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The Line Brightens Between Franchisors and Franchisees Under the FLSA

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Earlier this year, the United States Fifth Circuit Court of Appeals (which covers Louisiana, Mississippi and Texas) affirmed summary judgment in favor of a part-owner of a Houston nightclub company in a bartender's class action seeking back wages under the Fair Labor Standards Act (FLSA). The Fifth Circuit found that individual members of limited liability companies are not themselves "employers" under the FLSA. This was the first time in roughly 16 years the court addressed this issue in a published opinion, and it offers new guidance for franchisors seeking to insulate themselves from liability for franchisee misconduct. The case is also good news for LLC members who are not involved in the day-to-day management and supervision of LLC employees.

Nicholas Gray, a bartender at Pasha Lounge, sued both Pasha Entertainment Group LLC and LLC member Michael Warren Powers in 2008, alleging that he and other bartenders were only paid tips and no wages in violation of the FLSA. The employee argued that as a member of this Texas limited liability corporation, Powers was an "employer" under the FLSA and was therefore personally liable for the LLC's violations. The district court in Texas granted summary judgment in Powers' favor, ruling he was not an "employer" as the term is used for purposes of the FLSA.

The Act requires, generally, that employees receive a minimum wage and receive compensation at one and one-half times their regular rate for all hours worked over 40 in a week. Unlike the typical concepts of employment found in Title VII, the ADA or the FMLA, the FLSA generally takes an expansive view of the employer/employee relationship. Under the FLSA, an employee can make a claim against someone other than his employer (such as a franchisor) based on a showing that the person or entity exercised sufficient control over the employee's work. That concept is often called "joint employment."

On appeal, the Fifth Circuit agreed Powers was not a "joint employer" by applying the "economic reality" test to evaluate the employer/employee relationship under the FLSA. This four-part test requires consideration of (1) the power to hire and fire, (2) supervision and control of work schedules and conditions of employment, (3) determining the rate and method of payment, and (4) maintaining employment records.

The Fifth Circuit emphasized that the "economic reality" test must be applied to each individual or entity alleged to be an employer, each must satisfy the four-part test, and that actual operational control is necessary.

The court noted that Powers visited the club on five or six occasions total during the 17 months the club was open for business. On one occasion, he told Gray he was doing a "great job;" and on two other occasions, he asked Gray to serve specific people while Powers was a patron at the club. Beyond these instances, Gray could not point to any other occasions where Powers specifically "directed" him as an employee.

Further, while the evidence showed that Powers occasionally signed several pages of pre-printed checks and bartenders casually told him how much they made in tips during his rare trips to the club, it was insufficient to indicate Powers determined employees' rate or method of pay. Finally, and of some importance to franchisors, there was no evidence that Powers maintained the employment records of the LLC.

With this decision, the Fifth Circuit made clear that the joint employer doctrine is not without boundaries. Given this ruling, franchisors should take care to structure their franchise agreements and practices in a way so as to mitigate any potential exposure for franchisee liability under the FLSA. Contractual rights of defense and indemnity for a franchisee's conduct in this area are elementary requirements, but a franchisor's prophylactic measures should extend further.

Specifically, implementation of quality control standards for franchisees are not problematic for FLSA purposes. But, asserting some element of control, approval or even accountability regarding specific pay practices or employment decisions of franchisees could pose trouble for franchisors, if not structured correctly. In practice, the economic control test does not subject an individual to FLSA liability for merely being a franchisor, holding company, officer or shareholder. Rather, only those who have true operational control over employees may be individually liable for FLSA violations. Similarly, franchisors should take care to ensure that expectations of quality control and product delivery do not over-reach into the day-to-day employment practices of franchisees.