Testimony on HB 3095
House Business & Labor Committee
Submitted Jeff Freeman, CEO, Invictus Franchising
March 25, 2013

Chair Doherty, and members of the committee, I ask you to support HB 3095, which would clarify Oregon law regarding franchise/franchisee relationships, in particular giving state agencies the clear direction that franchisees are independent contractors and not employees.

I am the CEO of Invictus Franchising, which is a regional master franchisee and sub franchisor for JaniKing International, Inc. JaniKing has more than 100 franchisees – independent business owners – who provide cleaning services to building and facility owners in Oregon and southern Washington.

We had a situation where the Oregon Employment Department sought to reclassify our franchisee businesses as JaniKing "employees." Nothing could be farther from the truth.

Our franchisee owners are required to set up business entities to run their small independent businesses (i.e., LLC's, corporations, sole proprietorships).

The franchisee owners pay relevant business taxes, manage staff (including hiring and firing), they make payroll (which includes taking out payroll taxes, unemployment insurance, workers comp and TriMet/Lane Transit tax) and do everything else to make a small business survive and thrive in today's tough economy.

These franchisee owners do everything an independent business owner would do: hire and fire employees, set work hours, purchase supplies, buy insurance, procure any necessary permits and take risks. These risks include managing employees who sometimes are late or don't show up for work. The franchisees are on the hook if its employees don't perform quality work for its customers. Employees don't take of these risks and also don't get the associated rewards.

The only difference between a franchise business and any non-franchised business is that they operate under a nationally recognized "brand" and implement a proven system, thereby maximizing their prospects for success. Brand consistency is the hallmark of franchise arrangement.

Although franchisees are the quintessential independent businesses, and although franchising has been around for 50 years or so, the Oregon Employment Department and agencies in several states have started to reclassify franchisees as being employees of their franchisors.

This has created uncertainty among franchisors and franchisees. Businesses, particularly small businesses, hate uncertainty. It affects how they plan and operate their businesses.

According to 2007 statistics, in Oregon alone there are more than 10,400 franchisee establishments resulting in 114,200 direct jobs in franchised businesses.[1]

Our unfortunate situation with the Oregon Employment Department has been resolved for the time being. But the long term is still a question mark.

We are not asking the Oregon Legislature to right our wrong. Instead, we are asking the Legislature to clarify the law so business owners in the future are not put through the same scrutiny that we have had to endure. HB 3095 clarifies existing law and eliminates the uncertainty that exists today.

How Franchises Work

A franchise exists when a business (the franchisor) licenses its trademark or trade name (the brand, such as McDonald's or H&R Block) and its operating methods (its system of doing business) to a person or group (the franchisee) who agrees to operate according to the terms of a contract (the franchise agreement). The franchisor provides the franchisee support and typically exercises significant control over the way the franchisee operates under the brand. Significant control by the franchisor is necessary in order to protect its brand image and value and to create uniformity. In exchange, the franchisee pays the franchisor an initial fee (called a franchise fee) and/or a continuing fee (known as a royalty) for the use of the trademark and operating methods.

As the U.S. Department of Commerce has described, by purchasing a franchise, small business owners enjoy a competitive edge over other entrepreneurs by the use of recognized trademarks, marketing expertise, standardization of products and services, training, and advertising support from the franchisor.

[1] www.buildingopportunity.com/download/Full/Oregon.pdf.

Franchising represents the small entrepreneur's best chance to compete with large companies that dominate the marketplace. Indeed, without franchising, thousands of businesspersons would never have the opportunity of owning their own businesses or enjoying the rewards of the free enterprise system.

Franchisors maintain standard controls necessary to produce a uniform product or service such that customers cannot readily distinguish services offered by one franchisee from those offered by another. Different franchised locations, products, and services must appear consistent. Those standard controls do not make franchisors employers – they are inherent in franchising.

State and Federal Franchise Regulations Require Standard Franchisor Controls

Franchises are regulated by state and federal laws because of their integral role in local, state, national, and global economies. The Federal Trade Commission ("FTC") also regulates the sale of franchises, adopting specified disclosure requirements and prohibitions in the sale of franchise opportunities. The FTC has decided that the best way to protect franchisees is to require franchisors to make certain specified disclosures, as opposed to dictating the terms of franchise relationships.

The FTC's definition of a franchise requires that the franchisor exert or have the 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. See 16 CFR §436.1(h)(2). By legal requirement then, the franchisor must exercise control over the franchisee's operations.

The Oregon legislature also recognizes that the franchisee-franchisor relationship is a specific type of contractual relationship whereby the franchisee is purchasing a right to transact business pursuant to the franchisor's plan or system. See ORS Chapter 650 (governing sale of franchises). Like the FTC's federal definition of franchises, Oregon's franchise law also recognizes that standard franchisor controls are inherent in franchising:

> "'Franchise' means a contract or agreement, whether oral or written, by which:
>
> "(a) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor;
>
> "(b) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor of such plan or system; and

"(c) The franchisee is required to give to the franchisor a valuable consideration for the right to transact business pursuant to the plan or system. Payment for trading stamps in itself is not consideration for the right to transact business pursuant to a plan or system."

ORS 650.005(4) (Emphases added).

Courts and Others Recognize That Franchises Do Not Create Employment Relationships

The differences between an independently owned franchise and an employee are so significant that courts and others recognize that traditional "employee" classifications are not always applicable in the realm of franchises. In the laws of most states, a franchise relationship will not prevent a franchisee from being an employee of its franchisor in every case, but the employee status test used by most states, properly interpreted, will exclude most franchises, because the controls asserted are merely a necessary part of franchising.

For example, Virginia's Attorney General recently issued an advisory opinion letter that explained that a proposed worker misclassification law's employee status test, which is nearly identical to Oregon's employee/independent contract or statute, ORS 670.600,[2] would exclude typical franchises from its scope:

> "Application of the three-part [employee status] test, in general, would exclude franchises from the scope of S.B. 34. To begin with, the franchisee is not performing services 'for an employer.' Rather, the franchisee, upon reaching agreement with the franchisor, is performing services for the profit and account of the franchisee. In addition, unlike the ordinary contract of employment, the franchisee is not being remunerated by the franchisor. Instead, it is the franchisee that pays the franchisor for the privilege of using a trademark and business system. I also note that the typical franchisee is not an 'individual' but a corporation. Consequently, application of this [employee status] test to typical franchise agreements would result in the exclusion of franchisees and franchisors from the scope of this statute."

[2] The "ABC" employee status test proposed in Virginia's Worker Misclassification Act, SB 34 (2011), is similar to ORS 670.600. It provides that (1) the individual has been and will continue to be *free from direction and control* of the employer, both under his or her contract of service and in fact; (2) *the service is outside the usual course of the business of the employer*; and (3) the individual is *customarily engaged in an independently established trade, occupation, profession, or business,* both under his or her contract of service and in fact.

2011 VA AG LEXIS *5-6 (Jan. 25, 2011). The opinion letter also notes that specific regulation of franchises in a separate Retail Franchising Act indicated the legislature's understanding that "franchises are a distinct form of business enterprise and bolsters the conclusion that Virginia law does not view typical franchise relationships as an ordinary employer/employee relationship." Id. at *7.

At least two states have recently passed legislation clarifying this issue in those states. Bills are pending in other states. In Georgia, the Legislature amended its employee/independent contractor statute, Georgia Code §34-9-1(2) to add the following sentence: "Individuals who are parties to a franchise agreement as set out by the Federal Trade Commission franchise disclosure rule, 16 C.F.R. 436.1 through 436.11, shall not be deemed employees for purposes of this chapter."

Similarly, Oklahoma recently passed legislation to clarify that individuals who are parties to franchise agreements as defined by FTC regulations 16 CFR 436.1 through 436.11 shall not be misconstrued as "employees" for purposes of workers' compensation laws. Oklahoma Statute Title 85, § 85-311(7). [3]

Courts have also rejected the concept that franchisees are employees of the franchisors. In rejecting class certification for a group of California Jani-King franchisees, the federal District Court of the Northern District of California recognized that a "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. * * * California courts have consistently held that a principal-agent relationship exists only when the franchisor retains complete or substantial control over the daily activities of the franchisee's business." Juarez v. Jani-King of Cal., Inc., Case No. 09-3495 SC, 2011 U.S. Dist. LEXIS 28068 at *30 (ND Cal Mar. 4, 2011) (internal quotation marks and citations omitted; emphases added). Therefore, the court held that it could safely exclude from the employee-employer relationship analysis of any facts that merely showed the hallmarks of a franchise – those that constitute a uniform system under which the franchisee's operation is associated with the franchisor's trade name or goodwill.

Oregon courts also recognize that franchises are unique business arrangements where the issue of "control" must be viewed in context. See Viado v. Domino's Pizza, LLC, 230 Or App 531, 547-48, 217 P3d 199 (2009) (holding, as a matter of law, that given the complex nature of the franchise relationship, franchise owner was not an employee of

[3] Oklahoma — Title 85. Workers' Compensation, Section 85-311. "The Workers' Compensation Code shall not apply to the following employees: * * * (7.) Sole proprietors, members of a partnership, *individuals who are party to a franchise agreement as set out by the Federal Trade Commission franchise disclosure rule, 16 CFR 436.1 through 436.11 * * * .*" (emphasis added).

franchisor because, apart from standard franchisor controls, franchisor did not retain right to control franchisee in the way employer controls an employee ("In the context of a franchise agreement, the franchisor always can be expected to establish certain standards for uniformity of operations; it is that uniformity – and the expectations that are associated with the franchisor's trade name – that make the franchise valuable.")).

Control is not only necessary in the business of franchising, but in any trademark license, even if the license does not amount to a franchise relationship. Any trademark owner has a duty to maintain a certain level of quality control of the licensed use of its trademark, so that the public is provided with reasonable assurance of consistency in the quality of products or services bearing a trademark. Failure to maintain adequate control over the goods and services offered under a trademark may result in a court determining that the owner has abandoned the trademark, thereby depriving the owner of the value of the trademark and the goodwill that it worked to build.[4] Therefore, any facts that merely show standard franchisor controls designed to control the quality of the goods and services being offered should not be a basis for concluding that franchisees are employees of the franchisor.

Clarification of this issue is critical to franchise businesses in Oregon. HB 3095 would provide that clarification.

[4] *See Exxon Corp. v. Oxxford Clothes, Inc.,* 109 F.3d 1070, 1075 (5th Cir. 1997).