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Restaurant Chain Founder Chooses FLSA Exposure Over Franchise Compliance

Authors: Erin Pelleteri Howser
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Can a founder of a chain of restaurants be liable to an employee for unpaid wages even though he does not own the restaurant where the employee worked? A Texas district court says possibly so. In this case, the chain units were owned by a series of entities in which the founder had a varying ownership interest. The units were operated under common management. The case record and opinion are silent on whether the founder ever formally complied with Federal Trade Commission (FTC) and Texas laws governing franchises. Nor is there any record that the founder ever filed the notice with the Secretary of State required by the Texas business opportunity law to franchise in Texas.

The plaintiff was a cook at a pizza restaurant that was part of a multi-unit chain of restaurants. The defendant, the founder of the chain, owned some of the restaurants, but not the one where plaintiff actually worked. Nevertheless, the plaintiff alleged that the defendant was his employer and liable to him under the Fair Labor Standards Act (FLSA) because the restaurant where he worked was part of the defendant's enterprise. The defendant filed a Motion to Dismiss, arguing that the employee did not demonstrate the existence of an enterprise and, even if such facts were pled, he fell under the franchise exception. The court disagreed.

The minimum wage and overtime provisions of the FLSA apply to employees of "an enterprise engaged in commerce or in the production of goods for commerce." The three main elements to find the existence of an "enterprise" are: (1) related activities, (2) unified operation or common control, and (3) common business purpose. While these factors would seem to impose FLSA liability on every individual who creates a franchise, there is a specific regulatory exception for certain types of franchises.

To fall within this exception, the individual establishment must: (1) be a retail or service establishment under the Act; (2) not itself be an enterprise large enough to fall within the FLSA's coverage; and (3) be under independent ownership. The Department of Labor (DOL) regulations provide that, if these three requirements are met, then the establishment may enter into the following arrangements without losing its status as exempt from enterprise coverage: (1) any arrangement that it will sell, or sell only, certain goods specified by a particular manufacturer, distributor or advertiser; (2) any arrangement it will have the exclusive right to sell the goods or use the brand name of a manufacturer, distributor or advertiser within a specified area; (3) any arrangement that it will join with other such establishments in the same industry for the purpose of collective purchasing; or (4) any arrangement whereby the establishment's premises are leased to it by a person who also leases premises to other retail or service establishments.

The DOL regulations do not define the term "franchise," so a factual analysis is required to determine the instances in which a franchise or other arrangement will have the effect of creating a larger enterprise for FLSA purposes. We note with some curiosity that the DOL has not borrowed from 34 years of guidance on the definition of a franchise infused in the FTC Franchise Rule.

In determining whether the establishment was excepted from enterprise coverage, the court considered the allegations that the defendant held meetings at the restaurant; dictated signage, menu items, recipes, cooking procedures, ingredients and vendors through the franchise agreement; negotiated/contracted with vendors and managers; instructed the store owner and managers on which products they should purchase; made monthly

visits to monitor employees; met with and discussed performance of employees; managed an online system for fielding complaints; and instructed owners regarding the hiring and firing of employees. The court particularly noted the allegation that the defendant personally changed the plaintiff's work schedule. The court held these allegations sufficient to demonstrate that the restaurant was part of an enterprise operated by the defendant and also that the way that he operated his restaurants made the franchise exception inapplicable.

This case presents key lessons for: (1) franchisors who are tempted to become involved in the operations of their franchisees; and (2) restaurant chains ready to grow with investments from third parties. Franchisors intending to protect the franchise who participate in the daily business decisions of an independent store, including hiring and firing employees, blur or erase the line between franchisor and employer. FLSA lawsuits are at an all-time high and the DOL is focusing wage and hour audits on the service industry. Franchisors need be mindful of this risk. To achieve this same level of control without the accompanying risk, franchisors should consider revising their agreements to remove opportunities for an employee to argue the franchisor has assumed control. In addition, the focus should be on examining whether the franchisor needs to promulgate requirements for employees of the franchise beyond training, uniforms and general appearance, and background checks for sensitive positions. Avoiding any procedures, customs and practices that are tantamount to participation in personnel management should be an objective.

Franchisors should also be mindful of the fact that some of the factors that the court considered in finding an enterprise are requirements that appear in virtually all franchise agreements, such as signage or software specifications. Franchisors should ensure indemnity provisions in favor of the franchisor expressly cover labor law claims, and whether the cost of employment practices liability insurance is worth the risk mitigation for both franchisee and franchisor.

Multi-unit operators seeking to expand without formally franchising should be cognizant of the parallel risk of FLSA enterprise liability that is unshielded by the franchise exemption. Imagine the operator's chagrin at having FLSA enterprise liability for independently operated units and liability under the FTC Act and, in this case, the Texas Business Opportunity Act, for violation when the minority investors claim their relationship is a franchise sold without compliance, or claiming the franchise exemption when there is no evidence that the steps to undertake franchise compliance were taken. The defendant has now admitted under oath that his transaction violated the FTC Act and state law. That scenario could be very expensive.