COMMONWEALTH OF KENTUCKY
SUPREME COURT
NO. 2010-CA-000658

DOCTORS' ASSOCIATES, INC. APPELLANT

V. **BRIEF FOR UNINSURED EMPLOYERS FUND**

TONDA MICHELLE BROWN,
WATASH, UBC dba SUBWAY,
UNINSURED EMPLOYERS FUND,
HON. JOHN B. COLEMAN, ALJ,
and WORKERS' COMPENSATION BOARD APPELLEES

Respectfully submitted,

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CERTIFICATE

This is to certify the original pleading and nine copies were delivered to the Clerk of the Supreme Court via messenger mail, with copies mailed on this 1st day of March, 2011 to the following: Hon. Walter L. Sales, 2000 PNC Plaza, 500 West Jefferson Street, Louisville, Kentucky 40202-2828; Hon. Todd S. Page, 300 West Vine Street, Ste. 2100, Lexington, Kentucky 40507-1801; Hon. Forrest Ragsdale, 400 West Market Street, Ste. 1800, Louisville, Kentucky 40202; Hon. Aaron D. Van Oort, 2200 Wells Fargo Center, 90 South 7th Street, Minneapolis, MN 55402-3901; Hon. Kevin R. Mullins, 35 East Main, Whitesburg, Kentucky 41858; Watash, Inc., 714 Highway 2034, Whitesburg, Kentucky 41858; Hon. John B. Coleman, 107 Coal Hollow Road, Ste. 100, Pikeville, Kentucky 41501; and Hon. Dwight T. Lovan, Commissioner, Department of Workers' Claims, 657 Chamberlin Avenue, Frankfort, Kentucky 40601.

STATEMENT CONCERNING ORAL ARGUMENT

This is a case involving statutory construction, and the Uninsured Employers Fund has every confidence in the Court's ability to review the parties' briefs and render the correct decision. Accordingly, the UEF does not believe oral arguments to be necessary or helpful in this instance.

COUNTERSTATEMENT OF POINTS AND AUTHORITIES

COUNTERSTATEMENT OF THE CASE

1. Procedural overview

Appellee Tonda Brown suffered a work-related left wrist and back injury on May 17, 2000. Unfortunately, Appellee Brown's employer, Appellee Watash, Inc. dba Subway, had no workers' compensation insurance on the date of injury. That being the case, Appellee Uninsured Employers Fund ("UEF") was ordered to pay out ***$75,321.00*** in medical expense and ***$51,220.02*** in Temporary Total Disability benefits. The UEF ultimately paid ***$12,000.00*** for a "full and final" settlement of Ms. Brown's claim. (Total outlay = ***$138,541.02***) (Benefit Review Conference Order and Memorandum of December 6, 2000 and Agreement as to Compensation approved by ALJ Coleman on December 30, 2008)

Tonda Brown's Form 101 was filed on July 27, 2000. As the claim was being litigated it became apparent Appellee Watash was a franchisee of Appellant Doctors' Associates, Inc. ("DAI"), the parent company of the Subway sandwich shops. The UEF filed its *first* Motion to Join DAI in late November, 2000, and its Renewed Motion to Join in mid December, 2002. Appellee Coleman overruled both of those Motions, but on April 4, 2003 he sustained the UEF's second Renewed Motion to Join DAI.

The UEF and Tonda Brown negotiated a "full & final" settlement that the ALJ approved on December 30, 2008. As part of that settlement the UEF reserved all of its rights against DAI. A Benefit Review Conference was conducted on April 15, 2009 and briefs regarding "up-the-ladder" liability were submitted by May 20, 2009. In his Opinion and Order of July 2, 2009, ALJ Coleman dismissed the notion of "up-the-ladder" liability as it relates to the franchisor/franchisee relationship:

> *.....If the Legislature had intended for KRS 342.610 to encompass the relationship between a franchisor and a franchisee, it would have been very easy to include such language in the statute.....* (Page 3)

The Workers' Compensation Board affirmed the ALJ's decision in its Opinion rendered on January 15, 2010:

> *We agree with the ALJ that the legislature did not intend for KRS 342.610 to include the relationship between a franchisor and a franchisee.....* (page 8)

The Court of Appeals, in its Opinion Reversing and Remanding of September 3, 2010, disagreed with the idea of giving franchisors a blanket exemption from "up-the-ladder" liability:

> *.....(W)e are not persuaded that "business opportunity" relationships, or "franchise" relationships, are* per se *exempt from the purview of KRS 342.610(2)(b), and we find error in that part of the ALJ's order holding that "franchisors" are exempt from liability under the (Workers' Compensation) Act. The question of whether a particular business opportunity or franchise relationship satisfies KRS 342.610(2)(b) must be answered on a* ***case-by-case basis****, by examining the* ***specific relationship between the alleged contractor and subcontractor*** *and determining whether, pursuant to that statute, the alleged subcontractor has performed work "of a kind which is a regular or recurrent part of the work of the trade, business, occupation, or profession of (the contractor)."* (page 14) (Emphasis added.)

The Board ultimately remanded this matter and directed the ALJ to: (1) take additional proof regarding the nature of Petitioner's business and whether the work that Appellee Watash performed was a regular or recurrent part of its business under KRS 342.610(2)(b); and (2) make additional findings of fact, based upon substantial evidence of record, supporting the legal conclusion that KRS 342.610(2)(b) either does or does not apply in this instance, and to make any other findings not inconsistent with this opinion. (Page 20)

2. Terms of the Contractual Relationship between DAI and Watash

A copy of that Franchise Agreement ***drafted by DAI*** and executed by William Ihrig of Wa-

tash, Inc. is attached to Appellant's brief as Exhibit 7, and DAI's Operating Manual is incorporated by reference at Section 5.b. on page 5. Relevant pages of the Operating Manual are attached to those Answers to Interrogatories prepared by DAI's Director of Dispute Resolution, William Darrin, Jr..

Under Recital "B" on page 3 of the Franchise Agreement, DAI admits it "***operates***, and franchises others to operate ***sandwich shops*** under the trade name and service mark SUBWAY....." (Emphasis added.)

Under Recital "C", DAI refers to ***"the Company's sandwich business"***. (Emphasis added.)

At page 4 of the Agreement, the Franchisee (Watash) is directed to pay DAI a weekly "Royalty" equal to ***8% of the gross sales*** from its sandwich shop. (Emphasis added.)

At page 5 of the Agreement, DAI grants the Franchisee (Watash) "access to information pertaining to new developments and techniques in ***the Company's sandwich business***". (Emphasis added.)

At page 6 of the Agreement, DAI sets forth its insurance requirements:

> .....Insurance shall include, but not be limited to, comprehensive liability insurance including products liability in the minimum amount of $1,000,000.00. The Franchisee shall keep these policies in force ***for the mutual benefit of the parties. In addition, the Franchisee shall save the Company harmless from any claim of any type that arises in connection with the operation of the business***. (Emphasis added.)

Page 6 also memorializes Franchisee's agreement to "allow the Company's representatives or agents to enter his premises during regular business hours ***to inspect and audit his business operations".*** (Emphasis added.)

The term of the Franchise Agreement was twenty (20) years from the date of execution. (Page 7)

DAI's Operating Manual fleshes-out the insurance requirements imposed upon franchisees such as Watash:

> .....***you must name us***, our affiliates and the Development Agent, and our agents, representatives, shareholders, directors, officers, and employees, and those of our affiliates and the Development Agent, ***as additional insureds. Your insurance company must agree to give us at least 20 days prior written notice of termination, expiration, material modification, or cancellation of your policy, or cancellation of us or any other entities or individuals in the preceding sentence as an additional insured.....Under the Franchise Agreement, you must defend and indemnify us***, our affiliates, and the Development Agent, and our agents, representatives, shareholders, directors, officers, and employees, and those of our affiliates and the Development Agent, ***against any claim from the operation of your restaurant, regardless of cause or any fault or negligence*****.....**
>
> We designate 3 insurance companies under our Gold Standard Insurance Program. ***You must buy your insurance from one of the 3 designated insurance brokers or companies under Subparagraph 5.c. of your Franchise Agreement, including transfers and amendments***. We negotiated with these insurance brokers or companies to provide an insurance package, including property and casualty, general liability, ***workers' compensation***, business income, and additional forms of insurance coverage, for SUBWAY franchisees. (Page 31) (Emphasis added.)

The Operating Manual speaks to other areas in which DAI exercises ongoing control of a franchisee's day-to-day operations:

> .....At present, we have also approved one or more suppliers (including manufacturers, distributors, and other sources) as the required supplier for certain items and ***you must buy these items only from the required suppliers*** unless you request and receive approval from us to add another approved supplier for the item in accordance with our quality control procedures described below.....
>
> (Page 33) (Emphasis added.)
>
> ***You must purchase through us or lease from us substantially all major items of equipment for your restaurant*****.....** (Page 33) (Emphasis added.)
>
> At present, our affiliate Franchisee Shipping Center Co., Inc. ("FSCC") is ***the only approved supplier*** for your menu board translites, decals, Sub Club Card stamp dispenser and stamp materials, and certain operational items..... (Page 34) (Emphasis added.)

You must operate the restaurant in strict compliance with all required methods, procedures, policies, standards and specifications of the SUBWAY system in the Operations Manual and in other writings we issue. You must use the restaurant premises only for the operation of a SUBWAY restaurant and ***you may not operate any other business at or from the location without our prior written consent. You must offer and sell only those goods and services we have approved.....***

You must offer all goods and services we designate as required for all franchisees.... .....We reserve the right to designate additional required or optional goods and services in the future and to withdraw any of our previous approvals. ***There are no limits on our right to do so. You must comply with our new requirements.....***

*****.....You will have to follow the decision made for the market*** on items categorized as Marketwide Option Program items, unless we grant you a waiver.....

(Page 59) (Emphasis added.)

Significantly, none of facts of this case are in dispute. The issue here is a matter of law.

ARGUMENT

I. THE COURT OF APPEALS WAS INDEED FREE TO REVIEW THE BOARD'S APPLICATION OF KRS 342.610(2) TO THE FACTS OF RECORD.

When the Court of Appeals reviews a Workers' Compensation Board decision, it may reverse the Board's decision if it has overlooked or misconstrued controlling law or so flagrantly erred in evaluating the evidence that it has caused gross injustice. Western Baptist Hospital v. Kelly, 827 S.W. 2d 685, 687-88 (Ky. 1992). "It is well settled that a reviewing (body) may not substitute its judgment for that of an (administrative) board as a finder of fact." Paramount Foods, Inc. v Burkhardt, 695 S.W. 2d 418, 421 (Ky. 1985); KRS 342.285. "The substantial evidence test pertains (only) to questions of fact, not questions of law(.)" Brown By and Through Brown v. Young Women's Christian Association, 729 S.W. 2d 190, 192 (Ky. App. 1987). "An

erroneous application of the law by an administrative board or by the circuit court is clearly reviewable by this Court. Also, where an administrative body has misapplied the legal effect of the facts, courts are not bound to accept the legal conclusions of the administrative body." Abuzant v. Shelter Insurance Company, 977 S.W. 2d 259, 260-61 (Ky. App. 1998).

At page 8 of its January 15, 2010 Opinion Affirming, the Workers' Compensation Board concurred with the ALJ's interpretation of Kentucky workers' compensation law:

> *We agree with the ALJ that the Legislature did not intend for KRS 342.610 to include the relationship between a franchisor and a franchisee.....*

Appellee UEF respectfully submits the Board concluded as ***a matter of law*** Appellant had no "up the ladder" liability for Tonda Brown's work-related injuries. Accordingly, it was indeed within the Court of Appeals' province to review (and reverse) the Board's decision. Moreover, KRS 342.290 specifically grants the Court of Appeals the power to review "errors of law arising before the board and made reviewable by the rules of the Supreme Court....".

II. DAI QUALIFIES AS A CONTRACTOR UNDER KRS 342.610(2)(b).

This Court's holding in Firestone Textile Co. Div. v. Meadows, 666 S.W. 2d 730 (Ky. 1983), provides a backdrop for Appellee UEF's "up the ladder" liability argument against franchisors (generally) and DAI (specifically):

> The mandate of KRS 446.080 is particularly applicable to the Workers' Compensation Act which is often cited as an act ***to be liberally construed to effect its remedial purpose. All presumptions will be indulged in favor of those for whose protection the enactment was made.*** (Emphasis added.)

Moreover, this Court has previously recognized the purpose of KRS 342.610 is to prevent subcontracting to those people who have failed to secure workers' compensation benefits for their

employees. Fireman's Fund Insurance v. Sherman & Fletcher, 705 S.W. 2d 459 (Ky. 1986).

For purposes of this matter, the relevant portion of KRS 342.610(2)(b) is as follows:

> A contractor who subcontracts all or any part of a contract and his carrier shall be liable for the payment of compensation to the employees of the subcontractor unless the subcontractor primarily liable for the payment of such compensation has secured the payment of compensation as provided for in this chapter.....***A person who contracts with another:***
>
> **********
>
> ***(b) To have work performed of a kind which is a regular or recurrent part of the work of the trade, business, occupation, or profession of such person***
>
> ***shall for the purposes of this section be deemed a contractor, and such other person a sub contractor. This subsection shall not apply to the owner or lessee of land principally used for agriculture.*** (Emphasis added.)

Appellee UEF respectfully submits the wording of KRS 342.610(2)(b) provides a broadly-encompassing, open-ended definition of the "contractor/subcontractor" relationship, as well as a single, specific exclusion. It certainly appears as though the Legislature was trying to facilitate the imposition of "up the ladder" liability in as many cases as possible.

Appellant admits in its Franchise Agreement it is in the "sandwich business". Appellee UEF acknowledges Appellant sells "Subway" franchises, but that is in addition to developing menu items and marketing strategies that franchisees such as Appellee Watash are ***required*** to offer/ participate in. Appellee UEF respectfully submits Appellant maintains such tight control over its franchisees in an attempt to maximize that weekly "royalty" it collects from each one of them ***(8% of gross sales)***. In other words, by telling its franchisees what sandwiches to sell and how to sell them, Appellant is trying to make sure its 8% "cut" is as large as possible. Obviously, the more "Subway" sandwiches a franchisee sells, the more money Appellant DAI makes.

Appellee respectfully submits the relevant language of KRS 342.610(2)(b) is simple and

straightforward. Both Appellant DAI and Appellee Watash qualify as a "person" pursuant to the definition set forth at KRS 342.0011(16), and the Franchise Agreement is unquestionably a "contract". The Franchise Agreement benefitted Appellant in that it provided for the sale of "Subway" sandwiches in Letcher County, Kentucky (Ihrig depo. p 5), from which DAI would collect a weekly "royalty" of 8%. Selling "Subway" sandwiches is most certainly a "regular or recurrent part" of Appellant's "business", and Appellee Watash was selling "Subway" sandwiches on the day Tonda Brown was injured. Inasmuch as Watash was Ms. Brown's (uninsured) employer, "up the ladder" liability should have been imposed upon DAI.

Appellant takes issue with the notion Appellee Watash was performing "work" for it at the time of Tonda Brown's injury. Although "work" is defined at KRS 342.0011(34), Appellee UEF is not at all sure that particular definition serves any purpose other than to clarify the definitions of "Permanent partial disability" and "Permanent total disability" set forth in KRS 342.0011(11) (b) and (c). Nevertheless, the UEF maintains Appellee Watash was indeed "providing services" to DAI "in return for remuneration", especially since *Black's Law Dictionary* defines "remuneration" as "Reward; recompense; salary; compensation". Appellee Watash was selling "Subway" sandwiches in Whitesburg, Kentucky (a ***service*** that generated an 8% royalty for Appellant), and it was ***rewarded*** with continued access to DAI's sandwich-selling acumen and marketing prowess. As is the case with most other "contractor/subcontractor"relationships, ***both parties benefitted*** from their contractual relationship. Put another way, Tonda Brown's efforts for Appellee Watash helped generate those weekly royalties DAI collected. Accordingly, Appellant should have "up the ladder" liability for Ms. Brown's work injuries.

Appellee UEF does not want this Court to overlook the final sentence of KRS 342.610(2):

> .....*This subsection shall not apply to the owner or lessee of land principally used for agriculture.*

Obviously, the Legislature wanted a single, specific exemption from "up the ladder" liability, and it has nothing to do with "franchisors" such as Appellant. As opposing counsel points out at page 27 of their brief, "the express mention of certain conditions of entitlement (in a statute) implies the exclusion of others." Hearn v. Commonwealth, 80 S.W. 3d 432, 438 (Ky. 2002). The UEF respectfully submits the above holding would be equally true of the express mention of a specific exclusion.

Appellant DAI wears the mantle of "franchisor" as some sort of armor that deflects "up the ladder" liability. However, as the Court Of Appeals determined in R.O. Giles Enterprises, Inc. v. Mills, 275 S.W. 3d 211 (Ky. App. 2008), a party can not exempt itself from liability under KRS 342.610(2) simply by labeling its relationship as something other than that of contractor/subcontractor. In its Opinion Reversing and Remanding of September 3, 2010, the Court of Appeals held:

> .....*R.O. Giles* also reemphasizes that the label that one party attaches to an arrangement.....is entitled to no deference from the Court and is not dispositive to whether that arrangement qualifies that party as a contractor under the statute. Rather, legal fictions must be disregarded and the situation must be viewed "realistically" in light of the business being conducted and the services rendered. *See Commonwealth v. Potts*, 295 Ky. 724, 175 S.W. 2d 515, 516 (1943); *see also Brewer v. Millich,* 276 S.W. 2d 12, 16 (Ky. 1955) ("Courts look behind the legal terminology to discover and expose the real relationship between the parties as regards the question of the failure to obtain compensation coverage.")
>
> (page 18)

Finally, Appellee UEF is compelled to address that foot note on page 12 of Appellant's brief and the implication Appellant hopes this Court will glean therefrom. Appellant's counsel wrote as follows:

> Since discovery was completed in the workers' compensation action, DAI has greatly increased the number of franchises for which it acts as franchisor, with 33,700 Subway franchises in operation. Moreover, DAI no longer operates any company-owned stores.

This bit of information is not in the evidence of record, and the UEF has to believe counsel for DAI forced it in front of this Court in an attempt to bolster its "We're not in the sandwich business" argument. While the UEF doesn't believe this Court will find that argument persuasive, out of an abundance of caution it will remind the Court of its holding in Fireman's Fund Insurance Co. v. Sherman & Fletcher, 705 S.W. 2d 459, 462 (Ky. 1986):

> .....Even though he may never perform that particular job with his own employees, he is still a contractor if the job is one that is usually a regular and recurrent part of his trade or occupation. The business or occupation of Sherman & Fletcher was building construction, and rough carpentry is work of a kind which is a regular or recurrent part of the work of the business of building construction. Sherman & Fletcher would have been liable for the worker's compensation benefits to David George if Elder, Inc., his employer, had not not secured those benefits. KRS 342.610(2).....

Put another way, Appellant DAI does not need to operate company-owned "Subway" stores in order to have "up the ladder" liability for Tonda Brown's work injuries. (Of course, at the time it was executed, the Franchise Agreement in question proclaimed DAI "operates.....sandwich shops" and refers to "the Company's sandwich business".)

III. NO OTHER ISSUE IS PROPERLY BEFORE THIS COURT.

In its Petition for Review of Workers' Compensation Board Decision, Appellee UEF presented two Arguments to the Court of Appeals: (1) KRS 342.610(2) should apply to the franchisor-franchisee relationship, and (2) DAI is subject to "up the ladder" liability for Tonda Brown's work injuries. There was no cross-appeal, so no other issues were before the Court.

The UEF's position is confirmed by the opening paragraph of the Court's "ANALYSIS" at page 7 of its Opinion Reversing and Remanding:

> *The question presented in this case is whether the ALJ correctly determined that DAI is not responsible, as a matter of law, for providing workers' compensation benefits to an employee of Watash, pursuant to KRS 342.610(2)(b).*

At pages 33 - 36 of its brief, Appellant raises arguments regarding the timing of its joinder, as well as whether Appellee UEF has a right of subrogation/reimbursement against it. Inasmuch as DAI failed to raise or preserve these arguments at any lower level, the UEF respectfully submits said arguments are not properly before this Court and should not be considered.

IV. PUBLIC POLICY CONSIDERATIONS.

The International Franchise Association ("IFA") has filed an amicus curiae brief in support of Appellant DAI's position. At page 11 of its brief, under the heading **Sound Public Policy Supports the ALJ's Application of the Statute,** the IFA makes a somewhat impassioned plea:

> *.....The Court of Appeals' holding is a direct repudiation of the existence of franchisees as business owners. If left standing,* **it will require franchisors to to act more like employers to manage their own risk,** *and therefore hobble the very aspect of franchising that has allowed it to contribute 176,000 jobs and billions of dollars to the Kentucky economy.....* (Emphasis added.)

Appellee UEF respectfully submits the IFA may be unaware of those steps DAI took "to manage their own risk" in regard to the imposition of "up the ladder" liability pursuant to KRS 342.610. The UEF further submits if DAI had just enforced the terms of that Franchise Agreement it drafted, Tonda Brown would have received the workers' compensation benefits she was entitled to from her direct employer (Appellee Watash). After all, DAI ***required*** Watash to (1) purchase workers' compensation insurance, (2) name DAI as an additional insured, and (3) have the in-

surance company agree to give DAI "at least 20 days prior written notice of termination, expiration, material modification, or cancellation of your policy.....". (Operating Manual p 31) There is no evidence of record concerning what steps, if any, were taken to ensure Watash's compliance with these requirements, which were obviously imposed for the direct benefit and protection of DAI. However, DAI's enforcement of its own requirements would also have protected Ms. Brown's timely access to workers' compensation benefits. Because Watash was uninsured on May 17, 2000, Ms. Brown did not receive any benefits until after December 6, 2000, when the ALJ ordered Appellee UEF to begin paying them. The UEF respectfully submits one of the primary purposes of Kentucky's workers' compensation law (prompt payment of benefits) would be better served if franchisors such as DAI were subject to "up the ladder" liability.

The IFA claims the imposition of "up the ladder" liability would somehow "hobble" the growth of franchising in Kentucky. Appellee UEF respectfully submits making sure a franchisee has the requisite workers' compensation insurance in place would be no more "hobbling" to a franchisor than it currently is for a general construction contractor. (This would seem to be particularly true for Appellant DAI inasmuch as it already sends out "representives or agents" to "inspect and audit" its franchisees' business operations.) Plus, the franchisor would have the same right of reimbursement afforded to other contractors under KRS 342.610(2):

> *.....Any contractor or his carrier who shall become liable for such compensation may recover the amount of such compensation paid and necessary expenses from the subcontractor primarily liable therefore.....*

With all due respect, it seems as though the IFA is more concerned with the possible inconvenience associated with monitoring a franchisee's insurance coverage than it is with making sure

Kentucky's service industry workers get those workers' compensation benefits they are entitled to. Appellee UEF has to believe this Court will find the IFA's priorities to be at least a little bit misplaced and rule accordingly.

CONCLUSION

At this point, all involved will do well to remember what the focal point of the Court of Appeals' ruling was:

> .....The question of whether a particular business opportunity or franchise relationship satisfies KRS 342.610(2)(b) must be answered on a ***case-by-case basis***, by examining the ***specific relationship between the alleged contractor and subcontractor*** and determining whether, pursuant to that statute, the alleged subcontractor has performed work "of a kind which is a regular or recurrent part of the work of the trade, business, occupation or profession of (the contractor)." (Opinion Reversing and Remanding, p 14) (Emphasis added.)

In other words, and contrary to the holdings of the ALJ and the Workers' Compensation Board, nothing in or about KRS 342.610(2)(b) exempts a "franchisor" from "up the ladder" liability as a matter of law. Accordingly, the Court of Appeals has directed the ALJ to (1) take additional proof regarding the nature of Appellant DAI's business and whether Appellee Watash's work was a regular and recurrent part of that business under KRS 342.610(2)(b); and (2) make additional findings of fact, based upon substantial evidence of record, supporting his ultimate legal conclusion as to whether KRS 342.610(2)(b) applies in Tonda Brown's case.

Under the Court of Appeals' ruling, Appellant DAI may yet walk away from Tonda Brown's workers' compensation case unscathed. However, if that ultimately turns out to be the case, it will only be after a thorough examination of the "specific relationship" between Appellant and Appellee Watash, as well as a determination regarding whether Watash's sale of "Subway" sand-

wiches was a "regular and recurrent" part of DAI's business. (The fact that DAI was collecting a ***weekly, 8% royalty*** from Watash's sales certainly seems to indicate it was, but that is for the ALJ to decide.) Accordingly, Appellant's appeal should be dismissed, and the Court of Appeals' Opinion Reversing and Remanding should be affirmed.

Respectfully submitted,

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