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Domino's Challenges Joint Employer Liability for Franchisors

By Richard Blum and Hollis Pfitsch

After more than three years of litigation, delivery workers for four Domino's pizza restaurants in Manhattan are receiving payments for unpaid wages. The payments of nearly $1.3 million began in January and are divided among approximately 60 delivery workers. The case involves a rare situation: While the original lawsuit was against a franchise and individual franchise owners and managers, Domino's Pizza Inc., the international corporation, was successfully added to the lawsuit in a motion to amend seeking liability of Domino's as a joint employer. While rare, the case applied well-settled principles of joint employment under wage and hour law to bring in the franchisor.

The Case Is Settled

Cano v. DPNY, Inc., No. 10-cv-07100-ALC-JCF (S.D.N.Y), alleged a range of labor law violations, including time-shaving and off-the-clock work, and was originally filed in the Southern District by The Legal Aid Society and Shearman & Sterling as pro bono counsel. (**Note:** The authors were members of the Legal Aid team.)

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Is This a Franchise, or Not?

By Rupert M. Barkoff and Lindsay A. Victor

One of the challenges commonly facing franchise lawyers is that there are several definitions of the term "franchise." Regardless of whether the parties intend to establish a franchise relationship, if the relationship legally is deemed a "franchise," certain federal and state laws may apply. However, the definition of "franchise" often varies from statute to statute, and it may be difficult to determine whether a particular statute applies.

For example, one of the typical definitional elements of a franchise for purposes of franchise registration law is that the franchisor must prescribe or suggest a marketing plan to the franchisee. On the other hand, under many of the franchise relationship laws, which govern franchisor's obligations upon termination of franchisee rights under the franchise relationship (among other issues), a critical definitional element of the term "franchise" often is that there must be a "community of interest" between the franchisor and franchisee. This is true under many of the general franchise relationship laws, and is also an element of a franchise under relationship laws governing specific industries.

To add to the challenge, unfortunately, often these definitional elements are vague and undefined, making it most difficult to determine whether a particular relationship will be deemed a franchise.

A 'Community of Interest'

The issue came up recently in *C.N. Wood Company Inc. v. Labrie Environmental Group and Sanitary Equipment Co.*, Bus. Franchise Guide (CCH) ¶15,155 (D. Mass., June 5, 2013), which attempted to establish what exactly is meant by "community of interest." In *Wood*, the putative franchisee sold and serviced products sold by the alleged franchisor. The putative franchisor terminated the relationship without notice or cause. The question was whether the alleged franchisor wrongfully terminated the relationship, which in turn turned on whether the relationship was a franchise governed by the Massachusetts Motor Vehicle Act. The Act requires a "community of interest" for the relationship to be considered

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a franchise. However, the relationship statutes failed to flesh out what this term means. No Massachusetts courts had yet interpreted the term, so the *Wood* court looked for guidance from judicial decisions in states with similar language in their franchise relationship statutes.

Looking first to New Jersey law, the *Wood* court noted that the Third Circuit determined that "community of interest" hinged on the degree of control over the potential franchisee, holding that "community of interest" required more than the "mere fact that the two parties share in the profits realized when a product makes its way from manufacturer to the ultimate consumer." *Colt Indus. Inc. v. Fidelco Pump & Compressor Corp.*, 844 F.2d 117, 120 (3d. Cir. 1988). Rather, for a community of interests to exist, the dealer/putative franchisee had to demonstrate that the dealer was "subject to the whim, direction and control of a more powerful entity whose withdrawal from the relationship would shock a court's sense of equity."

The New Jersey Supreme Court took a similar approach in *Instructional Sys. Inc. v. Computer Curriculum Corp.*, 130 N.J. 324 (1992), in which the court looked at the interdependence of the parties and the licensor's control over and the licensee's dependence on the licensor. The court further noted that for a community of interest to exist, the franchisee must make "such a significant investment in the franchise as to grant essentially all of the controlling power in the relation to the franchisor."

The *Wood* court also looked at Wisconsin law in reaching its decision. As with the Massachusetts Motor Vehicle Act, the Wisconsin Fair Dealership Law also contains the term "community of interest." Because the Wisconsin Act only contains a "vague and unhelpful" definition of the term, courts have established their own standards in determining whether parties share a community of interest, looking at the interdependence between the two parties, whether they share common goals, and whether the dealer (franchisee)'s financial health would be threatened if the dealer's relationship with the supplier were terminated.

The *Wood* court also believed that Wisconsin law required the franchisor to be able to hold the dealer "over a barrel" and be subject to exploitation at the hands of the supplier in order for there to be a community of interest. *See*, *Home Proective Servs. v. ADT Sec. Servs., Inc.*, 348 F. Supp. 2d 1010, 1014 (E.D. Wis. 2004).

Ultimately, the *Wood* court concluded that the community of interest test in its case had not been met since only 10% of the putative franchisee's annual gross sales came from the alleged franchisor's products. Also, the relationship had lasted over six years, giving the putative franchisee the opportunity to recover its investment. Additionally, the putative franchisee carried competitor's products, and its equipment space was not restricted for use only with the purported franchisor's products.

Different Facts, Different Outcome

The court hearing *Wholesale Partners, LLC. v. Masterbrand Cabinets Inc.*, Bus. Franchise Guide (CCH) ¶15,136 (E.D. Wis. Oct. 4, 2013), was not as convinced as the *Wood* court that a community of interest did not exist under the Wisconsin

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New Arbitration Appellate Procedures Change Playing Field

By Charles S. Modell and Sawan S. Patel

Franchisors have historically struggled with whether to include provisions calling for mandatory arbitration of all franchise disputes in their franchise agreements. One of the main complaints about arbitration from franchisors and franchisees alike — and a reason many franchisors opt not to include arbitration provisions in their franchise agreements — has been the lack of an effective appeal process. Until recently, arbitration awards obtained under the American Arbitration Association (AAA) Arbitration Rules could only be appealed through the courts, and only for very limited and uncommon reasons — generally, arbitrator bias or an arbitrator's refusal to allow a party to submit appropriate evidence. If the arbitrator blatantly ignored the law or facts, there was little a party could do.

The rules have now changed for franchisors attuned to the recent amendment of the AAA's Arbitration Rules. Under the AAA's new Optional Appellate Arbitration Rules (New Rules), which became effective on Nov. 1, 2013, parties can now appeal arbitration awards for errors of law made by the arbitrator that are material and prejudicial, and for determinations of fact by an arbitrator that are clearly erroneous.

The Processes

The New Rules allow a party to initiate an appeal of an arbitrator's underlying award to the AAA within 30 days from the date that award is submitted to the parties. Any party that does not file an appeal has seven days after receiving notice of an appeal to file a cross-appeal. Once a Notice of Appeal is filed under the New Rules, the underlying award rendered by the arbitrator is not considered final and the time for commencement of judicial enforcement proceedings is tolled during the pendency of the appeal.

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The filing fee for an appeal is not insignificant and thus may discourage the filing of spurious appeals. The party initiating the appeal must pay a $6,000 fee, and any party filing a cross-appeal must also pay a $6,000 fee; the parties are also responsible for any other fees and costs of the appeal tribunal. Moreover, at the discretion of the appellate panel, the losing party to the appeal may be assessed fees and costs.

Under the New Rules, the appeal stays within the arbitration system. A tribunal of three arbitrators will hear the appeal. The appeal tribunal does not include the original arbitrator(s). The AAA sends a list of 10 prospective arbitrators from a special "Appellate Panel" to the parties. If the parties cannot agree on the appeal tribunal, each party has 14 days to strike names to which it objects and to number the remaining names in order of preference. The AAA then selects the tribunal from the lists returned to it.

The parties also have the right to request an appellate arbitrator with specific qualifications (such as panelists with franchise experience). The appellant must do so in its Notice of Appeal, and the other parties have three days after receipt of that notice to submit their request.

Once the tribunal is selected, the New Rules provide for a briefing schedule that spans the course of three to four months. The tribunal does not conduct a hearing, but is to issue a ruling on the briefs within 30 days of the filing of the last brief. They can adopt the underlying award, they can substitute their own award, or they can request additional information and extend the period for another 30 days; however, the tribunal cannot order a new arbitration hearing or send the case back to the original arbitrator(s) for corrections or further review. While parties who expect arbitration to provide an expedited procedure may be frustrated by this additional delay, the delay is certainly shorter than would be experienced if a judicial determination were appealed. Moreover, the cost of the delay may be much less than the cost of an arbitrary adverse decision.

Opting In

One drawback of the New Rules is that they specifically require the parties to opt into the appeal process. They can do so at any point in the arbitration procedure, but more importantly, they can do so in the initial agreement that establishes an arbitration procedure. While the AAA included in the New Rules some model language, the language could be as simple as one sentence:

> Franchisor and Franchisee agree that any award from the arbitrator may be appealed under the Optional Appellate Arbitration Rules of the American Arbitration Association.

For existing franchise agreements that do not contain an opt-in provision, franchisors and franchisees should both consider agreeing to adopt the New Rules soon after the initiation of the arbitration process. If both parties truly believe their position is correct in the facts and law, then both of them should want to assure the arbitrator does not make an erroneous determination of fact, or a ruling that is not based on existing law.

Once a dispute arises, not every party truly believes their position to be supported by the facts and law, and it will be difficult to obtain an agreement to adopt the New Rules in those circumstances. For that reason, franchisors who decide to include arbitration provisions in their franchise agreements should seriously consider adding an appeal right to their form arbitration provision.

Conclusion

A complete discussion of the advantages and disadvantages of arbitration versus litigation is beyond

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the scope of this article. For franchisors that have been on the fence in the past as to the adoption of an arbitration clause, the availability of an appeal right may turn the tide in favor of including an arbitration provision in their franchise agreements. However, for franchisors who already favor arbitration, the New Rules should give them significantly more comfort that decisions will be decided based on the facts and law, and their franchise agreements enforced. Moreover, the fact that an arbitrator knows his or her award can be appealed may encourage the arbitrator to more carefully consider the facts and the law before rendering an award.

For our franchise clients who have arbitration provisions in their franchise agreements, we will be inserting an appeal right in their agreements effective with their annual renewal this year. If you are a franchisor with an arbitration provision in your franchise agreement (or in supplier or other agreements), or have considered adopting an arbitration provision in your agreements, you should contact your attorney regarding the New Rules and the wisdom of including such a provision in your agreements.

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After the original defendant corporation, DPNY Inc., a franchisee, filed for bankruptcy, much of the litigation played out in bankruptcy court. On Dec. 4, 2013, Southern District Bankruptcy Judge James Peck entered an order confirming a plan of reorganization under Chapter 11 of the Bankruptcy Code for DPNY, Inc., which included a settlement agreement resolving the wage and hour claims of past and current delivery workers at the four stores of the franchise.

The workers will receive $1.282 million from the franchise, as well as a commitment that the franchise will follow requirements of federal and state labor law on an ongoing basis.

In addition, the plan was made possible only as a result of concessions from Domino's to the franchisee. Specifically, Domino's will not receive certain payments owed by the franchisee until after the delivery workers are paid in full. Domino's also waived some interest payments from the franchisee and reduced the rate of interest. Peck required that the corporation identify those contributions on the record in order to approve a release of claims.

Adding the Franchisor

Domino's required a release because Magistrate Judge James Francis granted plaintiffs' motion in the original wage and hour action to amend their complaint to add Domino's as a defendant. *See*, *Cano v. DPNY*, 287 F.R.D. 251 (S.D.N.Y. 2012). The court ruled that, under a Rule 12(b)(6) standard, plaintiffs had pleaded sufficient facts to state a claim against Domino's as a joint employer under the Fair Labor Standards Act (FLSA). While such a result would seem perfectly sensible to most non-lawyer observers, the decision set a new precedent for analyzing franchisor liability under the FLSA.

The court's reasoning applied existing joint employment standards to the facts pleaded, but, in the past, simply invoking the franchise structure has served as a bar to joint employer status. The *Domino's* case raises the question: Will courts take this cue to apply established FLSA principles to the facts pleaded against franchisors, regardless of their status as franchisors?

The best place to begin the analysis of Francis's decision is the language of the statute itself. The FLSA's definition section does not define the key terms "employ" and "employer." Instead, it articulates concepts included within the meanings of those terms. For example, under the FLSA, to "employ" includes to "suffer or permit" an individual to work. 29 U.S.C. §203(g). "'Employer' includes any person acting directly or indirectly in the interest of an employer in relation to an employee." Finally, the statute offers only a circular definition of "employee." 29 U.S.C. §203(d). An "employee" is "any individual employed by an employer." 29 U.S.C. §203(e).

The answer to why the definitions are not more definitive lies in Congress's intention to capture an extremely broad set of relationships and not to delimit coverage. As courts have repeatedly held, the FLSA definition of "employer" is "'the broadest definition [of 'employ'] that has ever been included in any one act." *Zheng v. Liberty Apparel Co. Inc.*, 355 F.3d 61, 69 (2d Cir. 2003) (quoting *United States v. Rosenwasser*, 323 U.S. 360, 363 n.3 (1945) (quoting 81 Cong. Rec. 7657 (1937) (statement of Sen. Hugo L. Black)). It "sweeps in almost any work … done for the employer's benefit or with the employer's acquiescence." *U.S. Dep't of Labor v. Lauritzen*, 835 F.2d 1529, 1543 (7th Cir. 1987) (Easterbrook, C.J., concurring).

The FLSA is a remedial statute designed to address the needs of workers who lack sufficient bargaining power to protect minimal labor standards. The drafters drew from earlier child labor statutes. The intention behind those statutes was to look beyond the formal relationships recognized by the common law to see if a party knew about the work and had the power to stop it. *See*, "Enforcing Labor Standards in the Modern American Sweatshop: Rediscovering the Statutory Definition of Employment," Bruce Goldstein, Marc Linder, Laurence E. Norton, II, Catherine K. Ruckelshaus, 46 UCLA L. Rev. 983 (1999) (http://bit.ly/1hxbsKn). Any party in that position was liable if children were found to be working illegally. The words adopted from the child labor law, "to suffer or permit … mean[] that [the employer] shall not … permit by acquiescence, nor

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suffer by a failure to hinder." *Curtis & Gartside Co. v. Pigg*, 134 P. 1125, 1126 (Okla. 1913)).

'Operational' or 'Functional' Control

A key principle that derives from this understanding of employment is that of joint employment. Under federal regulations, multiple individuals and entities can employ an employee at the same time. 29 C.F.R. §791.2. Therefore, any person or entity that suffers or permits an employee to work or acts directly or indirectly in the interest of an employer is itself an employer. The significance of joint employment, in turn, is that each employer is jointly and severally liable.

In applying this sweeping concept of "employer" under the FLSA, courts have developed the concept of an "economic realities" test, so designated to distinguish it from any test that looks at the formal relationships. Courts have come to label the key ingredient either as "operational" or "functional" control over the business in question. This test is a tool to assist courts in determining whether a putative employer knew about the work and had the power to stop the work or otherwise fix the violations at issue.

The U.S. Court of Appeals for the Second Circuit has issued a series of decisions developing its understanding of operational or functional control in determining whether a defendant is a joint employer under the FLSA. *See*, *Barfield v. N.Y.C. Health and Hosps. Corp.*, 537 F.3d 132 (2d Cir. 2008); *Zheng v. Liberty Apparel Co.*, 355 F.3d 61 (2d Cir. 2003); and *Herman v. RSR Sec. Servs. Ltd. (RSR)*, 172 F.3d 132 (2d Cir. 1999); *see also*, *Irizarry v. Catsimatidis*, 722 F.3d 99 (2d Cir. 2013). The court has found individuals to be liable as joint employers, not based on day-to-day control, but rather because of their operational or functional control. *RSR*, at 140-41; *Irizarry*, at 111-17. Having authority over the people who managed the business is sufficient. In *Irizarry*, for example, the Second Circuit held that a "person exercises operational control over employees if his or her role within the company, and the decisions it entails, directly affect the nature or conditions of the employees' employment." *Id*. at 110.

In particular, the court has noted that the power to shut down the business is demonstrative of operational control, and therefore, liability. *RSR*, at 140; *Irizarry*, at 115. The Second Circuit has also made clear that employer "status does not require continuous monitoring of employees, looking over their shoulders at all times, or any sort of absolute control of one's employees. Control may be restricted, or exercised only occasionally, without removing the employment relationship from the protections of the FLSA, since such limitations on control do not diminish the significance of its existence." *RSR*, at 139 (citation, internal quotation marks omitted).

Indeed, as the court held in *Zheng*, there is no rigid rule for identifying a FLSA employer and "in certain circumstances, an entity can be a joint employer under the FLSA even when it does not hire and fire its joint employees, directly dictate their hours, or pay them." *Id*. at 70.

In another joint employer case, *Barfield v. N.Y.C. Health and Hosps. Corp.*, 537 F.3d 132 (2d Cir. 2008), the court again found liability because the defendant "suffered" the plaintiff's work. The court held the New York City Health and Hospitals Administration liable as a joint employer of a nurse who had worked over 40 hours in many weeks, but through different temporary agencies, rejecting the defendant's argument that it had not reviewed and compared the time records from the different temporary agencies.

The court noted that the defendant possessed the information concerning the plaintiff's work hours. The fact that the defendant had not reviewed the information in its possession did not relieve it of responsibility as an employer. As Judge Benjamin Cardozo stated in a New York Court of Appeals case: "Whatever reasonable supervision by oneself and one's agents would discover and prevent, that, if continued, will be taken as suffered." *People ex rel. Price v. Sheffield Farms-Slawson-Decker Co.*, 225 N.Y. 25 (1918).

Franchisor Liability

These cases provided the basis for potential franchisor liability in the *Domino's* case. First, it is clear that the particular formal relationship does not preclude a review of the economic realities of that relationship. Thus, there is no per se rule exempting franchisors from liability as joint employers with their franchisees. It depends on the facts of the relationship, not the label.

Similarly, franchise agreement language declaring a franchisee's employees not to be employees of the franchisors cannot be determinative or it would completely undermine the FLSA. It is a bedrock principle of the FLSA that no entity can contract out of its obligations. *See*, *Brooklyn Sav. Bank v. O'Neil*, 324 U.S. 697, 706-07 (1945). The entire purpose of the FLSA is to establish rules that employers and employees cannot bargain their way out of, precisely from a recognition that some employees do not have sufficient bargaining power to sustain a floor of labor standards.

Beyond that, these decisions remind us that the traditional employment test might begin but does not end the inquiry. Even if an entity does not hire, fire or process payroll, it can still be a joint employer under the FLSA. If the clothing manufacturer at the top of a chain of contractors may hold enough control to be deemed a joint employer as in *Zheng*, a franchisor can also be held liable if it retains comparable control. Whether or not it does is a factual inquiry.

In the *Domino's* case, the plaintiffs alleged facts concerning corporate Domino's' control over key functions of their jobs, including hiring, management policies, training, staff equipment, uniforms, supplies, delivery areas and methods and procedures for delivery. For instance, the suit alleged that Domino's developed systems for screening,

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interviewing and assessing employment applicants that were used in its franchise stores in an effort to reduce employee turnover. It also alleged that Domino's imposed specific requirements for delivery employees' work, such as setting delivery areas, monitoring delivery times and specifying the methods and procedures used in preparing and delivering customer orders.

Perhaps most importantly, the plaintiffs alleged that Domino's controlled the record-keeping systems used by the franchise, specifically, records of workers' delivery times and of wages and hours and payroll. Domino's had the right or power to know of employees' unpaid work through the information collected by the trademarked computerized record-keeping system that it required franchisees to use. These records provided information far beyond that required to ensure "quality control" over the food products being served.

As in *Barfield*, the records to which Domino's had unfettered access, including employee wages and hours, gave them information necessary to determine not only that plaintiffs had worked certain hours but also that they had not been paid for all of that time.

Finally, the plaintiffs alleged that Domino's had the power to terminate the franchise if it determined that the franchise had violated any laws or company policies, or engaged in practices that adversely affected the good will of the Domino's trademark. The plaintiffs argued that these facts showed that Domino's had more than sufficient functional or operational control over the franchise to be considered suffering or permitting the employees' work or to acting indirectly in the interest of the franchise employer, and thus to be liable as a FLSA joint employer.

The plaintiffs did not argue that Domino's hired or fired or even paid franchise workers, since direct or day-to-day control is not necessary. Rather, the plaintiffs pointed to Domino's alleged involvement in the establishment of employment policies and practices, its monitoring of the workers' delivery times, its unfettered access to wage and hour records, and its ability to stop the work by closing or threatening to close the franchise.

Conclusion

As noted above, Second Circuit precedent precludes a "see no evil" defense that the putative joint employer simply did not avail itself of information that it had in its possession. In other words, that Domino's might not have compared its delivery time records to the clock in/clock out times in its possession, which would have demonstrated that the plaintiffs were not paid for all the hours they worked, does not protect it from a finding that it had the capacity to review this information and act on it.

Domino's argued that these points proved too much, specifically that on the plaintiffs' theory, all franchisors would be liable for the conduct of their franchisees. However, the plaintiffs' point was, on the contrary, that the franchise relationship does not determine joint employer status.

A study for the U.S. Department of Labor's Wage and Hour Division noted that in the fast-food industry, FLSA violations are much more common among franchise-owned businesses than businesses directly owned by national or international chains. *See*, "Improving Workplace Conditions Through Strategic Enforcement, A Report to the Wage and Hour Division," David Weil, Principal Investigator, Boston University, p. 44-49, available at http://1.usa.gov/1daCiuS. If the franchisor, in fact, retains sufficient operational control, it should be held liable as a joint employer under the FLSA, regardless of formal arrangements or disclaimers. This approach honors both the letter and the purpose of the statute.

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Franchise or Not

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Fair Dealership Law. In this case, the plaintiffs had bought its business from a third party. Within a year, the supplier terminated the relationship without advance notice. Nor did the supplier point to any problems that would have given the supplier grounds for termination. According to the court, a community of interest may exist under one of two circumstances: 1) when a large proportion of an alleged dealer's revenues are derived from the dealership; or 2) when the alleged dealer has made sizable investments specialized to the grantor's goods or services, and thus not fully recoverable when the relationship terminates. Here, the court determined that a dealership relationship could exist as, unlike in *Wood*, 43% of the dealer's revenues related to sales of the alleged franchisor's products. In addition, the dealer had made substantial investments in goods, inventory, fixed assets, advertising and training that were customized to the alleged franchisor's product line. As such, a genuine issue of material fact existed; the court therefore denied motions for summary judgment filed by both of the parties.

Conclusion

Although there may be some guidance in these cases based on the degree of reliance the franchisee's business has on the franchisor, neither of these cases gives clear vision as to what a "community of interest" is. Thus the battle between dealers' and suppliers' rights and obligations in Wisconsin and Massachusetts continues, leaving the business world in a state of uncertainty in these jurisdictions as to whether a franchise relationship exists between litigating parties.

COURT WATCH

By Rupert M. Barkoff and Lindsay A. Victor

Arbitration of Trademark Dispute Not Required

Twenty years ago, arbitration clauses were rarely found in franchise agreements, but they have become considerably more popular over the last two decades. However, while there are many franchisors that prefer arbitration over court, there are some issues that franchisors prefer not to have decided by arbitration — in particular, those relating to trademarks. Thus, it is common for broad arbitration provisions to have broad exceptions for disputes relating to trademarks. This was the case in *Synergistic International LLC v. Monaghan*, Bus. Franchise Guide (CCH) ¶15,146 (C.D. Ill., Oct. 10, 2013).

After the franchise agreement at issue in Synergistic expired, the franchisee committed numerous violations of the post-term covenants, including the non-compete and the cessation of trademark use provisions. Rather than instituting an arbitration proceeding, the franchisor immediately brought suit asking the court for, among other things, injunctive, declaratory and monetary relief. Arbitration was generally required under the franchise agreement, but each party had the right to opt out of arbitration under certain circumstances, including where disputes related to trademarks. Defendant franchisee argued, unsuccessfully, that all the issues should be decided by arbitration. The plaintiff franchisor successfully demonstrated, among other things, that all of the issues were "related to the marks" — including claims that: defendant failed to cease using plaintiff's methods of operations, telephone numbers and plaintiff's mark; failed to transfer the business to the franchisor as required by the franchise agreement; defendant established a competing business to which defendant's assets were transferred; and defendant failed to comply with the non-compete and other post-term obligations. Therefore, the court allowed the lawsuit to proceed in court, foregoing arbitration entirely.

Defendant's spouse, who was the principal in the competing company to which the defendant's business had been transferred, had also signed a separate confidentiality agreement with the plaintiff, but it did not contain an arbitration clause. Therefore, the court found that this agreement, too, did not require plaintiff to arbitrate claims arising under that document.

The moral of *Synergistic* is that good drafting can cause franchisors to have the benefits of arbitration and simultaneously protect the franchisor's valuable intellectual property rights through judicial proceedings, which have arguably greater benefits and protection than arbitration when it comes to matters involving intellectual property.

Court Finds Tax Preparer's Operations Shady, Puts It Out of Business

In a civil action, one would not expect a federal district court to impose a death sentence on a defendant, but that is, in effect, exactly what happened in *U.S. v. ITS Financial LLC*, Bus. Franchise Guide (CCH) ¶15,170 (S.D. Oo. Nov. 6, 2013), where the court found that the conduct by the corporate defendants was so outrageous that the corporate entities should be put out of business — and they were.

Ever since the Federal Trade Commission Disclosure Rule went into effect in 1979, critics have complained that the Disclosure Rule has no teeth and the FTC has no money to enforce it. *ITS* is not exactly a franchise case, but it does involve a franchise system that the court said had gone so far in its bad dealings that it must be stopped. Frequently in these types of cases, a franchisor has evolved into one of questionable integrity and sells franchises to the unsuspecting or encourages its franchisees to engage in dubious practices. It is not clear from the lengthy court opinion whether the franchisees were innocent when they signed up for the ITS army, but it is clear that when the system collapsed, the franchisees were part and parcel of many of the offenses committed by the system.

ITS sold franchises that permitted its franchisees to sell tax preparation services, but at some point, maybe even at its infancy, the system became corrupt. The 134-page opinion delineates in great detail numerous practices that were unlawful, and it was not only the franchisor who committed these sins. The franchisees were, literally, trained to engage in illegal activities, and in practice actively did so. A sampling of the unlawful acts committed by the franchisor and/or franchisees included:

- Issuing duplicate checks for instant advances on tax refunds or other loans, such that the banks would receive two demands for payments to the payee, one of the checks being based on forged signatures and resulting in payment refund demands by the bank;
- Failure to pay employment taxes, and submitting false reports to the IRS;
- Charging phony and exorbitant fees to ITS customers;
- Filing tax returns based on pay stubs, rather than W-2s, resulting in the customer failing to report all income on which taxes were due;
- Filing income tax returns without proper customer authorization;
- Encouraging franchisees to lie to government officials during government compliance visits;
- Hiding money in secret bank accounts;
- Violating the terms of a preliminary injunction order that required, among other things, for the franchisor to monitor the conduct of its franchisees;

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- In the case of franchisor, conducting seminars on how to file returns based on check stubs, rather than returns based on W-2s, and avoid detection by the Internal Revenue Service; and
- Forging signatures on customers' tax forms.

The court's decision gives a clear impression that these acts were more than inadvertent mistakes. The court found that not only did the defendants actively commit illegal acts, the defendants also acted with "willful blindness to misconduct" on the part of its franchisees, including by failing to conduct background checks because they did not want to know if any employees had criminal records, and failing to monitor franchisees to prevent fraud.

In the end, the court, without hesitation, issued a permanent injunction against the franchisor, the effect of which was to shut down ITS's business in its entirety. In addition, the franchisor's principal was permanently barred from operating, or being involved with in any way, any business relating in any way to preparation of tax returns. The court stated that these sanctions against "the fourth largest tax preparation business in the country" were "necessary to protect the public and the [U.S.] Treasury."

Over the 35 year history of the FTC Rule, the government has been strongly criticized for not vigorously enforcing the Rule. That may still be a credible argument in the normal case where the franchisees are innocent but the franchisor is corrupt. However, when the two groups join together to conduct unlawful activity, the IRS demonstrates in this case that neither group will escape the wrath of the government. The franchise community has for some time pictured the FTC as a bit of a toothless tiger. *ITS* projects a different image of the Internal Revenue Service. Perhaps some of its aggressiveness will set an example for the FTC.

Mode-of-Operation Liability Cannot Be Assumed

The defendants appealed from a jury verdict in favor of a plaintiff who fell while patronizing a fast-food restaurant; the primary issue on appeal was the scope of "mode-of-operation" liability. *Prioleau v. Kentucky Fried Chicken Inc.*, 2014 N.J. Super. LEXIS 29 (3/3/14).

The plaintiff and her adult children visited a Cherry Hill, NJ, Kentucky Fried Chicken franchise in December 2009. It was raining heavily that evening, and the plaintiff testified that she and her children were not carrying umbrellas, that they were wet when they entered the restaurant, and that they tracked water in with them. As the plaintiff's children went to the counter to order, the plaintiff headed to the restroom. About five feet from the restroom entrance, she slipped and fell, later testifying on cross-examination: "I felt it was wet first. It was slippery. And … when we first started sliding is when [sic] I realized that it was grease mixed with water." The plaintiff at first thought her injuries were minimal and refused the restaurant's assistant manager's offer of medical assistance. Later, however, she experienced more pain and consulted with several medical care providers. The plaintiff declined surgical injections or other intervention, but did attend physical therapy sessions for about two months. She never had to miss work because of her injuries. She brought suit against the restaurant on a premises liability theory. Over defense objection, the trial judge issued an instruction to the jury concerning "mode-of-operation" liability. The jury returned a verdict of $250,000, allocating 51% of the fault to the restaurant.

On appeal, the defendants challenged, *inter alia*, that the judge's instruction to the jury telling them that proof that the restaurant was on actual or constructive notice of a hazardous condition need not be shown if the defendant's mode of operation created the hazardous condition. Mode-of-operation liability may attach when the business allows customers to handle the merchandise in a way that is inherently likely to cause a hazardous condition, such as when customers are permitted to dispense their own ice and drinks. When mode-of-operation danger is shown, the plaintiff is relieved of responsibility for showing the defendant had actual or constructive notice of a dangerous condition, and the burden immediately shifts to the defendant to show that it did all that a reasonably prudent person could be expected to do to avoid a risk of injury. However, the trial judge here issued the instruction simply on the basis of the fact that the defendant operated a fast-food restaurant. The appeals court held this was error because "[c]ontrary to the trial judge's conclusion, defendants' business as a 'fast-food operation' has no relationship to plaintiff's fall. There is no link between the manner in which the business was conducted and the alleged hazard plaintiff slipped on or its source. No testimony showed the alleged wet/greasy floor was the result of a patron's spilled drink or dropped food. Further, there was no evidence the restaurant's floor was ill-kept, strewn with debris or laden with overflowing trash."

Because the jury charge had the capacity to mislead the jury, the judgment was reversed and the case remanded for a new trial.

— Janice G. Inman, Associate Editor

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