Despite Successes in Fending Off Claims Based on Actual Authority, Franchisors Still Face Difficulties in Defending Claims Based on Ostensible Authority

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The recent settlement last year of a class action against McDonald's Corp. for $3.75 million based on claims that McDonald's Corp. was liable for Labor Code violations of its franchisee brings home the dilemma that many franchise companies are facing. See, http://www.reuters.com/article/us-mcdonalds-settlement-idUSKBN12V1NJ, an October 31, 2016 Reuters article describing the settlement in *Ochoa v. McDonald's Corp*. The settlement is the culmination of a disturbing trend in franchise vicarious liability cases that has emerged in the past several years, where the courts have blindly accepted ostensible authority arguments to defeat what should have been summary judgment motions in the franchisor's favor on the issue of ostensible authority. This article briefly discusses the legal landscape and offers possible drafting solutions to the business lawyer.

The Legal Landscape

In *Ochoa v. McDonald's Corp.,*[1] the court held that the plaintiffs, employees of the franchisee suing over Labor Code violations, had raised an issue of fact as to whether the franchisee they worked for was the ostensible agent of the franchisor. "Ostensible agency exists where (1) the person dealing with the agent does so with reasonable belief in the agent's authority; (2) that belief is 'generated by some act or neglect of the principal sought to be charged,' and (3) the relying party is not negligent. *Kaplan v. Coldwell Banker Residential Affiliates, Inc.*, 59 Cal. App. 4th 741, 747, 69 Cal. Rptr.2d 640 (1997)."[2] The plaintiffs in *Ochoa* produced evidence that they believed they were McDonald's employees because they wore McDonald's uniforms, served McDonald's food in McDonald's packaging, received paystubs and orientation materials with McDonald's logo, and applied for their jobs through the McDonald's website. These facts could easily apply to most franchise relationships in the service industry. This was enough of a showing to defeat summary judgment based on cases like *Kaplan v. Coldwell Banker*, where summary judgment was denied on the basis of Coldwell Banker's "we are one big family" form of advertising. In *Kaplan*, the plaintiff, a superior court judge, was able to convince the court to deny summary judgment on the showing he reasonably relied on that advertising even though the advertising had a disclaimer, in small print, that the franchisee was "an independently owned and operated member of Coldwell Banker Residential Affiliates, Inc."

In 2016, to make matters worse for McDonald's, the court did an about face and ruled that ostensible authority could be decided on a class-wide basis despite

its earlier decision that there were issues of fact as to whether McDonald's held its franchisees out as agents of McDonald's.[3] The court reasoned that even though ostensible authority was based on the reasonable belief of each plaintiff and class member, since the underlying facts were the same as to the basis for that reasonable belief, the matter could be decided on a class basis.[4] Hence, McDonald's settled.

Franchisors thought that they had made great inroads in protecting themselves from vicarious liability claims by third parties and insiders, like employees, as a result of the California Supreme Court's decision in *Patterson v. Domino's Pizza*, *LLC*, 60 Cal. 4th 474 (2014). *Patterson* recognized that controls exercised by the franchisor over its franchisee to protect the brand image would not be equivalent to control over the day-to-day operations such that the franchisee would be considered the employee or agent of the franchisor. *Patterson* recognized that such controls related to brand and image protection were essential to franchising. Obvious examples of such control would be requirements that the franchisee wear uniforms with the logo of the brand or that food recipes be followed to the "T." A franchisor like McDonalds known for its Big Mac® should be able to control how the burger is cooked and the quality of the ingredients. If the franchisee deviated and produced inferior products, untold damage would be done to the McDonald's reputation. The following quote from *Patterson* is apt:

> The "means and manner" test generally used by the Courts of Appeal cannot stand for the proposition that a comprehensive operating system alone constitutes the "control" needed to support vicarious liability claims like those raised here. As noted, a franchise contract consists of standards, procedures, and requirements that regulate each store for the benefit of both parties. This approach minimizes chain-wide variations that can affect product quality, customer service, trade name, business methods, public reputation, and commercial image.[5]

Patterson was an actual agency case and explicitly did not decide the ostensible agency issue. In *Ochoa,* McDonalds was successful in establishing no actual agency based on its extensive controls to promote and preserve brand integrity, based largely on *Patterson*. But at the same time, summary judgment was denied on the ostensible agency ground based largely on *Kaplan v. Coldwell Banker*.

The "disclaimer" argument that was made in *Kaplan* was apparently not made in *Ochoa*, but it was made in *Salazar v. McDonald's Corp.*, 2016 WL 4394165 (N.D. Cal. 2016), another Labor Code violation case brought by the franchisee's employees. The franchisee's employees should know who employed them, unlike an unrelated third party who may not know the relationship between the franchisee and franchisor. In fact, the online employment applications that were used by the franchisee in *Salazar* stated that plaintiffs "were applying for employment with an independently owned and operated McDonald's franchisee, a separate company and employer from McDonald's Corporation and any of its subsidiaries." One would think that would be enough to defeat an ostensible agency claim that required a reasonable belief that the franchisee was the agent of the franchisor. "Not so" said the Court, relying on *Kaplan,* and noting, "[i]mportantly, similar disclosures, while persuasive, have not been found automatically to defeat the reasonableness of an individual's beliefs."[6]

Drafting Solutions

In light of these decisions, franchisors need to come up with creative solutions to obtain favorable determinations on the ostensible agency issue. One would think it should be relatively easy to fend off claims by "insiders," like employees or suppliers and the like, by having prominent disclaimers. However, they did not work in *Salazar* at the summary judgment stage. This may be because the disclaimer was simply part of the lengthy employment application. What might work is to require the employee, vendor, or supplier to sign a separate, short stand-alone acknowledgement that it is understood that the person they are dealing with is an independent businessman and not the agent or employee of the franchisor. Additional language might be helpful to the effect that the vendor, employee, or supplier is not relying in any way on any representation by the franchisor and understands that it will not be able

to make any claim for damages or compensation against the franchisor based on its dealings with the franchisee.

The more difficult scenario is with regard to third party claims by customers or members of the public who have no business relationship with the franchisee or franchisor and there is no opportunity to present them with some form of acknowledgement. They will claim that they believed the franchisee was the agent of the franchisor because of the common logo used and other indicia that the franchisor uses to convey to the public the integrity of the service or product. This is exactly what *Patterson* said would not result in actual authority. It may be possible to convince a court that the reasoning of *Patterson* should carry over to the ostensible authority arena, but this has not been done yet. A prominent disclaimer may work, but it needs to be worded in such a way as to promote the brand and at the same time distance the franchisor and franchisee. More needs to be said to convey the message and at the same time promote the brand. In *Kaplan*, a small disclaimer to the public did not work, but that disclaimer focused only on the fact that the franchisee was an independently owned business. The whole idea of franchising is to convey to the public a common source and it would be counterproductive to require a franchise operation to have a bold sign announcing it is a separate operation. However, thought should be given to something like this:

> This business is a franchise, independently owned and operated by X pursuant to the terms of a franchise agreement, under which X is granted a license to use the trademarks, trade secrets, and trade dress of [Franchisor] in conformance with operating procedures and standards set by [Franchisor]. Nonetheless, X operates this business, not [Franchisor], and X is legally responsible for its operation, not [Franchisor].

Some of this language could also be incorporated in the separate acknowledgement that employees, suppliers, vendors, etc. are required to sign.

A practical solution is to require that the franchisee procure comprehensive insurance with acceptable limits with the franchisor named as an additional insured. Almost all franchise companies require this, but enforcement and monitoring compliance might be lacking. In that way, the issue of ostensible or actual agency might become irrelevant for most third-party claims that are covered by insurance. Of course, in the cases discussed above, insurance coverage was unavailable, so disclosures and disclaimers are important.

Endnotes

1 133 F. Supp. 3d 1228 (N.D. Cal. 2015).

2 *Id.* at 1239.

3 Ochoa v. McDonald's Corp., 2016 WL 3648550 (July 7, 2016).

4 *Id.* at 3-4.

5 *Id.* at 497 (footnote omitted).

6 *Id.* at 13.