Mass. 7-Eleven Ruling May Threaten Some Franchise Models

By **Peter Loh and Betsy Stone** (April 5, 2022)

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Franchisees scored a win in the ongoing battle over when a franchisee is really an employee of a franchisor.

In Patel v. 7-Eleven Inc., 7-Eleven franchisees asserted a putative class action claiming that 7-Eleven misclassified them as independent contractors and not employees, in violation of Massachusetts law.

The U.S. District Court for the District of Massachusetts in 2020 granted 7-Eleven's motion for summary judgment and dismissed the plaintiffs' claim based on, in part, 7-Eleven's argument that the Federal Trade Commission's Franchise Rule preempted Massachusetts' state employment statute.

On appeal to the U.S. Court of Appeals for the First Circuit, 7-Eleven argued that the Franchise Rule requires franchisors to exercise control over the operations of their franchisees and thus preempts the Massachusetts statute dictating that such control creates an employment relationship.

Last August, the First Circuit certified the question of whether the federal rule preempts the Massachusetts statute to the Massachusetts Supreme Judicial Court, which sided with the franchisees on March 24 and held that the Franchise Rule does not preempt state labor laws.

Therefore, franchisees can be employees entitled to robust state wage and hour benefits.

This ruling is a setback for franchisors, at least in Massachusetts, who can no longer argue that these state labor laws do not apply to them.

The independent contractor versus employee debate is not a new legal question, but it is particularly complex in the franchise context because franchises are a unique business model.

Franchisees are not ordinary independent contractors subcontracted on a job-by-job basis to perform specific tasks as they see fit, and they are certainly not employees reporting to work for an employer at an hourly wage.

Instead, franchisees are small business owners.

Franchisors give franchisees all the ingredients for success — the secret sauce, in the form of a methodology for creating or delivering a product or service, and name recognition — and empower franchisees to take those ingredients, run an independent business, and determine their own success or failure.

The franchisor, of course, collects an upfront fee and a cut of franchisee revenues for providing this knowledge and name recognition. But otherwise, the franchisor lets the franchisee act as an owner, managing day-to-day operations and pocketing most of the profits.

If franchisees are really employees, then franchisors must pay wage and hour benefits going forward, as well as compensation for work the employee performed in the past.

This cost shifting could eliminate the financial incentive for the franchise model: Why foot the bill like a business owner, but relinquish managerial control and profits to the franchisee?

The stakes in this kind of litigation for the franchise model are high.

It was no surprise that the U.S. Chamber of Commerce, the International Franchise Association, and six other organizations all authored amicus briefs supporting 7-Eleven.

They warned that classifying franchisees as employees "would ensure the decimation of the franchise model in Massachusetts," in the words of the Chamber of Commerce's amicus brief, and affect other highly regulated industries, such as insurance.[1]

The Massachusetts attorney general and Immigrant Worker Center Collaborative, on the other hand, filed briefs in support of the franchisees, arguing that state labor laws should extend to franchisee workers.

Employee Classification

In Massachusetts, the question of employee classification revolves around the state's Independent Contractor Law, or ICL, which distinguishes employees from independent contractors.[2]

Like many other states, the law uses a three-pronged standard, commonly referred to as the "ABC test," requiring a business entity accused of misclassification to rebut that accusation by demonstrating:

1. The worker at issue "is free from control and direction in ... the performance of the service" provided, "both under his contract for the performance of [the] service and in fact";

2. "[T]he service is performed outside the usual course of the business of the employer"; and

3. "[T]he individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed."[3]

Misclassification suits like Patel invariably center on the first prong: Does the alleged employer exert such control over its franchisees that they are really employees working for an employer masquerading as a franchisor?

The franchisees in Patel asserted that 7-Eleven did.

Indeed, 7-Eleven does control certain aspects of store operations by, for example, communicating daily with the franchisees; inspecting their stores; and imposing standards regarding cleanliness, inventory and hours of operation.

The franchisees also complained that 7-Eleven mandates that franchise employees wear uniforms and use 7-Eleven's payroll systems.

7-Eleven countered that the franchisees are independent contractors responsible for hiring, training, compensating and managing all store employees, and for the payment of taxes.

7-Eleven argued that the Franchise Rule permits this level of control as the requisite oversight of any franchise system.

Specifically, the FTC's Franchise Rule defines a franchisor as "[exerting] or [having] authority to exert a significant degree of control over the franchisee's method of operation."[4]

The Franchise Rule and the ICL, 7-Eleven argued, are in conflict.

In other words, the FTC rule's requirement of significant control over franchisees placed the franchisor in jeopardy of satisfying the all-important first prong of the ABC test.

Accordingly, 7-Eleven argued that the FTC rule preempts the ICL.

What the Courts Found

7-Eleven's argument prevailed in the District of Massachusetts.[5]

The federal district court found an inherent conflict between the level of control required by the FTC rule and the control qualifying franchisees as employees under the ABC test.

To resolve the conflict, the district court held that the FTC's "franchise-specific regulatory regime … governs over the general independent contractor test in Massachusetts." As a result, the ICL categorically did not apply to 7-Eleven.

The court then denied the franchisees' summary judgment motion and their request for class certification.

The Patel franchisees promptly appealed.

The First Circuit then asked the Massachusetts Supreme Judicial Court to weigh in and resolve the narrower question of whether the ICL could apply to franchises when the franchisor must also comply with the Franchise Rule.[6]

When certifying this question, the First Circuit emphasized that the answer "impacts untold sectors of workers and business owners across [Massachusetts]."[7]

The Supreme Judicial Court of Massachusetts held that, yes, the ABC test can apply to franchisors, who must also comply with the FTC's Franchise Rule. In other words, the rule did not preempt Massachusetts' application of the ICL to franchisors.

The court's reasoning was threefold.

First, the ICL does not expressly carve out an exception for franchises. From this silence, the court inferred that the ICL must apply to franchises like any other business relationship.

Second, and relatedly, the ICL's purpose is the protection of Massachusetts workers, and without an express exception for franchisees, the court reasoned that these protections should apply with equal force to franchisees.

Third, the court disagreed with 7-Eleven that a fundamental conflict exists between the Franchise Rule and ICL.

Unfortunately for 7-Eleven, the FTC itself wrote an amicus brief that explained the rules do not conflict.

Both the court and FTC focused on the purpose of the FTC's rule as wholly unrelated to the ICL.

The Franchise Rule regulates the disclosure of information before the sale of a franchise and has nothing to do with the performance of the franchise relationship.[8]

The conduct of the franchisor-franchisee relationship is the province of the ICL.

Moreover, the rule does not mandate significant control over franchisees; instead, it applies when franchisors choose to exert that level of control.

The court, therefore, concluded that a franchisor can comply with both laws.

More importantly, the court clarified that compliance with the FTC "does not render every franchisee an employee under" the ICL's ABC test.

The court insisted that franchisors could exert significant control under the Franchise Rule without exercising so much control that franchisees are rendered employees.

In other words, franchisors can toe a line between the two laws.

The court held there is a threshold question that should render the ICL inapplicable to legitimate franchise relationships.

Answering this question will begin with an initial determination of whether the putative employee is performing a service for the alleged employer.

If so, then an employment relationship may exist.

Specifically, future analysis will answer the question of whether the franchisee is actually operating an independent business, or if the franchise relationship is instead a disguise for just outsourcing workers by classifying them as independent contractors instead of employees.

Now, Patel returns to the First Circuit, where the court will have to dig into the factual idiosyncrasies of the parties' relationships to determine whether 7-Eleven exerted control commensurate with that of an employer or a franchisor.

Takeaways

As the Chamber of Commerce foretold, Patel will have an impact on franchisors and potentially other highly regulated industries in Massachusetts.

The key takeaway is that the Franchise Rule no longer insulates franchisors from the ICL after the Patel court's rejection of 7-Eleven's preemption argument.

All is certainly not lost. Franchisees with their own legal entities and employees will have a hard time arguing they are employees of their franchisors.

Regardless of the size and sophistication of the franchisee, franchisors must pay closer attention to the control they exert going forward.

Franchisors should stay tuned for how the First Circuit resolves Patel, and specifically, where it draws the line of too much control.

Wherever courts ultimately draw that line, franchisors will need to integrate changes in their franchise relationships.

And Patel may be harbinger of what is to come in franchise law across the country. Franchisors should take stock of what this litigation trend means for their businesses.

Franchisors must prepare for the financial impact of misclassification suits. The obvious cost will be the wage and hour benefits potentially afforded to franchisees. But a successful misclassification suit could also result in treble or liquidated damages if permitted by state statute.[9]

States like Massachusetts may require franchisors to pay the franchisees' attorney fees accrued while asserting the claim.[10]

Some states permit criminal sanctions for successful misclassification suits as well. In severe cases, Massachusetts, for instance, even allows for fines and incarceration.[11]

The rise of misclassification suits and the risk of civil and criminal penalties could warrant adjustments to some franchise systems. Does the franchise model make financial sense if state labor laws apply? How does the uptick in litigation exposure affect that calculus?

These sanctions should also encourage franchisors to reevaluate their relationships with franchisees and, specifically, the level of control they exercise over them.

Franchisors should create and employ best practices with franchisees.

Beyond the franchise relationship itself, courts will likely take a close look at the parties' franchise agreement. Franchisors should revisit these agreements with Patel's control analysis in mind.

Last but not least, given the state-by-state nature of misclassification suits, franchisors must keep a close eye on this developing area of law to ensure nationwide compliance.

State courts will likely answer this question differently, and even if states agree that franchisees can be employees, they will create a patchwork of metrics to determine this fact-heavy issue of control.

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as legal advice.

[1] See, e.g., Brief for The Chamber of Commerce of the United States of America & National Federal of Independent Small Business Legal Center as Amici Curiae Supporting 7-Eleven, Inc., Patel v. 7-Eleven (No. SJC-13166).

[2] Mass. Gen. L. c. 149 - 151.

[3] G. L. c. 149, § 148B (a).

[4] 16 C.F.R. § 436.1(h)(2).

[5] Patel v. 7-Eleven, Inc., No. 17-11414 (D. Mass. Sept. 10, 2020). For more information about this ruling, see our prior article.

[6] Patel v. 7-Eleven, Inc., 8 F.4th 26, 28 (1st Cir. 2021).

[7] Id. at 29.

[8] See 16 C.F.R. §§ 436.2, 436.9; Letter from Federal Trade Commission Chair Joseph Simons to Representative Jan Schakowsky, at 1 (Oct. 15, 2020).

[9] G. L. c. 149, §§ 27C, 150.

[10] G. L. c. 149, § 150.

[11] G. L. c. 149, § 27C.