Insight

Recent Labor Regulations Will Disincentivize the Franchise Model

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Executive Summary

- The Biden Administration recently proposed two major changes to labor market regulation: the Joint Employer Standard and the Employee or Independent Contractor Classification (IC) rules.
- Intentionally or otherwise, the proposed rules would have a particularly significant impact on the franchise business model; franchisors would face an additional $5.7 million per hour in combined employment costs and require additional resources to negotiate labor and bargaining claims.
- The proposed changes would disincentivize participation in the franchise business model, leading to significant disruptions in the economy and labor market; they would also represent a failure to meet the standard that labor regulation should seek to be neutral across different business models.

Introduction

The Biden Administration recently proposed two major changes to labor market regulation: the Joint Employer Standard and the Employee or Independent Contractor Classification (IC) rules. These proposals have been widely debated in isolation, with a focus on workers' ability to obtain benefits, unionize, or otherwise reap greater benefit versus the costs to employers. Perhaps less well recognized is the fact that taken together the proposed rules threaten franchises in particular, and thus constitute a failure to meet the standard that labor market regulation should seek to be as neutral as possible across different business models.

This piece reviews the proposed rules from the perspective of the impact on franchises. To anticipate the key result, under the proposed rules, franchisors would face increased employment costs of at least $5.7 million per hour across all franchisors and spend more time negotiating unfair labor and collective bargaining claims. These added burdens will disincentivize participation in the franchise business model, leading to a significant impact on the economy and labor market, as franchising currently accounts for approximately $825 billion (3 percent) of the United States gross domestic product (GDP) and employs 8.4 million workers.

The Independent Contractor Rule and Franchises

The franchise business model relies upon franchisees operating as independent contractors who own and operate individual businesses under the franchisor. The proposed change to the Employee or Independent Contractor Classification rule would likely reclassify an estimated 790,500 franchisees as employees.

The purpose of the IC rule is to correctly classify workers under the Fair Labor Standards Act (FLSA) based on workers' dependency on their hiring entity. If classified as an employee, a worker is eligible for protections such as minimum wage and overtime pay under the FLSA. Independent contractors do not get the same protections but enjoy the flexibility of setting their own hours and pursuing business opportunities that don't align with the traditional employer/employee structure.

Worker dependency is determined by the "economic realities test," which considers six factors: the extent to which the work performed is an integral part of the employer's business; the worker's opportunity for profit or loss; the nature and extent of the worker's investment in his/her business; whether the work performed requires special skills; the permanency of the relationship; and the degree of control exercised or retained by the employer.

Under the proposed IC rule, at least four of the six factors could pose a problem for franchisees.

- The first is the extent to which the work performed is integral to the employer's business; by nature of the model, individual franchises operate to support and grow the overall brand, therefore acting as an integral part of the business.
- The second is whether the work requires special skills; although the franchisee is responsible for daily business operations, their skills are limited in scope as the operations must align with the overarching standards of the brand.
- The third is the permanency of the relationship; as an extension of the brand, the franchisee is bound to work for the franchisor until the expiration of their contract.
- The fourth is the degree of control exercised or retained by the employer; a franchisor must impose certain controls to protect the brand and ensure consistency among the various franchises.

Therefore, under the proposed holistic interpretation of the "economic realities test" in the proposed rule, most of the factors would assert that franchisees should be reclassified as employees, thus restructuring the franchisee/franchisor relationship and disrupting the franchise model. (See additional information on the new IC rule here.)

The Joint Employer Standard and Franchises

Under the proposed Joint Employer Standard, franchisors are more likely to be classified as joint employers and therefore responsible for the management and supervision of staff employment at the individual franchises under its brand. The proposed joint employer rule would label an entity as a joint employer if it "possesses the authority to control or exercises the power to control particular employees' essential terms and conditions of employment." This is a shift from the previous rule that specified that an employer must also exercise that power over its employees to fulfill joint employer status. (See additional information about the joint employer rule here.)

Under current DOL rules, franchisors are not considered employers of the franchisees and franchise staff. Under the new proposed rule, franchisors will likely be labeled as joint employers because of the brand-specific rules and procedures that they impose on franchises. Franchisors' oversight of the brands' franchises will be seen as possession of authority to control terms and conditions of employment, therefore subjecting them to the responsibilities of a joint employer. This is even more likely if both the new Joint Employer Standard rule is implemented and the new IC rule reclassifies franchisees as employees.

Combined Impacts on the Franchise Model

The restructuring of the franchisor/franchisee relationship under the two proposed regulatory changes will create dramatic disincentives to participate in the franchise business model.

The proposed IC rule will increase employment costs for franchisors. Under the proposed IC rule, franchisees, reclassified as employees, will be eligible for minimum wage and overtime pay, in addition to the profit margin they already claim from their individual franchise. Franchisors, acting as employers would be responsible for paying the new employment costs. As there are just under 790,500 franchisees currently in the United States, the total increase in employment costs for franchisors across the country would be approximately $5.7 million per hour, assuming the franchisees were all paid the federal minimum wage. This extra cost would disincentivize franchisors from participating in the franchise business model.

In addition to higher employment costs, franchisors, classified as joint employers under the proposed Joint Employer Rule, would more readily be implicated in collective bargaining negotiations and held responsible for resolving unfair labor practice claims. Addressing these claims and negotiations would be time-consuming and costly, especially for franchisors with thousands of locations. With unionization gaining popularity and increased media attention in recent years, this rule could produce a significant disincentive to participate in the franchise model.

Discouraging franchises is economically disruptive. Franchises currently contribute more than $825 billion in GDP, 3 percent of total GDP. Franchising has proved to be a successful business model that supports workers, large businesses, and entrepreneurs. Individuals wanting to start a business have a greater chance of success by opening a franchise, as 92 percent of franchisees remain strong after two years of operation, compared to 20 percent of independent businesses. By disincentivizing the franchise business model for franchisors, these rules are likely to limit entrepreneurship and profitability for individuals hoping to start a sustainable business. The labor market will also be disrupted, as approximately 8.4 million workers are currently employed by franchises in the United States, and franchise employment is estimated to further increase by about 257,000 jobs by the end of the year. As brands choose not to participate in the franchise model, many of these workers could lose their jobs or find it necessary to seek more traditional terms of employment.

Conclusion

By reclassifying franchisees as employees and franchisors as joint employers, recent proposed labor regulations will force a restructuring of the franchisor/franchisee relationship. Franchisors will face increased employment costs and be required to spend more time negotiating collective bargaining and unfair labor claims. These additional burdens would disincentivize their participation in the franchise business model. Ultimately, the combined impacts of the new proposed labor regulations will cause significant disruptions to the economy and the labor market as many brands will likely opt to abandon the franchise model.