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Keeping the American Dream Alive: The Challenge to Create Jobs Under the NLRB's New Joint Employer Standard

Testimony before the Committee on Small Business and Entrepreneurship

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James Sherk
Research Fellow in Labor Economics
The Heritage Foundation

Chairman Vitter, Ranking Member Shaheen, and members of the Senate Small Business and Entrepreneurship Committee, thank you for inviting me to testify. My name is James Sherk. I am a Research Fellow in Labor Economics at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The National Labor Relations Board's (NLRB) joint employer ruling will have a major impact on many American small businesses and their employees. It will make both business contracting and franchising very difficult – upending proven business models that provide opportunity for many workers and entrepreneurs.

Joint Employment and the NLRB

The National Labor Relations Act governs relations between employers and employees. As a result the Board must determine whether many entities are employers of employees or not. In many business relationships, such as contracting and sub-contracting, companies work cooperatively with employees they do not employ. The Taft-Hartley amendments to the National Labor Relations Act require the Board to use the common law test to determine whether an employment relationship exists. The common law test is a multi-factor balancing test, with the central factor the degree of control a putative employer has over a putative employees' work.[1] If a business exercises regular direct control over the details of how an individual works, courts will generally find them to have an employer-employee relationship. If a business does not exercise such control, but hires one or more people to perform a specified task and leaves the details of how to perform that task up to them, courts will generally

[1] See *Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440, 448–449 (2003)

find some other relationship exists (e.g. client-contractor).

The common law definition makes it possible for one or more employers to jointly employ a worker if they both exercise control over how that individual works. In 1964 the Supreme Court ruled the National Labor Relations Act encompasses this possibility.[2] For the next two decades the NLRB issued unclear and at time contradictor rulings over whether a joint employer relationship exists or not.[3] Then Board clarified the matter in two cases in 1984.[4]

In these cases the Board ruled joint employment existed when two or more companies "share or codetermine those matters governing the essential terms and conditions of employment . . ."[5] The Board assesses this by examining whether each company "meaningfully affects matters relating to the employment relationship such as hiring, firing, discipline, supervision and direction."[6]

Under this standard a business would be found to be a joint employer of its contractors' employees if it exercised meaningful and direct control over their work. For example, the Continental Winding Co. hired employees through a temp agency. The agency alone set and paid their wages. However, Continental assigned, scheduled, and directly supervised their work. The NLRB determined this made them a joint employer.[7]

Under this standard limited and routine oversight of another firms' employees while on company premises did not create joint employment. A company could tell contractors where and when to perform work on site without such routine details establishing joint employment.[8] The key question was "did the company have meaningful and direct control over their work or not?" This standard recognized the possibility of joint employment without preventing businesses from contracting for services outside their core competence.

The Browning-Ferris Decision

The National Labor Relations Board's recent *Browning-Ferris* decision abandoned this clear-cut standard.[9] The Board replaced the immediate and direct control standard with "indirect" or "potential unexercised" control over working conditions.

Browning-Ferris Industries (BFI) itself is a California recycling plant. Browning-Ferris focuses on its core competence: operating the heavy machinery involved in recycling glass, paper, metal, and plastics. It contracted with another company, Leadpoint Business services, to perform manual sorting of the recyclables and waste arriving at its plant. Leadpoint hired its own employees, set their wages, supervised them at the plant, and evaluated their performance.

BFI's contract with Leadpoint included specifying the hours the recycling plant operates, the speed at which the conveyor used for sorting materials would run, and the quality of recyclables needed.

[2] Boire v. Greyhound Corp., 376 U.S. 473, 481 (1964).

[3] See for example *Floyd Epperson*, 202 NLRB 23 (1973) and *Walter B. Cooke, Inc.*, 262 NLRB 626, 641 n.70 (1982). In the former case the NLRB concluded that indirect control over hours and wages sufficed to establish joint employment, while in the latter case the Board concluded indirect control was "insufficient to establish a joint employment relationship."

[4] *TLI, Inc.*, 271 NLRB 798, 798 (1984) and *Laerco Transp.*, 269 NLRB 324 (1984)

[5] *TLI, Inc.*

[6] *Laerco Transp.*

[7] *Continental Winding Co.*, 305 NLRB 122, 123 (1991)

[8] See, e.g., *Teamsters Local 776*, 313 NLRB 1148, 1162 (1994)

[9] *Browning-Ferris Industries*, 363 NLRB No. 95 (2015)

Leadpoint signed a "cost-plus" contract, so Browning-Ferris specified the maximum wages it would reimburse Leadpoint for. Browning-Ferris also reserved the right to dismiss any Leadpoint employees who impeded their operations. A Browning-Ferris manager once caught a Leadpoint employee with alcohol in their plant and asked Leadpoint to get him off their premises. Leadpoint promptly fired that worker.

The Board concluded that these contract specifications indirectly affected Leadpoint employees' working conditions. The Board reasoned that BFI's hours of operations determined the hours Leadpoint employees could get scheduled to work. The speed the conveyor belts operated and quality specifications affected their working conditions. The maximum payment BFI agreed to under "cost-plus" reimbursement limited their prospective wages. Further, the Board argued that BFI demonstrated potential control by having the employee caught with alcohol removed from their premises. The NLRB decided that this indirect and potential control sufficed to make BFI a joint employer of Leadpoint's workers.

Curtails Business Contracting

Most of the media attention on *Browning-Ferris* has focused on its considerable implications for franchised businesses. However, it will have an equally large effect on non-franchise businesses. The new *Browning-Ferris* standard will considerably impede business-to-business contracting.

The *Browning-Ferris* case itself had nothing to do with franchising. BFI simply signed a standard businesses service contract. Virtually all such contracts specify quality standards and prices. By law every company has potential control over another firm's employees operating on their premises. Any business can tell someone caught with alcohol around dangerous equipment to leave; if they do not they could face enormous legal liability. Business contractors also only operate on-site during the hours their client wants their services performed. The NLRB has ruled that these standard service contract provisions create a joint employment relationship.

This will make business contracting significantly more difficult. One of the advantages of business contracting is that it allows firms to focus on what they do best and hire other companies that specialize in handling details. If the client is not satisfied with their contractors' performance they can switch contractors. This is no longer possible if a joint employment relationship exists and the contractor is unionized. Companies have an obligation to collectively bargain with unionized contractors they jointly employ before terminating the contract.[10] Unions do not typically agree to contract terminations. Contracting with a firm that is or may become unionized becomes a near-permanent commitment to continue with that contractor's workforce.

Consider a power plant that hires a unionized firm to provide security, and that security proves sub-par. As a joint employer that power plant would have to bargain extensively before re-bidding the contract and replacing the contractor. The new contractor would further be bound to continue the terms and conditions of the old contractor's collective bargaining agreement.[11] These requirements would

[10] E.g. see *American Air Filter* Co. , 258 NLRB 49, 53 (1981), or *Fibreboard Corp. v. NLRB*, 379 U.S. 215 (1964);

[11] See *Whitewood Maintenance Co.*, 292 NLRB 1168–1169 (1989). The Board held that a contract was a joint employer with its subcontractor, so when it switched subcontractors the new subcontractor had to maintain the terms and

make the basic task of securing the power plant more difficult.

Joint employment would further require joint employers to engage in unwieldy multi-firm bargaining with all the other companies who jointly employ their contractors. In these negotiations many companies would have conflicting interests. Key concessions to one employer might not matter at all to another. For example, small businesses would probably care a lot about getting the best price on their contract. Large business might find other terms more important. If the large business competed directly against the small businesses they could easily prefer higher costs, in order to put their less well-capitalized rivals at a disadvantage. Just the legal fees from prolonged negotiations would strain many small businesses' finances. The new Joint Employer standards would make it prohibitively difficult for many businesses to sign service contracts. Service contracts would instead become agreements to partially merge with another business.

Reduced Productivity, Especially for Small Businesses

These changes undermine one of the major innovations in business management over the past generation: the shift to having businesses focus on their core competencies. Companies increasingly focus their efforts on what they do best, and contract out for the services necessary to support these operations.

Since the time of Adam Smith economists have recognized that the division of labor and specialization are central to creating economic value. Adam Smith used the example of pin makers, who could each individually produce at most twenty pins a day. However, by dividing the labor and specializing on each step of the task a factory with less than two dozen workers could produce tens of thousands of pins daily.

Businesses have realized that the logic of division of labor applies between companies, not just within them. A company that produces high quality manufactured goods may have no particular expertise in IT. A market research company may have employees with brilliant insights, but struggle at operating cleaning services. Consequently firms today increasingly specialize in their core expertise and contract out for other services. Most businesses, for example, do not have their own security or janitorial departments; they hire security and cleaning firms to handle these tasks. Many companies also contract for payroll and IT services rather than handling them in house. This division of labor makes companies more productive.

Such division of labor is especially important for small businesses because it allows them to benefit from economies of scale that they individually lack. For example, many small businesses have IT needs, but not enough to require dedicated full-time staff. Bringing on a full-time IT worker would impose an expensive financial burden on them. Contracting out allows small businesses to meet these needs as necessary without creating their own IT department. Similarly, many small manufacturing companies contract with shipping companies to transport goods to their clients. They could not afford to create their own shipping division. Business contracting allows these small businesses to compete against larger firms that could do these tasks internally.

The NLRB's new joint employer standard threatens all these business arrangements. "Indirect" and "potential unexercised" control are very vague and elastic terms that could encompass most

conditions of the old subcontractors' collective bargaining agreement.

business services contracts. Nothing in BFI's contract with Leadpoint stood out as unusual, but the NLRB nonetheless used it to change joint employment doctrine. Consequently businesses – large and small – will no longer know whether contracting creates a joint employment relationship or not. When the NLRB decides it does they will lose most of the benefits of business contracting. This will reduce American businesses competitiveness and their productivity. It will further hold back an economy struggling through the weakest recovery in the post-war era.

Discourage Hiring Unionized Contractors

The new joint employer changes also threaten many existing unionized contractors. The NLRB's new doctrine only has practical effects on contractors that are or may become unionized. It has little effect on businesses that hire non-union contractors. They would have no obligation to bargain over re-bidding their contracts. Nor would they have to engage in multi-employer collective bargaining negotiations. As long as employers do not do business with unionized contractors they do not risk semi-permanent entanglement with them.

This will strongly incentivize firms to hire only non-union contractors, and to change contractors if they suspect their current contractor may unionize. Although joint employment status will make it difficult for unionized contractors existing clients to terminate their contracts, that reality will make it very difficult for them to find new clients.

Threatens the Franchise Business Model

The new Joint Employer standards also threaten the entire franchise business model. Virtually all franchising arrangements dictate product quality and service standards. For example, fast food brands require their franchisees to serve customers within a specified window of time and to limit their prices. They do so to uphold core brand standards: most Americans order fast food precisely because they want fast and inexpensive food. If some Burger King franchises charged $10 and took 20 minutes to cook a Whopper it would undermine the these expectations for the entire brand.

These standards indirectly affect working conditions. The logic of *Browning-Ferris* implies joint employment between franchisors and franchisees. The NLRB's General Counsel has already brought charges against McDonald's corporate brand on exactly this basis. The General Counsel claims the McDonalds brand is responsible as a joint employer for its franchisees' alleged labor violations.

Media coverage of this case has focused on its implications for the fast food industry generally. However franchising in the U.S. is extends far beyond the restaurant sector. Tax preparation firms, pest control contractors, auto repair shops, convenience stores, hotels, and health clubs all widely use the franchise model (e.g. H&R Block, Terminex, Jiffy Lube, 7-Eleven, Holiday Inn, and Gold's Gym). *Browning-Ferris* affects all these industries.

If the General Counsel prevails the law will hold franchisors legally liable for their franchisees' potential labor violations. But franchise brands have no control over these workers. They do not hire, fire, schedule, promote, supervise, or pay them. The franchisees do. Franchise brands would face liability for actions they have no power to detect or prevent. To prevent this most currently franchised brands would probably replace their franchised stores with corporate owned ones. The new joint employment doctrine could destroy the franchise business model.

Eliminating Avenue for Upward Mobility

This would eliminate a key source of upward mobility. Franchising allows small business owners to overcome barriers to that could otherwise prove fatal to their business. Bureau of Labor Statistics data show that one-fifth of new business fail within a year, and half fail within their first six years.[12] This happens in part because new businesses face many difficult obstacles when starting from the ground up. They not only have to find a product that customers like, they have to produce it efficiently, and market their services to potential clients, all while handling the basic administrative and managerial tasks necessary to keep the business running.

Franchising acts like a "small business in a box" that removes many of these obstacles. The parent brand has already done the R&D necessary to develop an appealing product, and handles national marketing. That brand recognition drives sales and customers to the franchise. The corporate parents often give their franchises templates to use in their own local marketing efforts. The parent brand will also often provide guidance on how to structure their operations to operate efficiently. This allows franchise owners to focus their efforts on managing their small business. This system enables entrepreneurs who lack the know-how or experience to start a business from the ground up to nonetheless become small business owners.

As a result, the franchising model has proved an important avenue for upward mobility in America. Last year 780,000 franchised business establishments employed 8.8 million workers.[13] These franchised businesses are 50 percent more likely to be minority owned than non-franchised businesses.[14] Almost half of franchised businesses are either owned by women or equally owned by male and female owners.[15] If the NLRB's new joint employer doctrine stands, it will undermine a proven model of small business ownership. These business owners would be replaced by middle managers in the corporate brand's hierarchy.

This change would cut off an important source of access to small business ownership. It would also reduce quality at currently franchised businesses. Brands franchise their product in large part because business owners work harder than corporate managers. Franchised business owners reap the benefits of their business's success, and suffer the downsides of its failure. It is *their* business. As a result they put in greater effort than most managers reporting to a distant corporate hierarchy will.[16] Gutting the franchise model eliminates these economic benefits.

Conclusion

The NLRB's new joint employment doctrine, if allowed to stand, will upend both franchise businesses and business service contracting. The vague standards of "indirect" and "potential unexercised"

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[12] Bureau of Labor Statistics, Business Employment Dynamics, Table 7. Survival of private sector establishments by opening year

[13] International Franchise Assocation, "Franchise Business Economic Outlook for 2015," March 2015, page 2. Online at http://emarket.franchise.org/FranchiseBusinessOutlookMarch2015.pdf

[14] International Franchise Association, "Franchise Business Ownership: By Minority and Gender Groups," 2011, Table 1. Available online at http://www.franchise.org/sites/default/files/ek-pdfs/html_page/MinorityReport2011_0.pdf Their survey found that 14.2 percent of non-franchised businesses are minority owned, but 20.5 percent of franchised businesses are.

[15] *Ibid*, Table 3. 44.9 percent of franchised businesses fall into one of these categories.

[16] James Brickley and Frederick Dark, "The Choice of Organizational Form: The Case of Franchising," Journal of Financial Economics, Vol. 18, Issue 2, June 1987, pages 401-420

control can be extended to virtually all business service contracts and franchise relationships. The legal liability this entails would discourage businesses from signing service contracts. It would also drive many franchise brands to replace franchised stores with corporate-owned ones. This would undermine a proven business model that provides many economic benefits and opportunity for Americans.

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