The Legal Risks of Franchisee Screening

The best means for a franchisor to minimize legal exposure in the use of aptitude tests is to articulate legitimate business reasons for requiring examination, use tests provided by a reputable company, and administer the examinations in a fair and consistent manner.

By Daniel S. Kaplan

Although there are many legitimate benefits of using aptitude tests to screen prospective franchisees, such as predicting a likelihood of success within the franchise system, it would be wrong for a franchisor to assume that such tests are without legal risks. For example, if the tests prevent a person in a "protected class" from becoming a franchisee, the franchisor could have to defend a costly discrimination lawsuit. If the tests have the effect of precluding an existing franchisee from selling his franchised business, the franchisor might also face liability for violation of franchise and deceptive trade practices laws, as well as for breach of the franchise agreement.

Discrimination Laws

To successfully avoid liability for discrimination because of the use of aptitude tests, it is helpful to be aware of the discrimination laws and why they might apply in the franchise context. For example, under Title VII, 42 U.S.C., it is unlawful for employers to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to race, color, religion, sex, or national origin. Other federal discrimination statutes provide protection based on disability and age. Title VII, however, is of a rather limited risk to franchisors because the act has not been broadly interpreted beyond the employer-employee context. The granting of a franchise rarely creates an employer-employee relationship, and Title VII thus provides a limited risk to franchisors..

Section 1981, 42 U.S.C., on the other hand, has been applied in the franchisor-franchisee context. Section 1981 broadly protects persons in their right to make and enforce contracts. The aim of Section 1981 is to remove the impediment of discrimination from a minority citizen's ability to participate fully and equally in the marketplace. A franchisor's potential liability under Section 1981, however, usually requires intentional discrimination. The fact that the testing has a "disparate impact" and excludes persons in a "protected class" probably does not, in and of itself, create Section 1981 liability.

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States such as California have anti-discrimination laws that expressly apply to franchisors. For example, the California statute provides, "No franchisor shall discriminate in the granting of franchises solely because of the race, color, religion, sex, national origin, or disability of the franchisee and the racial, ethnic, religious, national origin, or disability composition of a neighborhood or geographic area in which the franchise is located." Under California law, a franchisor can be liable for utilizing screening tests to intentionally discriminate against persons in a protected class. However, the California statute probably would would not apply when screening tests are used in the transfer of an existing franchise, regardless of intent. The California statute applies to the "sale of a franchise," and a franchisor typically is not considered a party to the sale merely by exercise of the transfer approval process.

Other Potential Liability

Avoiding liability under discrimination statutes does not eliminate all legal exposure related to the use of screening tests. To illustrate this point, it is helpful to use an the following example that may be familiar to many franchisors:. A franchisee is in default of a

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franchise agreement and the franchisor grants the franchisee a limited opportunity to sell the franchised business in lieu of termination. In what ways could a franchisor be sued if the defaulted franchisee finds a ready and willing buyer, the franchisor requires the prospective franchisee to take a screening test, the candidate fails, the transferee is thus rejected, and the franchise agreement is terminated?

Clearly articulate legitimate business reasons for requiring examination.

If there is no disclosure that prospective franchisees will be required to successfully pass a screening test, it could be argued that this failure is a violation of the FTC Rule on Franchising. The FTC Rule and other state disclosure laws require disclosure of terms related to termination, cancellation and renewal of the franchise. This may also be actionable by a franchisee or prospective franchisee through state deceptive trade practices acts. The franchisor could arguably face liability for non-disclosure of the testing requirements, even with a legitimate non-discriminatory business reason for requiring the tests. A franchisor can eliminate this disclosure risk by disclosing the testing requirement in the offering circular, and can also minimize its legal exposure by including the testing requirement in manuals that are disseminated to franchisees.

Even disclosing the testing requirement, however, does not remove all potential legal liability. Nearly all franchise agreements grant the franchisor the right to approve the transfer of a franchise agreement, with such approval not to be unreasonably withheld. The obligation to act reasonably related to terms in a franchise agreement is also implied by the covenant of good faith and fair dealing and some state relationship laws. A franchisee and or prospective franchisee harmed by the testing requirement could therefore allege that the franchisor has acted unreasonably and in bad faith if, for example, the franchisor selectively decides who is required to take the tests, or allows only some applicants to retake the tests. Liability could also exist if the examinations were offered on a very limited schedule, making it nearly impossible to meet the deadline to close the sale, or if the examinations were known to be an unreliable predictor of success.

Franchisors may be able to avoid many of these risks by, when possible, amending the franchise agreement to grant the franchisor the right to approve a transfer in its "sole and absolute discretion" and for "any reason." The best means, however, for a franchisor to minimize all types of legal exposure in the use of aptitude tests is to clearly articulate legitimate business reasons for requiring examinations, utilize tests provided by a reputable testing company, and administer the examinations in a fair and consistent manner throughout the system. ■

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