overall remuneration, including possible bonus payments, allowances and non-cash benefits, to be on the safe side.
- Earnings relating to other professional activities of the manager are not automatically set off against the non-compete compensation.
- If the agreed scope of the post-contractual non-compete covenant is too broad, it will not automatically be reduced to the maximum scope permitted by law. Instead, the whole clause will be considered null and void unless expressly agreed otherwise.
- The company may waive non-compete restrictions at any time, in general even after the end of the service relationship. The parties may agree that the company shall be released from the obligation to compensate the manager within three to six months (rather than one year) after the date of the waiver, subject to the circumstances of the case.

Non-Compete Restrictions for Shareholders

Non-compete restrictions may finally also apply to the shareholders of a company. Since non-compete restrictions arising out of a shareholder's fiduciary duty generally end once the shareholder leaves the company, post-contractual non-compete restrictions must expressly be provided for in the articles of association or in the shareholders' agreement. Under German antitrust law, non-compete restrictions for shareholders are only permissible to the extent necessary to prevent a post-contractual weakening of the company due to the loss of valuable information and know-how. As a consequence, according to German case law, post-contractual non-compete covenants may only be negotiated with (i) majority shareholders and (ii) minority shareholders with a certain degree of control over management or with access to sensitive information and know-how. In other cases, a legitimate interest of the company in non-compete restrictions is regularly denied. In addition, in terms of both the factual and geographical scope and the term of the non-compete prohibition, the covenant must not unreasonably hinder the shareholder in his or her freedom of action. In particular, the non-compete prohibition must not extend beyond the business of the enterprise or its territorial extension. With board members and managing directors, the term of the prohibition may generally not exceed a period of two years. Finally, while it is generally recognized that shareholders must be compensated for refraining from competition with the company, the amount of compensation due is still unclear.

Conclusion

In Germany, post-contractual non-compete restrictions may be negotiated with employees as well as with managers and shareholders. While the legal requirements for non-compete restrictions vary, the non-compete clause must always reflect legitimate business interests of the company and not unreasonably hinder the individual in his or her professional advancement. Rather strict requirements regarding the term and scope of the covenant must be observed. In particular, non-compete compensation should be agreed upon, and in the case of employees, the compensation must be at least 50% of the employee's most recent overall remuneration to comply with statutory requirements. Furthermore, in general, the term of the post-contractual non-compete restriction must not extend beyond two years.

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