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13 Attorneys for Plaintiffs
14 INTERNATIONAL FRANCHISE ASSOCIATION,
15 ASIAN AMERICAN HOTEL OWNERS
16 ASSOCIATION, THE SUPERCUTS
FRANCHISEE ASSOCIATION, and the
DD INDEPENDENT
FRANCHISE OWNERS ASSOCIATION

17
18 **UNITED STATES DISTRICT COURT**
19 **SOUTHERN DISTRICT OF CALIFORNIA**

20
21 INTERNATIONAL FRANCHISE
ASSOCIATION, ASIAN AMERICAN
22 HOTEL OWNERS ASSOCIATION,
23 SUPERCUTS FRANCHISEE
ASSOCIATION, and the DD
24 INDEPENDENT FRANCHISE OWNERS
ASSOCIATION,

25
26 Plaintiffs,

27 v.

CASE NO.

**COMPLAINT FOR
DECLARATORY AND
INJUNCTIVE RELIEF**

1 STATE OF CALIFORNIA; XAVIER
2 BECERRA, IN HIS OFFICIAL
3 CAPACITY AS ATTORNEY GENERAL
4 FOR THE STATE OF CALIFORNIA;
5 JULIE SU, IN HER OFFICIAL
6 CAPACITY AS LABOR
7 COMMISSIONER OVER THE DIVISION
8 OF LABOR STANDARDS
9 ENFORCEMENT; LILIA GARCIA-
10 BOWER, LABOR COMMISSIONER OF
11 THE CALIFORNIA DEPARTMENT OF
12 INDUSTRIAL RELATIONS; KATIE
13 HAGEN, DIRECTOR OF THE
14 DEPARTMENT OF INDUSTRIAL
15 RELATIONS; and PATRICK HENNING,
16 DIRECTOR OF THE EMPLOYMENT
17 DEVELOPMENT DIVISION,

Defendants.

15 Plaintiffs, the International Franchise Association (the “IFA”), the Asian
16 American Hotel Owners Association (“AAHOA”), the Supercuts Franchisee
17 Association (“SFA”) and the DD Independent Franchise Owners Association
18 (“DDIFO”), as and for their Complaint against Defendants, allege as follows:

19 INTRODUCTION

20 1. The IFA, AAHOA, SFA and DDIFO (collectively, “Plaintiffs”) bring this
21 lawsuit to enforce its federal rights as provided by federal statute and guaranteed by
22 the Supremacy Clause of the United States Constitution. The Plaintiffs seek
23 declaratory and injunctive relief prohibiting Defendants from enforcing against
24 franchisors and franchisees (as those terms are defined under 16 C.F.R. § 436.1(i) and
25 (k)) California’s new test for determining whether a worker is an employee or
26 independent contractor, as interpreted by the California Supreme Court in *Dynamex*
27 *Operations West, Inc. v. Superior Court*, 4 Cal. 5th 903 (2018) (“*Dynamex*”) and
28

1 subsequently codified by the California Legislature through Assembly Bill 5 (“AB-
2 5”) and Assembly Bill 2257 (“AB-2257”) (“California’s ABC Test”).

3 2. Franchising has “existed in this country in one form or another for over
4 150 years” (*Patterson v. Domino’s Pizza, LLC*, 60 Cal. 4th 474, 489 (2014)), and,
5 more recently, has “become a ubiquitous” and “thriving business model.” *Id.* at 477.
6 Under this business model, the franchisor, “sells the right to use its trademark and
7 comprehensive business plan” to franchisees who “independently own[], run[], and
8 staff[] the retail outlet that sells goods under the franchisor’s name.” *Id.*

9 3. Franchised businesses currently operate in more than a hundred different
10 business sectors. In addition to industries in which franchising has long been
11 prevalent, such as automotive repairs and services, hotels and motels, quick-service
12 and full-service restaurants, tax preparation businesses and real estate brokerages,
13 franchised industries also include, among many others, home health care and senior
14 care, home repair and remodeling, package shipping, hair care, fitness, financial
15 services, childcare, tutoring, and swim schools.

16 4. The entities that choose to operate franchised businesses are as varied as
17 the types of businesses that have chosen to franchise their business models. While a
18 large segment of franchisees are individual entrepreneurs seeking to own and operate
19 their first business, many franchisees have grown into immense operations with tens
20 of thousands of employees and hundreds of locations. Many operate multiple brands.
21 Still other franchisees are public companies. In light of its enormous growth,
22 franchising has a profound effect on the economy, both nationally and in the State of
23 California. In 2019, in California alone, there were more than 82,600 independently
24 owned and operated franchised businesses. These franchised businesses collectively
25 generated more than \$82.9 billion in economic output.

1 5. Further, franchisees are significant job creators in their communities. In
2 2019, franchisees in this State employed almost 827,000 people, and collectively
3 generated \$35.3 billion in payroll.

4 6. Franchisors and franchisees share the common goals of success and
5 survival. Matters which restrict or undermine franchisors will invariably have an
6 equal or greater detrimental effect on franchisees (who rely heavily on the franchisor's
7 brand and systems for operation) and the nearly 827,000 people employed by
8 franchised businesses in this State.

9 7. Franchising offers a wide array of individuals the opportunity to develop,
10 own, and operate their own businesses and, as such, franchising represents for many
11 Americans a piece of the American Dream. This is especially true for those whose
12 education level or other characteristics could pose barriers in other industries.

13 8. Franchising is also a statutorily recognized and permissible method of
14 doing business. Without exception, all of the statutes that regulate franchising
15 recognize that the relationship between a franchisor and its franchisees is a
16 commercial relationship, not an employment relationship. Importantly, the Federal
17 Trade Commission ("FTC"), which authorizes and regulates the sale of franchises in
18 the United States, defines a "franchise" in part as "any continuing *commercial*
19 *relationship or arrangement*" whereby the franchisor promises that the franchisee
20 "will obtain the right *to operate a business* that is identified or associated with the
21 franchisor's trademark ..." 16 C.F.R. § 436.1(h)(1). (16 C.F.R. § 436 *et seq.* is
22 hereinafter the "Franchise Rule").

23 9. The FTC Franchise Rule defines a "franchise" as "any continuing
24 commercial relationship or arrangement, whatever it may be called, in which the
25 terms of the offer or contract specify, or the franchise seller promises or represents,
26 orally or in writing, that ... [t]he franchisor *will exert or has authority to exert a*
27 *significant degree of control* over the franchisee's method of operation, or provide
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1 significant assistance in the franchisee's method of operation.” 16 C.F.R. § 436.1
2 (emphasis added).

3 10. Likewise, the FTC Franchise Rule requires that a franchisee receive from
4 the franchisor “the right to operate a business that is identified or associated with the
5 franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities
6 that are identified or associated with the franchisor's trademark.” 16 C.F.R. § 436.1.
7 And, the federal statute which permits the licensing of trademarks (the Lanham Act)
8 *mandates* that trademark licensors maintain control over the use of their trademarks.
9 *See* 15 U.S.C. §1127 (2000). In fact, “[w]here a licensor fails to exercise adequate
10 quality control over a licensee, a court may find that the trademark owner has
11 abandoned the trademark, in which case the owner would be estopped from asserting
12 rights to the trademark.” *Barcamerica Int’l v. Tyfield Importers, Inc.*, 289 F.3d 589,
13 595 (9th Cir. 2002).

14 11. These controls, however, are not just intended to protect a franchisor’s
15 system or the value of its trademarks. Because “uniformity of product and control of
16 its quality cause the public to turn to franchise restaurants” (*Burger King Corp. v.*
17 *Stephens*, 1989 WL 147557, at *12 (E.D. Pa. Dec. 6, 1989)), the value of the brand a
18 franchisee chooses to affiliate with is directly impacted by a franchisor’s ability to
19 maintain consistency and quality. “By following the standards used by all stores in
20 the same chain, the self-motivated franchisee profits from the expertise, goodwill, and
21 reputation of the franchisor.” *Patterson*, 60 Cal. 4th 477. A satisfactory experience
22 in one franchised location may encourage a consumer to visit that location again, or,
23 critically, other locations in the system that offer the same satisfactory experience.
24 Conversely, consumer dissatisfaction with an experience at a single franchised
25 location can be attributed to the franchise system as a whole. Therefore, the standards
26 a franchisor is required to establish greatly impact and help protect a franchisee’s
27 investment and the equity it has built in its business.

1 12. Franchisors, franchisees, and franchisees' employees who work in
2 franchised businesses all derive mutual benefit from this unique, controlled, and
3 codified "business relationship". See, e.g., Cal. Corp. Code §31001; §31005(a)(2);
4 and §31011.

5 13. A franchisor's controls over system standards help protect the interests
6 of consumers. By establishing and enforcing standards for operational matters like
7 cleanliness, food storage and preparation, and safety, franchisors not only protect the
8 expectations of consumers who choose to patronize franchised businesses, but help
9 ensure that guidelines are put in place to protect their health and safety.

10 14. The FTC Franchise Rule is logically consistent in treating franchise
11 relationships and employment relationships as mutually exclusive – *i.e.* a franchise is
12 not an employment relationship.

13 15. The California Legislature has enacted two statutes to regulate franchise
14 relationships in this State (the California Franchise Investment Law [the "CFIL"] and
15 the California Franchise Relations Act [the "CFRA"]). These statutes have co-existed
16 with the Lanham Act for almost 50 years because they contain similar definitions of
17 the "franchise" relationship and, thus, are legally compatible. Like the FTC's
18 Franchise Rule, these enactments repeatedly characterize franchises as "businesses"
19 and describe the relationship created between a franchisor and a franchisee as a
20 "business relationship." See, e.g., Cal. Corp. Code §31001 (disclosures are designed
21 to give a better understanding of the parties "business relationship"); §31005(a)(2)
22 ("[t]he operation of the franchisee's business" must be substantially associated with
23 the franchisor's trademark); §31011 (franchise fee is the amount paid "for the right to
24 enter into a business under a franchise agreement").

25 16. For clarity, it is not suggested in any manner that the CFIL, the CFRA or
26 any other state statute that deals with franchising is somehow preempted, or
27 inconsistent with, the FTC Franchise Rule or the Lanham Act.

1 17. California's ABC Test, however, is irreconcilable with the federal laws
2 that regulate franchising and the trademark license underlying all franchised
3 businesses. The ABC Test impermissibly impinges on the essential feature of the
4 franchise model—control over brand-specific systems and business models. Without
5 control, franchisors would be forced to abandon their required support and system
6 oversight, resulting in harm to both franchisees and consumers.

7 18. Prong A of California's ABC Test, which requires a showing that workers
8 are entirely free from the control of the hiring entity in connection with the
9 performance of work both under contract and in fact, threatens to convert all franchise
10 relationships into employment relationships, and thus conflicts with and undermines
11 the federally approved franchise business model.

12 19. Specifically, under Prong A of the ABC Test, a person may not be
13 classified as an independent contractor unless that person is "*free* from control and
14 direction in connection with the performance of the service, both under his contract
15 for the performance of service and in fact." Cal. Labor Code § 2775(b)(1) (emphasis
16 added). As such, the ABC Test, if strictly interpreted to apply to a franchisor-
17 franchisee relationship, would have the perverse effect of converting all franchise
18 relationships, which necessarily require some element of control as defined by the
19 FTC Franchise Rule, into employment relationships despite those relationships being
20 arms' length and governed by contract.

21 20. Similarly, under Prong B of the ABC Test, a person may not be classified
22 as an independent contractor unless that person "performs work that is outside the
23 usual course of the hiring entity's business." Cal. Labor Code 2775(b)(1)(B). By
24 definition all franchisees are granted the right to operate a business that is identified
25 or associated with the franchisor's trademark." 16 C.F.R. 436.1(h). If operating a
26 business identified or associated with the franchisor's trademark (or offering, selling,
27 or distributing goods, services, or commodities that are identified or associated with
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1 the franchisor's trademark) is considered performing work that is within the usual
2 course of the franchisor's business, and the ABC test otherwise applies to franchisees,
3 then franchisees (under federal law) would be employees under the ABC Test.

4 21. Recently, this dissonance between the ABC Test and the franchise
5 business model was emphasized by the United States District Court for the District of
6 Massachusetts. In the case of *Dhananjay Patel v. 7-Eleven, Inc.*, No. 1:17-cv-11414-
7 NMG. (Sept. 10, 2020), the District Court correctly identified the "inherent conflict"
8 between the FTC Franchise Rule and Massachusetts' version of the ABC Test, which
9 mirrors California's version of the ABC Test. The Court stated that: "It cannot be the
10 case, as plaintiffs suggest, that, in qualifying as a franchisee pursuant to the FTC's
11 definition, an individual necessarily becomes an employee. In effect, such a ruling
12 by this Court would eviscerate the franchise business model, rendering those who are
13 regulated by the FTC Franchise Rule criminally liable for failing to classify their
14 franchisees as employees." *Patel*, 2020 U.S. Dist. LEXIS 165057, at *24.

15 22. As noted above, Prong A of California's ABC Test requires that a person
16 be "*free from control and direction in connection with the performance of the service,*
17 *both under his contract for the performance of service and in fact.*" Cal. Labor Code
18 § 2775(b)(1) (emphasis added). This cannot be reconciled with the FTC Franchise
19 Rule. Specifically, the FTC Franchise Rule precludes satisfaction of Prong A exactly
20 in the manner identified by *Patel* because the FTC Franchise Rule *defines* a franchise
21 as a relationship in which "the franchisor *will exert or has authority to exert a*
22 *significant degree of control over the franchisee's method of operation*". *Patel*,
23 2020 U.S. Dist. LEXIS 165057, at *19 citing 16 C.F.R. § 436.1 (emphasis added).

24 23. The ABC Test thus stands as an obstacle to the accomplishment and
25 execution of the full purposes and objectives of Congress, including the authorization
26 and regulation of the sale of franchises and the licensing of trademarks in connection
27 therewith.

1 24. For these and the additional reasons set forth below, Plaintiff seeks a
2 declaration that California's ABC Test as applied to franchisors and franchisees is
3 preempted by the FTC Franchise Rule and the Lanham Act, and a corresponding
4 injunction prohibiting Defendants from enforcing California's ABC Test against
5 franchisors and franchisees.

6 JURISDICTION AND VENUE

7 25. This Court has subject matter jurisdiction over this matter under 28
8 U.S.C. § 1331, in that this action arises under the Constitution and laws of the United
9 States, including the Supremacy Clause (U.S. Const. Art. VI), the Lanham Act (15
10 U.S.C. § 1051, *et seq.*), and the FTC Franchise Rule (16 CFR § 436.1, *et seq.*). This
11 Court also has subject matter jurisdiction over this matter under 28 U.S.C. § 2201 in
12 that this is a proceeding for declaratory judgment and injunctive relief under 28 U.S.C.
13 §§ 2201-2202 and the Supremacy Clause of the United States Constitution. This
14 action presents an actual controversy within the Court's jurisdiction.

15 26. Venue is proper in this judicial district pursuant to 28 U.S.C. § 1391(b)
16 Plaintiffs' members entered into franchise agreements that contemplate performance
17 in this judicial district, such that a substantial part of the events giving rise to the
18 claims occurred in this judicial district.

19 PARTIES

20 27. The IFA is the world's oldest and largest organization representing the
21 franchising industry. Since 1960, it has educated franchisors and franchisees on
22 beneficial methods and business practices to improve franchising. It also advocates
23 on behalf of franchisors and franchisees. Through its educational, public-policy, and
24 government-relations programs, it furthers the interests of the more than 733,000
25 franchise establishments which span over 300 different industries, support nearly 7.6
26 million jobs, and contribute more than \$674 billion to the U.S. economy. Its members
27 operate in all 50 states, including California.

1 28. AAHOA is the largest hotel owners' association in the nation. AAHOA's
2 more than 19,500 members own almost one in every two hotels in the United States.
3 With billions of dollars in property assets and hundreds of thousands of employees,
4 AAHOA's members are core economic contributors in virtually every community.
5 AAHOA's mission is to advance and protect the business interests of hotel owners
6 through advocacy, industry leadership, professional development, member benefits,
7 and community engagement.

8 29. Supercuts Franchisee Association ("SFA") represents over 1500 salons
9 across the United States, including in the State of California. Founded in 1985, SFA
10 is dedicated to enhancing the personal and professional lives of its members through
11 education, leadership development, best practice sharing and advocacy in the
12 franchising and Salon Industries. The SFA is a founding member of the Washington,
13 D.C. based Coalition of Franchisee Associations.

14 30. The DD Independent Franchise Owners Association ("DDIFO") is an
15 independent association of Dunkin' franchisees located throughout the United States,
16 including in the State of California. DDIFO has been advocating for and protecting
17 the interests of its members since 1989. DDIFO is a founding member of the
18 Washington, D.C. based Coalition of Franchisee Associations and proudly supports
19 the Dunkin' brand and the franchise ownership business model in Washington, D.C.
20 and in state legislatures throughout the United States.

21 31. The IFA, AAHOA, SFA and the DDIFO have standing to pursue this
22 action as associations because: (a) one or more of each of their members would have
23 standing to sue in their own right; (b) the interests asserted in this litigation are
24 germane to the their purposes as associations promoting and defending the franchise
25 business model; and (c) neither the asserted claims nor the requested relief requires
26 their members to participate individually. *See Hunt v. Washington State Apple*
27 *Advertising Commission*, 432 U.S. 333 (1977).

1 32. Defendant State of California is a sovereign state.

2 33. Defendant Xavier Becerra is the Attorney General of California and is
3 charged with enforcing and defending all state laws, including the California Labor
4 Code and California's wage orders. California's wage orders are constitutionally
5 authorized, quasi-legislative regulations that have the force of law. *See* Cal. Const.,
6 art. XIV, § 1; Cal. Labor Code §§ 1173, 1178, 1178.5, 1182, 1185; *Industrial Welfare*
7 *Comm'n v. Superior Court*, 27 Cal. 3d 690, 700-703 (1980). Because this action
8 challenges the constitutional validity of the wage orders and the Labor Code as
9 authoritatively interpreted by the California Supreme Court (*see Auto Equity Sales,*
10 *Inc. v. Superior Court of Santa Clara County*, 369 P.2d 937, 939 (1962) ("The
11 decisions of this court are binding upon and must be followed by all the state courts
12 of California")), the Attorney General is an appropriate party to defend this action.
13 *See* Cal. Gov't Code § 12510 *et seq.*

14 34. Defendant Julie Su is the Secretary of the California Labor and
15 Workforce Development Agency. The Labor and Workforce Agency is an executive
16 branch agency overseeing the Department of Industrial Relations and its Divisions,
17 including the Division of Labor Standards Enforcement and the Industrial Welfare
18 Commission, the Employment Development Department, and the California
19 Unemployment Insurance Appeals Board. *See* Cal. Gov't Code § 12813.

20 35. Defendant Katie Hagen is the Director of the Department of Industrial
21 Relations, an executive agency in California that is charged with defending,
22 amending, and republishing California's Wage Orders.¹ *See* Cal. Labor Code § 1182.

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¹ The Industrial Welfare Commission, a five-member commission within the Department of Industrial Relations (Cal. Labor Code § 70), is charged by statute with promulgating wage orders for various industries. Cal. Labor Code § 517. Although the IWC was defunded by the Legislature effective July 1, 2004, its wage orders remain in effect. *Bearden v. U.S. Borax, Inc.*, 138 Cal. App. 4th 429, 434 (2006).

1 36. Defendant Lilia Garcia-Brower is the Labor Commissioner of the
2 California Department of Industrial Relations, which is a department of the California
3 Labor and Workforce Development Agency. The Office of the Labor Commissioner
4 (also known as the State "Division of Labor Standards Enforcement," or "DLSE") is
5 specifically empowered by the Legislature to interpret and enforce the Industrial
6 Welfare Commission ("IWC") Wage Orders. *See* Cal. Labor Code §§ 61 and 1193.5.
7 The DLSE investigates complaints and takes enforcement actions against companies,
8 seeking to impose penalties on the basis that the company has misclassified
9 employees as independent contractors. Enforcement actions taken by the DLSE
10 include audits of payroll records, collection of unpaid wages, and issuing citations for
11 violations of any applicable wage order and Labor Code provisions. The DLSE also
12 adjudicates wage claims, pursuant to California Labor Code §§ 96 and 98, on behalf
13 of franchisees who file claims contending that they are employees misclassified as
14 independent contractors.

15 37. Defendant Patrick Henning is the Director of the Employment
16 Development Department. The Employment Development Department is specifically
17 empowered by the Legislature to interpret and enforce the Unemployment Insurance
18 Code. *See* Unemployment Ins. Code § 317.

19 38. Defendants Becerra, Su, Hagen, Garcia-Bower, and Henning are sued in
20 their official capacities as representatives of California and as the officials responsible
21 for enforcing California's ABC Test.

22 The Nature Of Franchising

23 39. Until the Lanham Act was passed in 1946, licensing a trademark was
24 deemed a deceptive trade practice. Once the Act was passed, a trademark could only
25 be licensed as long as the licensor "sufficiently policed and inspected its licensees'
26 operations to guarantee the quality of the products they sold under its trademarks to
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1 the public.” *Dawn Donut Co. v. Hart’s Food Stores, Inc.*, 267 F.2d 358, 367 (2d Cir.
2 1959).

3 40. The establishment of the right to license a trademark created the modern
4 franchise business model and has fueled the explosive growth of franchising over the
5 last seven decades. That business model and the “contractual arrangement [that
6 underlies all franchised businesses] benefits both parties.” *Patterson*, 60 Cal. 4th at
7 477.

8 41. On the franchisor’s side, franchising allows franchisors to monetize their
9 brands and intellectual property in a way that both (i) preserves the powerful
10 performance incentives associated with individual ownership at the retail level, and
11 (ii) minimizes the investment in organizational structure and capabilities (including
12 human capital and financial capital) needed to create a fully integrated retail business.
13 In this way, franchising allows franchisors to focus on the development of the know-
14 how they license to their franchisees, who pay royalties and fees for the right to use
15 this know-how and “the right to sell products or services under the franchisor’s name
16 and trademark.” *Patterson*, 60 Cal. 4th at 489.

17 42. On the franchisee’s side, franchisees receive among other things the
18 advantages of brand equity of the franchisor’s brand which draws customers to their
19 retail businesses. Brand equity may not only drive up the revenue a franchisee might
20 expect as compared to a similar, independent business, but may also impact the value
21 of a franchised business, which inures to a franchisee’s benefit during the business’s
22 operations and when that franchisee elects to sell the franchised business.
23 Accordingly, part of the value a franchisee receives when the franchisee enters into a
24 franchise agreement is the franchisor’s motivation and commitment to expend money
25 and effort maintaining and enhancing the brand’s value in addition to other benefits
26 including the provision of training, marketing assistance as well system controls and
27 oversight.

1 43. Franchisors build brand equity by, among other things, enforcing quality
2 standards. The failure to enforce standards can impact each franchisee and the value
3 of a franchisor's trademark. Consumer dissatisfaction at a single franchised location
4 may be wrongfully attributed to the entire system, thereby damaging the value of a
5 franchisee's business, the goodwill associated with the franchisor's brand, and the
6 health of a franchise system as a whole.

7 44. In addition, franchisors offer their franchisees access to a tested
8 operational system. As the California Supreme Court has observed, in addition to a
9 license to use the franchisor's trademark, a franchisee "also acquires a business plan,
10 which the franchisor has crafted for all of its stores. This business plan requires the
11 franchisee to follow a system of standards and procedures. A long list of marketing,
12 production, operational, and administrative areas is typically involved. The
13 franchisor's system can take the form of printed manuals, training programs,
14 advertising services, and managerial support, among other things." *Patterson*, 60 Cal.
15 4th at 489-90 (emphasis omitted).

16 45. Access to a franchisor's system creates significant operational
17 efficiencies which are intended to reduce franchisee financial risks because, instead
18 of having to create an entirely new business from the ground up, a franchisee has
19 access to an established brand and business system and can trade on the consumer
20 goodwill that the brand has generated as a result of the "control over the franchisees'
21 method of operation" exercised by the franchisor.

22 46. Notwithstanding the franchisor's establishment of a detailed operational
23 system, the franchisee "retains autonomy as a manager and employer." *Patterson*, 60
24 Cal. 4th at 478. "It is the franchisee who implements the operational standards on a
25 day-to-day basis, hires and fires store employees, and regulates workplace behavior."
26 *Id.* In fact, franchisees retain complete control over the employees they choose to hire
27 in their franchises.

1 47. Indeed, franchisees do not embark on ownership and operation of
2 franchised businesses as an "employee" of the franchisor. Quite the contrary,
3 franchisees obtain an independent business for their own benefit and for the benefit
4 of the brand which receives support from franchisors that is not available in ostensibly
5 comparable independent business ventures, subject to the aforesaid controls and
6 applicable contract provisions.

7 Regulation of Franchising

8 48. Franchise arrangements are heavily regulated, both at the state and
9 federal level. Likewise, both state and federal law define what it means to be a
10 "franchise."

11 49. Under two separate statutes, control is an essential element of all
12 franchised businesses.

13 50. First, control is an element of the definition of "franchise" under federal
14 law. Under the FTC Franchise Rule, a franchise is defined as "any continuing
15 commercial relationship or arrangement, whatever it may be called, in which the
16 terms of the offer or contract specify, or the franchise seller promises or represents,
17 orally or in writing, that:

18 (1) The franchisee will obtain the right to operate a business that is
19 identified or associated with the franchisor's trademark, or to offer, sell, or
20 distribute goods, services, or commodities that are identified or associated with
21 the franchisor's trademark;

22 (2) *The franchisor will exert or has authority to exert a significant*
23 *degree of control over the franchisee's method of operation, or provide*
24 *significant assistance in the franchisee's method of operation; and*

25 (3) As a condition of obtaining or commencing operation of the
26 franchise, the franchisee makes a required payment or commits to make a
27 required payment to the franchisor or its affiliate."
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1 FTC Franchise Rule, 16 C.F.R. § 436.1(h) (emphasis added).

2 51. The same concept is reflected in the state statute which regulates the sale
3 of franchises in this State. The CFIL defines a “franchise” as a contract or agreement,
4 either expressed or implied, whether oral or written, between two or more persons by
5 which:

6 (1) A franchisee is granted the right to engage in the business of
7 offering, selling or distributing goods or services *under a marketing plan or*
8 *system prescribed in substantial part by a franchisor*; and,

9 (2) The operation of the franchisee’s business pursuant to such plan
10 or system is substantially associated with the franchisor’s trademark, service
11 mark, trade name, logotype, advertising or other commercial symbol
12 designating the franchisor or its affiliate; and

13 (3) The franchisee is required to pay, directly or indirectly, a franchise
14 fee.

15 Cal. Corp. Code § 31005(a) (emphasis added).

16 52. In fact, according to a release issued by the California Department of
17 Financial Protection and Innovation, the agency responsible for regulating
18 franchises, (Commissioner’s Release 3-F, available at
19 <https://dfpi.ca.gov/commissioners-release-3-f/>), “[i]f no marketing plan or system is
20 prescribed and the franchisee is left entirely free to operate the business according
21 to the franchisee’s own marketing plan or system, the agreement is not a franchise.”

22 53. Second, for a business relationship to constitute a “franchise” under the
23 FTC Franchise Rule, the franchisee must obtain the right to use the franchisor’s
24 trademark or service mark. The Lanham Act, in turn, obligates a licensor to exercise
25 control over the use of its trademark(s). “The Lanham Act allows the use of a
26 trademark by someone other than the owner *only* when the owner exercises sufficient
27 control over the nature and quality of the goods or services sold under the trademark
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1 of the other.” William Finkelstein & James Sims, *The Intellectual Property Handbook*
2 39 (2005). “Where a licensor fails to exercise adequate quality control over a licensee,
3 a court may find that the trademark owner has abandoned the trademark, in which
4 case the owner would be estopped from asserting rights to the trademark.”
5 *Barcamerica Int’l v. Tyfield Importers, Inc.*, 289 F.3d 589, 595 (9th Cir. 2002) (internal
6 quotations omitted). The California Supreme Court and the Ninth Circuit Court of
7 Appeals, in fact, have both recognized that a franchisor *must* have the freedom to
8 “impose[] comprehensive and meticulous standards for marketing its trademarked
9 brand and operating its franchises in a uniform way.” *Patterson*, 60 Cal. 4th at 478;
10 *accord Salazar v. McDonald’s Corp.*, 939 F.3d 1051 (9th Cir. 2019).

11 54. The control over the methods, systems, and processes of the business that
12 licensors are required to exercise over the use of their trademarks benefits not just
13 franchisors, but consumers, who rightly assume that goods and services provided
14 under the same mark should carry the same level of quality. Such control also benefits
15 franchisees, who profit from the reputation and goodwill attached to the marks they
16 have been licensed to use.

17 California’s ABC Test

18 55. In April of 2018, the California Supreme Court issued its opinion in
19 *Dynamex Operations W. v. Superior Court*, 4 Cal. 5th 903 (2018). *Dynamex* adopted
20 a new test – the “ABC Test” – for determining whether a worker is an employee or
21 independent contractor for purposes of the Wage Orders of the Industrial Welfare
22 Commission, 8 Cal. Code Regs. § 11000, *et seq.*

23 56. Under the ABC Test, a worker is properly considered an independent
24 contractor to whom a Wage Order does not apply only if the hiring entity establishes
25 each of the following three criteria:
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1 (A) that the worker is free from the control and direction of the hirer in
2 connection with the performance of the work, both under the contract for the
3 performance of such work and in fact;

4 (B) that the worker performs work that is outside the usual course of the
5 hiring entity's business; and

6 (C) that the worker is customarily engaged in an independently established
7 trade, occupation, or business of the same nature as the work performed for the
8 hiring entity.

9 *Dynamex*, 4 Cal. 5th at 916-917.

10 57. On September 11, 2019, the California Legislature passed AB-5, which,
11 among other things, was intended to "codify the decision of the California Supreme
12 Court in *Dynamex* and ... clarify the decision's application in state law." Cal. Labor
13 Code § 2750.3. The law, which was signed by the Governor on or about September
14 18, 2019, makes the ABC Test applicable to the provisions of the Labor Code, the
15 Unemployment Insurance Code, and the Wage Orders of the Industrial Welfare
16 Commission.

17 58. Under AB-5: "[A] person providing labor or services for remuneration
18 shall be considered an employee rather than an independent contractor unless the
19 hiring entity demonstrates that all of the following conditions are satisfied:

20 (A) The person is free from the control and direction of the hiring
21 entity in connection with the performance of the work, both under the contract
22 for the performance of the work and in fact;

23 (B) The person performs work that is outside the usual course of the
24 hiring entity's business; and

25 (C) The person is customarily engaged in an independently
26 established trade, occupation, or business of the same nature as that involved
27 in the work performed.

1 59. AB-5 took effect on January 1, 2020.

2 60. On September 4, 2020, the Governor signed AB-2257, which revised and
3 recast the provisions of AB-5 and created certain exemptions. Under AB-2257, the
4 ABC Test applies to provisions of the Labor Code, the Unemployment Insurance
5 Code, and the Wage Orders of the Industrial Welfare Commission. AB-2257 took
6 immediate effect on September 4, 2020.

7 **The Purposes of AB-5 Are Not Served by Applying it to Franchises**

8 61. AB-5's stated intent is to address the "harm to misclassified workers who
9 lose significant workplace protections, the unfairness to employers who must compete
10 with companies that misclassify, and the loss to the state of needed revenue from
11 companies that use misclassification to avoid obligations such as payment of payroll
12 taxes, payment of premiums for workers' compensation, Social Security,
13 unemployment, and disability insurance." AB-5, § 1(b).

14 62. The California Legislature enacted the ABC Test in order "to ensure
15 workers who are currently exploited by being misclassified as independent
16 contractors instead of recognized as employees have the basic rights and protections
17 they deserve under the law... By codifying the California Supreme Court's landmark,
18 unanimous *Dynamex* decision, this act restores these important protections to
19 potentially several million workers who have been denied these basic workplace
20 rights that all employees are entitled to under the law." AB-F 1(e).

21 63. The franchise relationship is properly outside the ambit of California's
22 ABC Test, which was implemented to ensure that workers who should properly be
23 classified as employees have access to, among other things, workers compensation
24 and unemployment benefits. These kinds of employee benefits are not appropriate
25 for franchisees who, by definition, are owners granted the "right to operate a business"
26 (16 CFR 336.1(h)(1)). Instead, as independent business owners, franchisees keep
27 their businesses' profits, can sell their businesses, can access tax benefits like
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1 business-related deductions, and are eligible for programs for business owners, like
2 the Paycheck Protection Program, that employees cannot access.

3 64. The franchise model offers franchisees independence as business owners
4 to operate their own businesses, while also receiving the benefits of being part of a
5 system. While system standards may be uniform across locations, how one franchisee
6 or another chooses to manage his or her business can vary greatly. Notably, franchise
7 agreements that govern the relationship between franchisor and franchisee typically
8 specify that franchisees are responsible for their own employment decisions and give
9 franchisees the day-to-day control necessary to operate their individual businesses,
10 subject to limited controls designed to protect the brand and consumer goodwill.
11 Unlike employees, franchisees also build equity in their businesses and benefit from
12 that equity when franchisees sell their businesses.

13 65. In addition, franchisees are already required to pay appropriate payroll
14 and withholding taxes on behalf of their employees, furnish them with appropriate
15 workers' compensation insurance, and otherwise comply with wage and other
16 employee protections in accordance with state law and federal law. As a result, AB-
17 5's stated intent is inapplicable in the franchise context, where workers are already
18 considered employees of their respective franchised business and receive the
19 attendant employment protections and benefits under California law.

20 **When Applied to Franchises, California's ABC Test is Preempted by the FTC**

21 **Franchise Rule**

22 66. The FTC Franchise Rule authorizes and regulates the sale of franchises.

23 67. Under the FTC Franchise Rule, franchise relationships and employment
24 relationships are mutually exclusive – *i.e.* a franchise is not an employment
25 relationship and an employment relationship is not a franchise. The FTC Franchise
26 Rule Compliance Guide states that employment relationships “are excluded from
27 coverage.” See <https://www.ftc.gov/system/files/documents/plain-language/bus70->
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1 franchise-rule-compliance-guide.pdf. As long ago as 1978, in the Statement of Basis
2 and Purpose Relating to Disclosure Requirements and Prohibitions Concerning
3 Franchising and Business Opportunity Ventures, the FTC drew a distinction between
4 employees and franchisees: "The popularity of franchising is, to a large extent, the
5 result of the nature of franchising, a bringing together of persons who desire to be
6 their own bosses with those who have an accepted product or a proven operating
7 procedure and who have a need for expansion of capital and new management talent.
8 Thus, franchising allows a firm to expand more rapidly than could be expected
9 through internal growth, since it is designed to allow individuals to have more
10 autonomy than mere employees while working at the same time with a profit
11 incentive."

12 68. If interpreted strictly, the "A" Prong of California's ABC Test could
13 convert all franchises, as defined by the FTC Franchise Rule, into employment
14 relationships, remove franchises from the purview of the FTC Franchise Rule and,
15 therefore, stand as an obstacle to the accomplishment and execution of the full
16 purposes and objectives of Congress, including the authorization and regulation of the
17 sale of franchises.

18 69. Under Prong A of the ABC Test, a franchisee is deemed an employee
19 rather than an independent contractor unless the franchisee is *free* from the control
20 and direction of the hiring entity in connection with the performance of the work, both
21 under the contract for the performance of the work and in fact. However, under the
22 FTC Franchise Rule and the plain language of the Lanham Act, a franchisee cannot
23 be free from the control and direction of the franchisor. Therefore, when interpreted
24 strictly, Prong A classifies every franchisee as an "employee" of the franchisor.

25 70. Similarly, under Prong B of the ABC Test, a person may not be classified
26 as an independent contractor unless that person "performs work that is outside the
27 usual course of the hiring entity's business." Cal. Labor Code § 2775(b)(1)(B). By
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1 definition, all franchisees are granted the right to operate a business that is identified
2 or associated with the franchisor's trademark. 16 C.F.R. 436.1(h). If operating a
3 business identified or associated with the franchisor's trademark (or offering, selling,
4 or distributing goods, services, or commodities that are identified or associated with
5 the franchisor's trademark) is considered performing work that is within the usual
6 course of the franchisor's business, then Prong B of the ABC Test would convert all
7 franchise relationships into employment relationships.

8 71. By converting all franchises into employment relationships if interpreted
9 strictly, California's ABC Test removes all franchises from the purview of the FTC
10 Franchise Rule. It therefore stands as an obstacle to the accomplishment and
11 execution of the full purposes and objectives of Congress, including the authorization
12 and regulation of the sale of franchises.

13 **When Applied to Franchises, California's ABC Test is Preempted by the**
14 **Lanham Act**

15 72. One purpose and objective of the Lanham Act is to protect a trademark
16 owner's investment in the trademark. The Act specifically provides that "[t]he intent
17 of this chapter is to regulate commerce within the control of Congress by making
18 actionable the deceptive and misleading use of marks in such commerce; to protect
19 registered marks used in such commerce from interference by State, or territorial
20 legislation; to protect persons engaged in such commerce against unfair competition;
21 to prevent fraud and deception in such commerce by the use of reproductions, copies,
22 counterfeits, or colorable imitations of registered marks; and to provide rights and
23 remedies stipulated by treaties and conventions respecting trademarks, trade names,
24 and unfair competition entered into between the United States and foreign nations."
25 15 U.S.C. § 1127.

26 73. A critical piece of the trademark's value to the trademark owner is the
27 well-established right to license the trademark; so long as the trademark owner
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1 maintains control over the quality of the goods and services sold under the trademark
2 by the licensee. Franchising is one such form of licensing.

3 74. The Lanham Act expressly “protect[s] registered marks used in such
4 commerce from interference by State or territorial legislation.” 15 U.S.C. § 1127.

5 75. California’s ABC Test is preempted with respect to franchisors and
6 franchisees because it “stand[s] as an obstacle to the accomplishment and execution
7 of the full purposes and objectives of Congress” (*Hillman v. Maretta*, 569 U.S. 483,
8 490 (2013)) including, without limitation, the protection of a trademark owner’s
9 investment in its trademark, its right to license the use of that mark, and its right and
10 obligation to control the use of the mark.

11 76. Franchising is fundamentally incompatible with the obligations that
12 would be triggered if franchisees were deemed employees of franchisors under
13 California’s ABC Test. For example, all franchise systems contemplate the franchisee
14 will retain the profits and bear the losses of its own business. However, the California
15 Labor Code requires employers to indemnify their employees for all necessary
16 expenditures or losses incurred by the employee in direct consequence of the
17 discharge of his or her duties, meaning the franchisor (at least arguably) would need
18 to bear the franchisee’s losses. Most franchise systems require franchisees to pay the
19 franchisor an initial franchise fee and/or ongoing royalty fees in return for the rights
20 and support that the franchisor provides to the franchisee. However, the California
21 Labor Code prohibits an employer from compelling any employee to patronize his
22 employer in the purchase of anything of value, meaning the franchisor (at least
23 arguably) could not charge the franchisee such fees. Franchising is not viable if the
24 franchisor must bear all the franchisee’s losses and expenses and cannot charge any
25 fees to the franchisee, as AB-5 would (at least arguably) require if interpreted strictly.

1 **FIRST CLAIM FOR RELIEF**

2 **Declaratory Relief (28 U.S.C. section 2201)**

3 77. Plaintiffs incorporate by reference Paragraphs 1 through 76 of their
4 Complaint, inclusive, as and for this Paragraph 77, as if fully set forth herein.

5 78. Under the Supremacy Clause of the U.S. Constitution, Plaintiffs'
6 members may not to be subjected to or punished under state laws that are preempted
7 by federal law.

8 79. An actual controversy exists among the parties because Plaintiffs assert
9 that the application of California's ABC Test to franchisors and franchisees is
10 preempted by federal law, specifically the FTC Franchise Rule and the Lanham Act,
11 while Defendants assert it is not.

12 80. Plaintiffs seek a declaration that the application of California's ABC Test
13 to franchisors and franchisees, as defined by the FTC Franchise Rule, is preempted
14 by federal law, specifically the FTC Franchise Rule and the Lanham Act.

15 **SECOND CLAIM FOR RELIEF**

16 **(Injunctive Relief)**

17 81. Plaintiffs incorporate by reference Paragraphs 1 through 80 of their
18 Complaint, inclusive, as and for this Paragraph 81, as if fully set forth herein.

19 82. Defendants should be preliminarily and permanently enjoined from
20 enforcing against franchisors and franchisees California's ABC Test.

21 83. Enforcement against franchisors and franchisees of California's ABC
22 Test severely and irreparably harms Plaintiffs' members. Absent an injunction,
23 Plaintiffs' members will suffer severe and irreparable harm, which includes, without
24 limitation, the risk of civil liability, criminal liability, and determinations which
25 threaten the viability and goodwill of their businesses and their constitutional rights.

26 84. As a result, the Plaintiffs and their members have no adequate remedy at
27 law.

1 85. Plaintiffs' members' injuries are preventable and redressable with
2 appropriate injunctive relief that prevents Defendants from enforcing the ABC Test
3 against franchisors and franchisees.

4 86. The balance of harms weighs in favor of the entry of injunctive relief.
5 Defendants cannot claim an interest in the enforcement of an unconstitutional law.

6 87. The public interest also favors the entry of injunctive relief because the
7 public is interested in the enforcement of constitutional rights and because
8 franchising, and the continued viability of the franchise business model, is beneficial
9 to the public and the California economy.

10 **Prayer for Relief**

11 WHEREFORE, Plaintiffs demand judgment against Defendants as follows:

12 A. A declaration that, with respect to franchisors and franchisees, as those
13 terms are defined by the FTC's Franchise Rule, California's ABC Test is preempted
14 by federal law;

15 B. A preliminary and permanent injunction prohibiting Defendants, and any
16 division, board, or commission within such Defendants, from enforcing California's
17 ABC Test with respect to franchisors and franchisees; and

18 C. Such other relief as this Court deems just and proper.
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2 DATED: November 17, 2020

Respectfully submitted,

/s/ Karen C. Marchiano

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