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Vicarious Liability in the Franchise Industry: Is Too Much Control ever Enough?

By: Stephen M. Parham

INTRODUCTION

Franchisors and franchisees enjoy a unique relationship. From a legal perspective, the typical franchisee operates an independent business pursuant to a license to use a franchisor's trademark and trade secrets. To protect the franchisor's goodwill with the public, a written franchise arrangement between the parties usually includes uniform and very detailed quality, marketing, and operational standards. However, even though the franchisee must comply with those set standards and cooperate with the franchisor's business and marketing plans, a franchisee is still an independent business owner who faces the constant challenges of leading a small company to success.

The Truth About The Franchisor /Franchisee Relationship: Perception Is Not Reality

Often the general public misunderstands the true nature of the legal relationship between a franchisor and its franchisee, assuming the franchisor is legally responsible for all actions of its franchisee. For instance, customers or competitors will sue both the franchisee and the franchisor under a common law theory known as "vicarious liability." Typically, these suits allege that the franchisor has such extensive control over the manner and method of a franchisee's business operations that the franchisee "must be" acting as the franchisor's direct agent.

A Closer Look At Vicarious Liability

In general "the right to control the work of another carries with it the correlative obligation to see to it that no torts shall be committed by the other in the course of the work." *Allen v. Choice Hotels*, 942 So. 2d 817, 821 (Miss. Ct. App. 2006) (internal quotations omitted). In a vicarious liability analysis, courts will consider whether there is "actual agency." That is, does the agent have legitimate authority to represent the principal and to bind it at some level by his acts. They will also consider "apparent agency," or whether the appearance of authority to the outside world is so great that a principal can be bound by a non-agent's acts, regardless of how little authority to act actually exists. Apparent agency principles were intended "to create vicarious liability for a principal who retains an independent contractor and then represents to the world that the independent contractor is an agent whom the principal has the authority to control." *Roessler v. Novak,* 858 So. 2d 1158, 1163 (Fla. Dist. Ct. App. 2003).

Some states have refined and narrowed the test for agency liability in franchise contracts. *See, e.g., Allen v. Greenville Hotel Partners*, 409 F. Supp. 2d 672, 674 (D. S.C. 2006) (applying the "specific instrumentality" test in which a franchisor must be found to be in control of the specific instrumentality which caused the harm before vicarious tort liability will attach); *Schlotzky's, Inc. v. Hyde*, 538 S.E. 2d 561 (Ga. Ct. App. 2000) (holding that the setting and continuous monitoring of detailed mandatory standards governing operations, including how a food product is manufactured, packaged, prepared, or served, was not sufficient control to establish vicarious liability of a restaurant franchisor in a food poisoning case brought against the franchisee). This article will focus on the refinements in franchisor vicarious liability cases in Alabama, Georgia, and Mississippi.

Alabama: Franchise Agreements Plus "More"

The analysis of Alabama courts of vicarious liability in the franchisor/franchisee context stays fairly close to the traditional common law theories of agency. *See, e.g., Kennedy v. Western Sizzlin'* Corp., 857 So. 2d 71, 77 (Ala. 2003) (equating a vicarious liability tort claim against the franchisor to the doctrine of respondeat superior and stating that "the test for determining whether an agency relationship exists is whether the alleged principal reserved a right of control over the manner of the alleged agent's performance"). However, Alabama's black letter law also expressly establishes that "[a] franchise agreement, without more, does not make the franchisee an agent of the franchisor." *Carlton v. Alabama Dairy Queen, Inc*., 529 So. 2d 921, 924 (Ala. 1988) (citing *Murphy v. Holiday Inns, Inc*., 219 S.E.2d 874, 877 (Va. 1975)).

The seminal Alabama case considering franchisor vicarious liability claims is *Wood v. Shell Oil Co*., 495 So. 2d 1034 (Ala. 1986). Shell Oil Company ("Shell Oil") was the owner of real property that it leased it to an operator ("Parker Shell") and with whom Shell Oil entered into a petroleum dealer agreement. Plaintiff sued both Shell Oil and Parker Shell for personal injury when the plaintiff slipped and fell on the premises. In attempting to establish the agency relationship between Mr. Parker and Shell Oil, the plaintiff cited a number of areas controlled by Shell Oil under the terms of the two written agreements, including (1) required hours of operation; (2) required approval of all physical alterations on the premises; (3) required diligent merchandising and promotion of Shell Oil's products; (4) required type and style of uniforms; (5) required notification to Shell Oil of any injuries or damage occurring on the Parker Shell premises; (6) stipulated Shell Oil's right to offer supplemental training to Mr. Parker's employees; (7) stipulated Shell Oil's right to inspect the dealer's premises, books, and records to determine compliance with the terms of the dealer agreement; and (8) stipulated Shell Oil's right to terminate the agreement for Mr. Parker's failure to carry out the above provisions.

Nevertheless, the Alabama Supreme Court refused liability for Shell Oil writing that:

> [There is no evidence that Shell Oil] retained any right or control over the manner in which Parker Shell performed in order to meet the requirements of the lease and dealer agreement. Although the lease and the dealer agreement specify, in some detail, what Parker Shell must do in order to conform to the terms of these contracts, and gives Shell Oil the right to approve certain aspects of Parker Shell's operation, they do not determine how Parker Shell is to achieve compliance with these terms.

In the years since the *Shell Oil* decision was published, Alabama courts considering vicarious liability claims against franchisors have used the same tests repeatedly. *See, e.g., Rosser v. AAMCO Transmissions, Inc.*, 923 So. 2d 294, 300-301 (Ala. 2005) (holding that, as a matter of law, franchise agreement alone was not sufficient evidence that franchisor held franchisee out to public as an agent); *Western Sizzlin',* 857 So. 2d at 77; *Dairy Queen*, 529 So. 2d at 924; cf. *Freeman v. Suddle Enter., Inc. d/b/a Huddle House # 389*, 179 F. Supp. 2d 1351, 1355 (M.D. Ala. 2001) (holding that sexual harassment imputes vicarious liability only when a franchisor is in a position to readily observe egregious behavior amongst a franchisee's employees). Thus, in Alabama, a franchisor's written contractual requirements applicable to the franchisee's business operations simply are not enough to establish vicarious liability in most contexts. It is only when a franchisor closely directs the franchisee as to how he or she must accomplish those requirements that problems may arise.

Georgia: "Time and Manner" Considerations

In Georgia, "vicarious liability is premised on a principal's right to control the time and manner of an agent's work*."* *Coldwell Banker Real Estate Corp. v. DeGraft-Hanson*, 596 S.E.2d 408, 410 (Ga. Ct. App. 2004). Without that type of control, "even franchisors are not liable for the torts of franchisees." Id.; *see also, e.g., Baldino's Giant Jersey Subs v. Taylor*, 454 S.E. 2d 599 (Ga. Ct. App. 1995). In the context of franchisees and apparent agency, Georgia courts have held that such agency is present only when (1) a franchisor holds out its franchisee as its agent to another; (2) the plaintiff justifiably relies on the franchisee's skill or care based on the franchisor's representation(s); or (3) the justifiable reliance leads to injury.

In *Coldwell Banker*, a family sued a realty company and an individual real estate broker, alleging violation of the Fair Housing Act and intentional infliction of emotional distress. In holding that the broker was not an agent of the real estate franchisor, the Court noted that "it is not sufficient that the [real estate] agent represent[s] its [own] status as an

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agent [of the franchisor]; it must be established that the [franchisor] held out the [franchisee] as its agent." In other words, a franchisee may not place himself or herself into the role of a legal agent based solely on his or her own representations. At some point, the franchisor must make a public pronouncement of such agency before liability may be incurred.

This above analysis works well for tort and contract violations; but, what about other types of claims that a franchisor might face, such as intellectual property infringement? As with the Freeman employment discrimination case in Alabama, these types of cases in Georgia often revolve around the franchisor's knowledge and/or intent, which may be evidenced by the details of a franchisor's day-to-day control over the franchisee.

Consider Mini Maid Service Co. v. Maid Brigade Systems, Inc., 967 F.2d 1516 (11th Cir. 1992), in which the holder of a registered trademark sued a competing franchisor after its franchisee allegedly infringed on the trademark. At trial, the court directed a verdict for the plaintiff, reasoning that the franchisor had failed to exercise "reasonable diligence" over its franchisee to prevent such an infringement. The appeals court reversed, holding that the "reasonable diligence" standard should not apply. However the court noted that, under certain circumstances, "a franchisor might be liable for contributory trademark infringement, even if the franchisor did not itself perform any infringing acts" if: (1) the franchisor intentionally induced its franchisee to infringe on the trademark; or (2) the franchisor knowingly participated in a scheme of trademark infringement carried out by its franchisees. The court summarized its position that "any liability for contributory infringement will necessarily depend on whether or not the contributing party intended to participate in the infringement or actually knew about the infringing activities," considering "the nature and extent of the communication between a franchisor and franchisee regarding the infringing act." The Mini Maid court also directed lower courts to consider whether, upon discovering the infringing acts, a franchisor fails to make a good-faith effort to invoke a clear contractual right to halt the infringement. As the Mini Maid court explained, "[w]ithout these standards[,] . . . the combination of a renegade franchisee and an ambiguous franchise agreement might leave a franchisor in a very difficult position."

In the Mini Maid context, a franchisor with knowledge of ongoing improper acts by its franchisee(s) will want to act decisively in controlling its franchisee's behavior. At first glance, such an instruction may appear to be divergent from the "hands off" approach indicated by cases like Coldwell Banker. A closer examination shows the court reached the common sense conclusion that a franchisor with intimate knowledge of a franchisee's wrongdoing and who fails to eradicate that behavior, tacitly condones its franchisee's method of operations in a fashion very similar to a franchisor who tells its franchisee exactly how to carry out its obligations. In each case, the franchisor has gone beyond merely just controlling its business goodwill.

Mississippi: Specific Control

Mississippi franchisor vicarious liability law is still developing. In November 2006, for the first time, a Mississippi appellate court established the standards that should govern the determination of vicarious liability for a franchisor. In Allen v. Choice Hotels International, 942 So. 2d 817 (Miss. Ct. App. 2006), plaintiff sued a hotel franchisee and franchisor for the wrongful death of her husband, and for her personal injuries sustained after robbers broke into the couple's hotel room. Noting the lack of Mississippi case law on the subject of franchisor/franchisee liability, the Mississippi Court of Appeals reverted to a general principle of Mississippi case law that establishing one party's liability for the actions of another "typically revolve[d] around the idea of control."

After reviewing the non-exclusive list of factors set forth in Kisner v. Jackson, 132 So. 90, 91 (Miss. 1930), which are used to determine whether one party is the master of another, the Choice Hotels court noted that the franchisor "did not pay the hotel staff's wages, . . . did not have the right to hire or terminate 'subemployees' or to fix their wages, and . . . had no right to direct the details of the operation of [the particular hotel in question]."

After Admitting that the relationship of a franchisor and franchisee is "far different from a contract of employment where the rules of master/servant are typically applied," the Choice Hotel court opted to follow decisions of other states and find a franchisor vicariously liable for its franchisee's acts or omissions "only when it had the right to control the specific instrumentality of or aspect of the [franchise] business that was alleged to have caused the harm." Id. at 821-22 (citing Kerl v. Dennis Rasmussen, Inc., 682 N.W.2d 328, 337 (Wis.2004)).

The *Choice Hotel* court then examined the facts of the case, including the written franchise agreement, which required the franchisee to (1) use the franchisor's computer reservation system; (2) display the franchisor's logo and marks; (3) post signs indicating the franchisee's participation in the franchisor's business referral and credit card arrangements; and (4) pledge a high standard of service, courtesy, and cleanliness, utilizing the franchisor's "plan and system." In return, the franchisor promised to (1) lend the franchisee an operations and service manual setting out the administration and operation of the system; (2) provide an orientation program for the franchisee's employees; and (3) periodically inspect the hotel to evaluate the franchisee's compliance with the franchisor's rules and regulations. The franchisee also was obligated to follow the detailed operational guidelines set forth in a 145-page proprietary document known as the "Rules and Regulations."

The *Choice Hotels* court found that the written franchise agreement was intended "to provide a system of uniformity for *Choice* franchisees" (citing *Anderson v. Turton Dev*., 483 S.E.2d 597, 601 (Ga. Ct. App. 1997) (finding that *Choice's* franchise agreement and Rules and Regulations did not "direct or control the time, manner, and method of performance of the daily operations of the franchise but [were] a means of achieving a certain level of quality and uniformity within [its] system")). The court further observed that the operational standards contained in franchise agreements and documents, such as the Rules and Regulations manual, were necessary to protect "the goodwill value of the product and the trademark associated with the business" and to protect the public's expectations of consistent levels of product and/or service quality from one franchisee to another. 942 So. 2d at 826.

Ultimately, the Mississippi Court of Appeals granted summary judgment to the franchisor and held that "[w]e find no evidence in the record which would show that Choice had the right to control the day-to-day activities of [its franchisee]."

Agency by Estoppel: A Cautionary Tale

Despite the courts' reluctance to find elements of control in the typical franchisor/franchisee relationship, it is not impossible for courts to find such control. For instance, in *Crinkley v. Holiday Inns, Inc.*, 844 F.2d 156 (4th Cir. 1988) (applying North Carolina law), a jury found that the franchisor was vicariously liable under a theory of apparent agency. In Crinkley, the plaintiff husband and wife, while unloading the last of their baggage from their car parked in front of their assigned room at the franchise motel, were pushed into their room by a man with a gun. The gunman beat the husband and threatened the wife. The plaintiffs brought suit against various defendants, including the franchisor, and alleged that the franchisor was negligent by providing inadequate security on the theories of the franchisee's actual authority or, alternatively, apparent agency.

In affirming the jury verdict for the plaintiffs, the Fourth Circuit held that agency may be imposed where a plaintiff shows (1) that a principal represented or permitted representations that the party dealing with the plaintiff was its agent; and (2) that the plaintiff has changed his position in reliance on such representations. In *Crinkley*, the franchisor retained a significant degree of control over the franchise premises. The franchisor originally designed and built the motel and advertised nationally to promote its national system. It also published a directory listing properties within the system, without distinguishing between company-owned and franchise properties. The only indication the motel was not owned by the franchisor was a sign in the restaurant which stated the motel was operated by the franchisee. The franchisor also contended the franchise agreement disclaimed any agency relationship. The court found that such a denial is not determinative of liability under apparent agency. Under these circumstances, the court held the jury could reasonably conclude that operation of the motel created the appearance it was owned by the franchisor, as intended by the franchise agreement.

Turning to the reliance prong of the test, the court pointed out that the plaintiffs' testimony that they had previously stayed at the franchisor's motels, that they were familiar with its national advertising, and that, after their unsuccessful attempt to make reservations at one of the franchisor's motels at their actual destination, they used the franchisor's directory to find another of the franchisor's motels in a city more than 20 miles away rather than staying at a different motel closer to their destination. The plaintiffs also testified they did not know the difference between motels owned by a franchisee and a franchisor and were surprised to learn the franchisor was not involved in the operation of the franchise premises. The *Choice Hotels* court found this evidence was marginal, but it still was sufficient to get the case to the jury.

Conclusion: Seek Expert Advice

There are no easy answers to the question of how a franchisor can determine when it is stepping across the invisible line of asserting too much control over its franchisee and potentially exposing itself up to a vicarious liability claim. Most courts construe the facts on a case-by-case basis; and, what may amount to "specific control" or "time and manner" restrictions in one case may not in another. Franchisors and franchisees both should consider engaging experienced counsel to review existing franchise agreements, written rules and regulations, and other franchise policies to point out potential problems. In these situations, an ounce of prevention really is worth a pound of cure.