Complying With System-Wide Standards (Basics Track)

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Complying With System-Wide Standards (Basics Track)

What Are System Standards

The words, symbols and colors that distinguish the products and services of one source from those of another – trademarks, service marks and trade dress – are protected by the federal Trademark Act of 1946 (the "Lanham Act"), 15 U.S.C. § 1051 *et seq.* The value of a trademark – what makes it worth protecting – lies in its ability to induce consumers to associate the trademark with a particular source of products or services because (more fundamentally) they have learned to expect a consistent level of quality or service from that source. It is this consistency that gives franchising its power, the expectation that a Big Mac will taste the same in London as it does in Cleveland, and the same today as it did last month. The more consistency consumers experience, the more they come to expect and the stronger the trademark under which the products or services are sold becomes.

System standards are the operational directives established by a franchisor to ensure quality and consistency – that the Big Mac will taste the same, with the same ingredients, from comparable sources, prepared the same way, wrapped in the same packaging, and served in a restaurant that looks and feels the same, at any location. System standards also provide a valuable roadmap for franchisees and distinguish the system from others.

Virtually any aspect of operating a business – from the number of slices of ham (cut to a certain thickness) that must be put into a particular sandwich to what type of cleanser to use on the counter, from how the signs must be lit to how accounting functions must be performed – can be part of a franchisor's system standards. System standards can also consist of more general imperatives: uphold the high-quality image of the product, keep the store clean at all times, be friendly and polite to customers. System standards may be referenced in a franchise agreement – and failure to follow standards is generally a breach of the franchise agreement – but they are generally detailed in an Operations Manual, which is incorporated by reference into the franchise agreement and is explicitly subject to change from time to time.

What Gives A Franchisor Authority To Impose System Standards?

A franchisor's authority to impose system standards is based on both statutory and contractual sources: the Lanham Act, the Franchise Agreement, and the Operations Manual. As noted above, in the United States, the Lanham Act protects trademarks, service marks, and trade dress that are registered with the U.S. Patent and Trademark Office.[1] All trademark owners, including franchisors, are obligated to take affirmative steps to protect and regulate the use of their trademarks. Failure to do so can result in a weakening of the legal protections available, and may even lead to a

[1] 15 U.S.C. §1051(a)(1). Note: A complete discussion of the Lanham Act, as well as similar laws in non-U.S. is beyond the scope of this paper.

finding that the mark has been abandoned and therefore unprotectable.[2] Moreover, since the trademark is generally the most important asset of a franchisor, [3] a franchisor also must regulate the overall system associated with its marks. Indeed, most courts recognize that a franchisor must impose relatively detailed system standards (above and beyond measures that would be necessary to protect trademarks generally) to ensure continued protection under the Lanham Act, as well as to protect the goodwill value of the trademark and the franchise system.[4] In other words,

> A distributor of gasoline does not really need to specify the exact shape, layout, and color scheme of a service station franchise to protect the trademark on its petroleum products. On the other hand, such details might be critical to the validity of the service mark of a McDonald's restaurant, a Blockbuster Video store, or a 7-Eleven convenience store.[5]

In addition to the Lanham Act, a franchisor typically derives its authority to impose standards from the franchise agreement, as well as the operations manual. The franchise agreement, which is negotiated and signed by both the franchisor and the franchisee, provides the contractual authority for imposition of system standards. The actual system standards, however, generally are not included in the franchise agreement itself, as the franchisor needs the flexibility to modify the standards over time without seeking formal amendments to the franchise agreement for each change. For example, a franchisor of hotels may wish to change the standard on required thread count for sheets from time to time, but may avoid doing so if it were necessary to get hundreds or even thousands of franchisees to sign formal amendments to their franchise agreements. To avoid this burdensome process, franchisors typically set forth the system standards in a separate operations manual. In addition, most franchisors expressly claim ownership of the operations manual, define it as "proprietary information," and often include it as part of the franchisor's intellectual property.

Importance Of Enforcing System Standards

The value of a trademark, service mark or trade name is derived from consumers' association of the mark or name with certain characteristics. Whether consumers come to associate a mark or name with quality, cleanliness, safety, value and speed of service or with less savory qualities depends on their experiences over time with the mark or name. It may take many years of providing consistently excellent products and services to build customer loyalty; however, a few mediocre experiences – or perhaps a single dramatically negative experience – can erode that loyalty. The

[2] Under the Lanham Act, a trademark can be considered "abandoned" if "any course of conduct of the owner, including actos of omission as well as commission, causes the mark . . . to lose its significance as a mark." 15 U.S.C. §1127.

[3] *Allen v. Choice Hotels Int'l*, 942 So.2d 817 (Miss Ct. App. 2006)

[4] *Allen v. Choice Hotels Int'l; Allen v. Greenville Hotel Partners, Inc.,* 409 F.Supp. 2d 672, 677 (D.S.C. 2006); *Kerl v. Rasmussen*, 682 N.W.2d 328, 338 (Wis. 2004)

[5] *Allen v. Choice Hotels Int'l* (citing Michael R. Flynn, Note, The Law of Franchisor Vicarious Liability: A Critique, 1993 COLUM. BUS. L. REV. 89, 99).

franchisor and the entire system can be harmed, perhaps irreparably, by the act or omissions of a few errant franchisees.

Brand Integrity

Just as a prudent franchisor would not permit unauthorized use of a trademark by a counterfeiter, it should not countenance a franchisee's failure to abide by the system standards that support the trademark. Because a franchisee's license to use the trademarks is conditioned on its strict compliance with system standards – a fact that should be made abundantly clear in the franchise agreement – a failure to comply with standards can constitute an unauthorized use of a trademark.

From a practical standpoint, it is important for franchisors to be vigilant in protecting their trademarks by enforcing the system standards that support them. Not only does a lax franchisor risk damaging its reputation and brand among consumers, but news of tolerated noncompliance can spread rapidly throughout a system. If standards violations are not addressed promptly, compliant franchisees may decide that the risks of noncompliance are worth the cost and effort savings. It is less expensive over time, and more protective of brand integrity, for franchisors to address the trickle of standards violations as they occur in individual franchises, rather than to try to stem the tide of system-wide failures and the accompanying public perception.

Vicarious Liability

There is a distinct tension between the prudent enforcement of system standards and the exercise of control over routine decisions that any businessperson must make. While it is essential that a franchisor maintain the quality and consistency of its products and services to protect the value of its trademarks, overzealous enforcement can subject a franchisor to vicarious liability for its franchisee's acts and omissions. Plaintiffs commonly target franchisors, either because they fail to understand the contractual relationship or because they assume that franchisors have deeper pockets and less tolerance for negative publicity.

As a general rule, a franchisor will not be held liable for its franchisee's conduct if the franchisee did not act as the franchisor's agent (actual authority), and if the franchisor did not give the public a reason to believe that the franchisee acted as its agent (apparent authority). Contractual language establishing an independent contractor relationship is helpful, but not necessarily determinative. The level of day-to-day control exerted by a franchisor over a franchisee's operations is the critical factor in assessing the existence and extent of an agency relationship. Although agency tends to be a fact-specific inquiry, matters that may fall under the heading of "day-to-day control" and that should be left to the franchisee's discretion include controlling employment decisions (some states' statutes prohibit franchisors from exercising excessive control over a franchisee's management decisions),[6] setting prices and

[6] States with this type of provision include Arkansas, Minnesota (by regulation), Nebraska and New Jersey.

specifying certain equipment. The general rule is that the "time, method and manner" of completing the work should be left to the franchisee. To minimize the risk of vicarious liability, franchisors may give franchisees independence to make decisions in areas where these decisions do not directly affect the quality and consistency of the product or service.

The case law illustrates the difficulty of drawing a line between the level of standards enforcement necessary to protect the franchisor's trademarks and day-to-day control. For example, in *Potts v. Budget Rent A Car System, Inc.*, 2005 WL 3057175 (N.D. Fla. Nov. 14, 2005), the court declined to dismiss a claim against the franchisor, holding that the franchisor's policy of requiring strict compliance with its operations manuals created a fact issue as to whether the franchisor exerted sufficient control as to be vicariously liable for the franchisee's negligent acts. By contrast, in *Allen v. Choice Hotels Int'l*, 942 So. 2d 817 (Miss. Ct. App. 2006), the court held that a hotel franchisor did not exercise day-to-day control over the franchisee's operations and was therefore not vicariously liable for a security breach, despite the fact that the franchisor established standards relating to security. Factors that were important to the *Allen* court's ruling were the fact that the franchisor had no control over hiring and firing decisions and did not set rates.

How Are System Standards Created And Implemented?

Franchise Agreement

The original source of a franchisor's ability to create, change and enforce system standards must come first from the franchise agreement itself. The franchise agreement should contain a provision that requires the franchisee to abide by the system standards, that allows the franchisor to change system standards when appropriate and requires the franchisee to comply with any new or revised system standards. Generally, the franchise agreement will provide that the actual standards are contained in a separate document, the operations manual. The system standards are not contained within the franchise agreement because changes to the franchise agreement require the signatures of both the franchisor and the franchisee, making it administratively difficult to obtain each time a standard is revised or added. With the necessary authority granted in the franchise agreement, the operations manual can be changed whenever necessary, without requiring the franchisee's signature.

The franchise agreement, including the sections addressing standards and the operations manual, should be drafted by an attorney, with a review by the business people.

A sample franchise agreement provision addressing system standards is noted below:

SAMPLE ONE

1.1 Standards means the guidelines, standards, specifications, rules, requirements, and directives we establish, including without limitation our standards and specifications as to recipes, ingredients, food preparation, food storage, interior and exterior design and décor, sanitation, maintenance, and equipment. We may add to, delete from, or modify the Standards from time to time.

* * *

2. COMPLIANCE WITH STANDARDS

2.1 Compliance with Standards. You must comply with our Standards. All references herein to the Agreement and the System include the Standards.

2.2 Changes to the Standards. We will communicate changes in the Standards in writing or electronically to you, as we deem appropriate. Changes in the Standards may obligate you to invest additional capital in the Franchised Business and incur higher operating costs; provided, however, they will not: (i) materially and unreasonably increase your investment under this Agreement; or (ii) materially alter your fundamental rights under this Agreement.

2.3 Variances. You agree that complete uniformity under many varying geographic and other conditions, and over extended spans of time, is not practical and may be detrimental to the System, and that as a result: (i) we may vary the Standards for any franchisee as we deem necessary; (ii) we may grant franchises using the System under terms that may differ materially from the terms of this Agreement; and (iii) our obligations and rights with respect to our various franchisees may differ materially from our obligations and rights with respect to you, without in any way affecting our rights with respect to you. You will have no right to require that we disclose any variation to you or that we grant you the same or a similar variation.

3. STANDARD OPERATING PROCEDURES MANUALS

3.1 Manuals. We own the Manuals for the System. We will loan you one copy of the Manuals during our Initial Training Program, which Manuals you may keep on loan during the Term. We may provide the Manuals, and any Supplements to the Manuals (defined below), to you in hard copy or electronically via diskette, CD ROM, electronic mail, the internet or other electronic format.

3.2 Supplements to the Manuals. We may make additions to, deletions from, and modifications to the Manuals from time to time (the “Supplements to the Manuals”). All Supplements to the Manuals are binding on you. All references in this Agreement or otherwise to the Manuals will include Supplements to the Manuals.

3.3 Operation. You will operate the Facility in compliance with the Manuals, including without limitation all operational systems, procedures, policies, methods, and requirements in the Manuals from time to time applicable to the type of Facility franchised under this Agreement. You will immediately adopt and use any Supplements to the Manuals. The Manuals and Supplements to the Manuals will not materially alter your fundamental rights and obligations under this Agreement.

3.4 Master Copy. You will ensure at all times that your copy of the Manuals is current and up-to-date. If there is any dispute as to your compliance with the Manuals, the master copy of the Manuals we maintain will control.

3.5 Ownership. You agree that we own all proprietary rights in and to the System and the Manuals. The Manuals will at all times remain our property and you and all your directors, officers, shareholders, partners, members, employees, agents, independent contractors, and others who gain access to the Manuals and the information contained in the Manuals will treat the Manuals and the information in the Manuals as our confidential information.

Operations Manual

The actual specifics of the system standards are stated, in detail, within the Operations Manual. Common topics may include:

- importance of confidentiality of the manual
- overview of the franchisor's organization
- pre-opening requirements (business entity restrictions, site selection, lease approval, licenses and permits, insurance, build-out, equipment, sourcing restrictions, utilities, banking arrangements, approved suppliers, initial training, grand opening marketing)
- personnel (employment law basics, OSHA, job descriptions, recruiting, employment applications, interviewing, background checks, pre-employment testing, new hire paperwork, employee training, employment policies, compensation, scheduling, motivations, performance evaluations, discipline, and termination)
- daily operating procedures (required hours of operations, opening procedures, customer service, merchandising, food preparation, transacting sales, managing inventory, loss prevention, cleaning, maintenance, handling emergencies, and closing procedures)
- business management (setting up books and records, required reporting to the franchisor, required government reporting, and profit and loss statements)
- marketing (use of franchisor's marks and logos, local marketing, and community involvement)
- proprietary products or recipes (sourcing restrictions for ingredients, preparation methods, and storage)
- importance of compliance with applicable laws

The physical form of the Operations Manual can vary (as long as the franchise agreement permits) – bound volume, spiral bound, 3-ring binder (this form allows updates easily), system memoranda, email bulletins, intranet postings, etc.

The Operations Manual should be drafted by the business people charged with enforcing the standards, with a review by the attorney to ensure compliance and consistency with the franchise agreement.

A sample table of contents, showing the topics that may be covered in the Operations Manual, is shown below:

SAMPLE OPERATIONS MANUAL TABLE OF CONTENTS	
Restaurant Operations Manual	
CHAPTERS	**TOTAL PAGES**
I. INTRODUCTION	
A. Introduction	2
II. MANUAL USAGE	
A. Introduction	1
III. MENU REQUIREMENTS, RECIPES & PROCEDURES	
A. Standard Deli Menu Requirements	14
B. Menu boards	11
C. Opening Prep Procedures	97
D. Bakery Procedures	78
E. Sandwich Recipes & Procedures	94
F. Pizza Recipes & Procedures	25
G. Salad Recipes & Procedures	13
H. Soup Recipes & Procedures	4
I. Wrap Recipes & Procedures	15
J. Deli Deals ™ Program	5
K. Kid's Deals Recipes & Procedures	6
L. Beverages	5
M. Desserts	2
N. Nutrition	2
O. Promotions	208

APPENDIX (Book 1 of 2)

Entry	Pages
Bun Specifications (Crumb/Crust/Physical Characteristics)	17
Charts and Instructions	34
Forms	21
Ideal Food and Paper Costs Report	10
Nutrition Information Statements	13
POS Cash Register Programming Procedures/Deli Deals TM – (Phase II)	7

IV. FOOD SAFETY, SANITATION & CLEANING

Entry	Pages
A. Introduction	2
B. Food Safety & Sanitation	5
C. Food Handling	9
D. Cleaning & Sanitation	20
E. Garbage Removal	1
F. Pest Control	1
G. Your Local Health Department or Agency	2

V. PURCHASING/RECEIVING/STORAGE

Entry	Pages
A. Introduction	2
B. Food & Related Products	9
C. Small wares	1
D. Furniture, Fixtures & Equipment	1
E. Logo-Imprinted Products	1
F. Miscellaneous	1

VI. CUSTOMER SERVICE

Entry	Pages
A. Introduction	1
B. Employee to Customer Interaction	6
C. Taking Customer Orders	7
D. Customers with Disabilities	1
E. Speed or Service Guidelines	1
F. Owner/Operator to Customer Interaction	3
G. Refusing to Serve a Customer	
H. Customer Feedback from the Schlotzsky's Home Office	1

VII. FINANCIAL 1

VIII. QUALITY, SERVICE, CLEANLINESS AND COMPLIANCE
A. Introduction 1
B. QSCC Evaluation 2
C. QSC Sales Drivers – Daily Checklist 2

IX. TRADE DRESS 1

X. ADMINISTRATION
A. Trademark Usage 5
B. Required Hours of Operation 1
C. Required Days of Operation 1
D. Minimum Records Retention Schedule 1
E. Royalty, N.A.M.F. & Advertising Contribution Reporting 2
F. Insurance 1
G. Confidentiality Agreement 1
H. Independent Business Ownership Notice Decals 1
I. Remodel & Upgrade Obligations 2
J. ADA Compliance Obligations 1
K. Internet & Extranet Activities 2
L. Gift Certificate Program 5
M. Safety 4
N. Security 2
O. Crisis Management 3
P. Uniforms 4
Q. Human Resources 5
R. Carry-Out Catering Program 48

APPENDIX (Book 2 of 2)

Critical Items List 6
Forms 147
Master Cleaning Schedules (Examples) 5
Product Shelf Life Information 14
Remodel and Relocation Standards 3
Specification 45

Station Checklists (Examples)	7
Supplier Contacts	4
Things to do. . . (Examples)	3
TOTAL PAGES	1,090

Franchisee Input (Associations, Advisory Councils, Ad Hoc Committees, Chain Leaders)

When creating and enforcing system standards, a franchisor is well served to solicit input from its franchisees, which can be efficiently accomplished if there is a franchisee association, franchisee advisory council, or similar organized group of franchisees. Most franchisors have one of these forms of franchisee groups. When this type of franchisee group exists, the activities of the group should be governed by written documents such as bylaws, which should establish the purpose of the group, the manner in which franchisees are elected or appointed to serve on the group, the criteria for which franchisees are eligible to serve, voting rights within the group, and how the group's activities are to be conducted.

Most franchisee groups are formed for the purpose of advising the franchisor on the franchisees' needs and providing feedback on proposals made by the franchisor. These groups are generally advisory only and do not have the right to vote on whether standards are implemented or changed and do not have the right to veto a franchisor's decisions in this regard.

In order for the franchisee group to maintain credibility with the remainder of the franchisees in the system, it is generally advisable that the franchisees that serve on the group be nominated and elected by the franchisees in the system rather than by appointment from the franchisor. Appointed franchisee members are generally perceived to be more likely to accept a franchisor's decisions rather than truly represent the franchisees' interests. In addition, members of the franchisee group should adhere to certain standards, such as a requirement that they remain in good standing under their franchise agreements with the franchisor and remain a franchisee at all times. The effectiveness and credibility of the franchisee group is eroded when the franchisee members of the group do not themselves abide by the franchisor's standards.

The franchisor should meet regularly with the franchisee group in order to propose both new ideas and changes to existing standards. The franchisee group is well positioned to provide feedback on the actual need for a new or revised standard as well as the costs of implementation and likelihood of compliance throughout the franchised system. The franchisee group also can propose alternative methods of achieving the desired goals.

When a new or revised standard has received the support of the franchisee group, the rest of the franchised system is more likely to accept the standard, thereby increasing the likelihood of system wide compliance.

Implementation (Identify The Problem, Design A Solution, Testing The Implementation And Impact, Identifying Resources, Measuring Impact, Communication To Franchisees, Monitoring Implementation And Compliance, Enforcement)

In order to ensure that the standards adopted are reasonable and necessary, a franchisor should follow most or all of the following steps in evaluating each proposed standard. While implementing these steps, the franchisor should obtain franchisee feedback, usually through the franchisee advisory council, throughout this process.

A franchisor should try to isolate what the exact problem is that requires correction. Once the true problem has been identified, several proposed solutions to the problem should be evaluated to determine whether the solutions will actually solve the problem, will be cost effective and practical to implement, and will be accepted by the franchisees so that system wide compliance occurs.

Once the best solution or solutions have been identified, the franchisor should conduct tests of the solution by implementing the proposed standard in franchisor-owned units and/or in franchisee test locations. When franchisee test locations are used, the franchisor normally will make some concession to the testing franchisees to make the process easier for the franchisees, such as paying for all costs of implementing the test, paying for costs of removing it once completed, and paying for any supplies needed during the testing phase. The test locations should be as diverse as possible, to improve the validity of the results. The length of the test should be adequate to determine the effect of seasonality, weather, holidays, etc. This testing will provide the franchisor with feedback on the ease of implementation, the costs associated with the implementation, the practical difficulties encountered and whether the solution actually solves the problem. The testing process normally results in revisions to the solution to make it easier to implement and more effective. These revisions may require that the test be extended to evaluate additional results.

When the final solution has been identified for implementation, the franchisor's procurement group should identify suppliers for all materials needed to implement the standard and should make sure that these suppliers are able to fulfill all orders that it will receive from franchisees on implementation of the standard. The franchisor may wish to negotiate special financial arrangements with these suppliers in order to ease the burden of implementation.

Once the suppliers and resources have been identified, the franchisor can create an implementation guide that shows each franchisee what the true impact of implementing the standard will be along with the results that will be expected and the manner in which results will be judged. Along with this guide, the franchisor can identify the benefits or results expected from implementing the standard.

Once the expected costs and benefits are documented, the franchisor should evaluate the resources that will be needed to communicate the new standard to the franchised system, to train all franchisees on implementation, to support franchisees' efforts to implement the new standard, to monitor the status of the implementations and to enforce the standard against franchisees that ultimately choose not to implement the standard.

When the implementation planning has been completed, the franchisor will need to determine the methods that it will use to communicate the change throughout the franchised system and the timeframe for completing the implementation. The communication to the franchised system should state what the new or changed standards are, identify why the standards are being implemented, what beneficial results are expected from the standard as well as when and how the standards will be implemented. Ideally, the communication to the franchised system should be accompanied by an endorsement of the standard from the franchisee advisory council.

When the initial communication to the franchised system has been completed, the franchisor will begin conducting the training necessary on the implementation of the new standard. Once the implementation has begun, the franchisor will monitor each franchisee's progress in adhering to the new standard and will provide support as needed to ensure compliance. This monitoring is generally accomplished through field visits. Finally, once the timeframe for the implementation has passed, the franchisor will need to evaluate how to enforce the standard against those franchisees that have chosen not to implement the standard. The methods of enforcement are discussed later in this paper.

How Are System Standards Changed?

Similar to creation of system standards, changes to system standards can be made through the franchise agreement or the operations manual. In addition, similar to creation of system standards, any major systemwide changes will require franchisee support, as well as a detailed implementation plan.

Franchise Agreement

As noted above, the franchise agreement generally provides the contractual authority for imposing, modifying, and adding system standards, but does not include a detailed list of specific standards to avoid the need for continuous amendments to the agreement. In rare instances, however, a franchisor may determine that a standard could have such a significant impact on the system and the franchisees' operations (and

finances) that formal amendments to the franchise agreements are warranted. For example, before implementing a new standard that would require franchisees to purchase expensive machinery or make other large capital expenses, a franchisor may determine that it would be prudent to have franchisees agree in writing to such a requirement.

Operations Manual

Most system standards are changed or added by amending the operations manual. Depending upon how broadly "operations manual" is defined, making changes can be as simple as issuing a memorandum, letter, brochure or other document to franchisees or simply updating the actual operations manual to reflect the changes. Similar to the creation of initial standards, any new or revised standards generally should be drafted by the responsible business people and reviewed by an attorney before publication. When revising the operations manual it is also important that the franchisor ensure that the latest versions (including electronic versions) of all documents that comprise the "operations manual" are maintained and archived in a central location.

Methods For Monitoring Compliance With System Standards

Training

Each franchisor should train its own employees and its franchisees on what the system standards are and what is acceptable as compliance with the standards. In this manner, the franchisor provides the knowledge to ensure compliance and to remove ambiguities or differing interpretations of what the system standards are. The system standards are then what the franchisor says they are.

The most common group training opportunities occur at the franchisor's initial training program, at regional meetings held throughout the year and at an annual convention. The franchisor's field consultants also should provide training when they are on site for field visits or inspections.

Each time a material system standard is revised or a new standard is added, the franchisor's employees and then the franchisees should receive training on the revised or new standard. This also may provide a good opportunity to include refresher training on problem areas.

When adequate resources are available, the franchisor also may prepare training materials for the franchisee to use with his or her own employees, such as in written materials, CDs, web based training, pod casts, interactive games, etc.

Field Consultant Visits

A franchisor's field consultants are usually a franchisee's first and most frequent contact with the franchisor. Therefore, the field consultants must be experienced so that the franchisees will believe that the field consultant's advice is credible. In addition, a field consultant must be capable of maintaining a good, productive working relationship with each franchisee, so that the field consultant will be able to encourage and influence franchisees to comply with the system standards.

The franchisor's field consultant employees should periodically visit each franchised location to monitor system compliance and to train and advise the franchisee and its employees on proper adherence to system standards. During these visits, the field consultant can offer training on new products or procedures, offer refresher training on problem areas, correct areas of non-compliance and offer advice on efficient ways to stay in compliance. The field consultants also can share the benefits of remaining in compliance, such as increased sales and reduced operating costs for the franchisee.

Quality Assurance Reviews

Most franchisors conduct periodic inspections at each franchised location to determine the franchisee's compliance with the quality assurance requirements of the franchise agreement and operations manuals. These inspections are generally conducted by the franchisor's employees (but can be outsourced to independent third party companies that provide this service), who have been specifically trained on the franchisor's requirements. The inspectors use a form that the franchisor has developed to evaluate each area of importance under the franchise agreement, such as cleanliness, sanitation, exterior and interior appearance, compliance with current marketing programs, adherence to standard recipes or procedures, product or service quality, maintenance of inventory levels, etc. If there are significant areas of non-compliance, the inspector may obtain additional documentation (other than the quality assurance report) such as photographs or video of the violations. This evidence should be immediately labeled with the identification of the franchised unit, the date, time and nature of the subject, as well as identify who gathered the evidence. This may become valuable evidence if the franchisee ever challenges the validity of the quality assurance review.

At the conclusion of each inspection, the inspector should thoroughly review each area of compliance and non-compliance with the franchisee, and should help the franchisee to develop an action plan to address areas of deficiency. If appropriate, the franchisor may offer additional training in areas of non-compliance, to assist the franchisee in reaching and maintaining the appropriate standards.

For those franchisees that fall below an acceptable score, the franchisor should be diligent in applying and enforcing its right under the franchise agreement, up to and including the default and termination process. Most franchise agreements also provide remedies short of default and termination, such as requiring the franchisee to attend refresher training or the implementation of a financial fine for repeated non-compliance with the standards.

Failing to default substandard franchises will cause a deterioration of the public's perception of the brand, will undermine the franchisor's credibility with its franchisees, who will then become lax in their own adherence to system standards, and will erode the morale of the franchisor's employees, who perceive their efforts to enforce compliance as a waste of their time.

Quality assurance ("QA") reviews may be either announced or unannounced. With an announced inspection, the franchisee is most likely to be present, so that a review of the scores and development of an action plan are possible. However, with an announced inspection, the franchisee has the opportunity to "cleanup" before the inspection and alert its employees to be on their best behavior. Conversely, with an unannounced inspection, the franchisee may not actually be present, but the QA review is more likely to reflect the true day-to-day status of the unit.

In the rare instance in which a franchisee refuses the inspector access to the franchised premises, the inspector should document the refusal but should not try to force his or her way in to the premises. The franchise agreement should contain a provision stating the consequences for the franchisee's failure to admit the inspector and the franchisor should pursue its remedies for this violation.

Finally, some franchisors have outsourced the quality assurance review process to independent third parties that are trained and experienced in conducting inspections. The most common reason for this is to allow the franchisor's field consultants to focus on building a positive and constructive relationship with the franchisee, rather than being perceived as an adversarial "enforcer." In addition, a third party inspection may be less likely to challenge by the franchisee based on a perceived bias of a field consultant against a particular franchisee. A franchisee is more likely to try to comply with the deficiencies identified if the franchisee believes that the inspection was objectively conducted.

Financial Audits

A financial audit is intended to determine whether a franchisee is complying with the sales reporting, recordkeeping, and payment provisions of the franchise agreement. These audits may be conducted by internal personnel on the franchisor's staff or by an independent third party retained for this purpose, such as an outside accounting firm. If the franchisor's employees are used, they should be thoroughly trained in the financial requirements of the franchise agreement and in standard audit protocol so that the audit results will withstand any legal challenge that a franchisee may bring. If a third party is

retained to conduct the audits, make sure that the third party is experienced in conducting financial audits and in testifying and defending the results of the financial audits in court proceedings.

Often, the nature of the franchised system will help the franchisor identify which franchisees may likely be underreporting. For example, a franchisor may be able to estimate the sales level by evaluating the quantity of certain purchases that the franchisee makes. A franchisee that purchases 1,000 cups in a coffee franchise but reports a sales level of only 500 cups might be a good candidate for a financial audit. In the hotel industry, a franchisor may be able to identify underreporting franchisees by comparing reported room sales with the room sales contributed through the franchisor's reservation system. A franchisor should be careful when determining which franchisees are audited to make sure that the selection methods are not discriminatory. One method of ensuring this is to randomly select the franchisees whose books will be audited.

Mystery Shops

A franchisor may implement a mystery shopper program by contracting with an independent third party company, whose employees or independent contractors will conduct the mystery shop in each franchise location. In these situations, an individual, known as a "mystery shopper," will pose as a customer of the location and will make a purchase. The mystery shopper then evaluates the experience in categories such as cleanliness, service levels, quality of product, inventory levels, and any other characteristics that would be readily visible to a customer.

A mystery shopper program will not evaluate areas of the franchised business that are not visible to a customer. Therefore, a mystery shopper program will not provide feedback on cleanliness behind-the-scenes or adherence to proper preparation procedures. One of the benefits of a mystery shopper program is that the evaluations are conducted by independent third parties which may be more credible to a franchisee in some circumstances. In addition, the mystery shops are unannounced visits, while many franchise consultants announce their visits in order to ensure that the franchisee is present when the consultant visits the location. Therefore, the mystery shop is an evaluation of the franchised location as it truly is to customers and not as it might be staged for a franchise consultant's visit.

When contracting with a mystery shopper company, a franchisor can expect to pay a flat fee for each mystery shop conducted as well as to reimburse the mystery shop company for the value of the purchase. Depending on the frequency of the mystery shopping experiences, the costs can become quite high. Finally, because of the sensitivity of the information collected, you will want to make sure that you contract with a reputable company and make sure that your contract has a favorable confidentiality provision, by which the mystery shop company and all mystery shoppers are bound.

Customer Complaint Hotlines

A franchisor also may implement a toll-free hotline and/or website where customers can report comments on their experiences in the franchised locations. In this manner, a franchisor can obtain feedback from actual customer experiences and can allow the franchisee and/or franchisor to ensure that customer complaints are promptly and properly resolved. Under a hotline system, the customer comments are generally categorized based on a priority system. Complaints involving safety issues such as foreign objects or potential legal issues such as discrimination complaints or personal injury complaints are given the highest level priority. Other levels of priority are used for other types of complaints. Once received, the complaints are distributed to the franchisee and to relevant employees on the franchisor's staff. A franchisor should have policies and procedures in place on how each level of complaint is addressed, as well as a tracking system to ensure that each franchisee responds appropriately.

Customer Surveys

Some franchisors use customer surveys as another tool to gauge compliance with system standards (as well as to determine whether revisions to any standards are necessary). Customer surveys typically evaluate actual experience in certain categories, such as cleanliness, service levels, and quality of product, as well as the customer's likelihood to recommend the franchised location to somebody else. Similar to a mystery shopper program, customer surveys will not show compliance with back-office or preparation procedures, but will indicate whether the end customer was satisfied with his experience at the franchised location and may possibly identify specific areas for improvement in the system as a whole or at a particular location.

Reward Programs

Many franchisors have periodic or annual awards programs that reward franchisees that consistently demonstrate adherence to system standards. These rewards may include franchisee of the year, highest quality assurance score, highest mystery shopper score, and similar categories. In addition, a franchisor may implement reward programs for the employees of franchisees.

Methods Of Enforcing System Standards

Alternatives To Termination

Depending on the severity and scope of a franchisee's standards violations, its history of violations, its willingness and ability to improve operations and the availability of replacement franchisees, among other factors, it may be in a franchisor's best interests to seek to correct standards violations in a manner short of termination. Termination is a drastic remedy that potentially threatens a franchisee with the loss of his or her livelihood. A franchisee under such a threat is much more likely to seek counsel, and perhaps assert counterclaims. Even if baseless, these claims may slow

down the process and may be required disclosures on the franchisor's UFOCs. Because of the high stakes involved, courts also tend to scrutinize termination cases and often look to protect franchisees. While still obviously raising important issues, a standards case seeking a mandatory injunction enforcing standards is really just asking the court to require the franchisee to do what he or she agreed to do in the franchise agreement, and to pay the franchisor's attorneys' fees. These cases are much less likely to draw counterclaims, courts don't feel the pressure of closing down a business and, if this is a routine method of standards enforcement, word will travel quickly through the chain that it is easier and less expensive to clean up voluntarily than to force the franchisor to take them to court.

If counseling, re-training and notices of default do not resolve a franchisee's standards deficiencies, the franchisor must look to more coercive strategies.

Injunctive Relief/Attorneys' Fees Claims

Once a re-inspection has indicated that a franchisee has failed to correct standards deficiencies, the franchisor may file a complaint for injunctive and declaratory relief against the franchisee. Claims can include (among other things) breach of contract, false designation of origin and trademark dilution (by tarnishment). Franchise agreements with mandatory arbitration provisions should be drafted to provide "carve-outs" for access to a judicial forum for non-monetary relief to protect the franchisor's rights in its trademarks.[7]

An important benefit of seeking injunctive relief is that equity cases are decided by the judge without a jury. From the standpoint of a franchisor, which is often the larger entity, having a judge review the facts and law is generally preferable to leaving the matter to the whim of a jury, which may be swayed by its sympathy for the franchisee. A court may find it more palatable to enjoin an errant franchisee from operating in violation of the system standards than to terminate a franchise. If the standards deficiencies are related to health and safety – which is often the case in matters that get to this stage – a court can feel comfortable that it is protecting not only the franchisor's trademark rights but also the public health. Finally, injunction proceedings tend to be speedier and involve less discovery than a damages action.

Although courts in the different federal circuits apply somewhat different standards to prevail on a claim for preliminary injunctive relief, some variation of the following factors is generally applied: (a) a substantial likelihood of success on the merits; (b) irreparable injury that will result unless the injunction is issued; (c) threatened harm to the franchisor if the injunction is not issued, which outweighs the threatened harm to the franchisee if the injunction is issued; and (d) the public interest. Under the federal rules, a party who obtains a preliminary injunction is generally required to post a bond (or other security) to pay any damages incurred by another party if the injunction is later found to have been wrongfully issued. By requesting that the preliminary and permanent injunction be consolidated under Fed. R. Civ. P. 65, a prevailing franchisor

[7] *See* "Alternative Dispute Resolution" section below.

can avoid the bond requirement. State courts have varying standards for the issuance of preliminary injunctions.

Following a trial on the merits (which may or may not be consolidated with the preliminary injunction hearing), the court may make the injunction permanent if it determines that the franchisor is entitled to relief on its claims. Misuse of a trademark, through false designation of origin or dilution, satisfies the irreparable injury factor. In addition, many franchise agreements include an acknowledgment by the franchisee that noncompliance with system standards constitutes irreparable injury. Because the franchisor seeks only compliance with standards, rather than cessation of operations, courts often have little difficulty finding that the harm to the franchisor outweighs that to the franchisee, and that the public interest will benefit.

Most franchise agreements include a provision under which the franchisee agrees to pay any attorneys' fees incurred by the franchisor in seeking to enforce the terms of the agreement. Simply filing the lawsuit and demanding attorneys' fees may encourage compliance. As the litigation progresses, an attorney fee provision keeps pressure on the franchisee to resolve the matter satisfactorily to the franchisor. As stated above, word of a franchisor's willingness and ability to pursue a standards enforcement case, and to collect its attorneys' fees, spreads quickly through the franchise chain. Often, after a few initial victories, the franchisor finds that franchisees get the message.

Alternative Dispute Resolution

Submitting a dispute to mediation or arbitration – if required by contract – can facilitate a resolution while keeping certain costs of litigation, such as discovery, down. Mediation, which is non-binding, can give the parties the benefit of a neutral third-party's review of the facts and law and, because it is relatively less contentious, can minimize damage to the parties' working relationship. Because parties to an arbitration generally agree to share costs, and because most franchise agreements contain forum selection clauses providing that the arbitration will be conducted near the franchisor's place of business, the threat of arbitration can also encourage a noncompliant franchisee to correct standards deficiencies. A key disadvantage to arbitration is that, although arbitrators often have the authority to issue interim relief, they often decline to do so, either because they are uncertain of their authority in this area or because they prefer to resolve the entire issue after all fact finding has been completed. Generally, ADR is not as effective in resolving standards disputes as getting in front of a judge.

State Franchise Relationship Laws

Terminations

Eighteen states,[8] the District of Columbia, Puerto Rico and the Virgin Islands have enacted statutes relating to the termination of franchises, designed to protect franchisees from abuses by franchisors. These statutes specify some or all of the following (among other things): how far in advance of termination notice must be given, whether the franchisee must be given an opportunity to cure the deficiency and how long that cure period must be, whether good cause is required for termination and what constitutes good cause. In some cases, the statutes require the franchisor to compensate the franchisee for inventory, equipment and other items purchased from the franchisor or approved suppliers.

It is essential that a franchisor seeking to terminate a franchisee comply scrupulously with the requirements of the applicable statute, as well as with any contractual requirements. Failure to do so may subject the franchisor to liability for wrongful termination and inevitably complicates and slows down the process.

Most statutes that impose a notice and/or opportunity to cure period contain exceptions in certain situations where notice is considered unnecessary – these can include the franchisee's bankruptcy, conviction of certain felonies, eviction from the premises or voluntary abandonment of the franchise. The determination as to whether a franchisor had good cause to terminate a franchise is generally considered to be a question of fact rather than a question of law; thus, if the termination is litigated, the franchisor is unlikely to obtain a summary adjudication on this point.[9]

Transfers

Some states' statutes limit franchisors' exercise of discretion to withhold consent to the transfer of a franchise.[10] Under these provisions, the franchisor may be required to articulate certain (in some cases enumerated) material reasons before it may withhold consent. Where the proposed transferee is one of certain specified persons, such as spouses, children or employees, the franchisor's discretion may be even more limited.[11]

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[8] These states are Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, North Dakota, Virginia, Washington, and Wisconsin. In addition, Maryland has a similar law that applies only to dealerships, and not franchises.

[9] *See* "Alternatives to Termination" section above.

[10] These states include Arkansas, Hawaii, Iowa, Michigan, Minnesota, Nebraska and New Jersey.

[11] States whose statutes address these successor issues include Arkansas, California, Indiana, Iowa, Nebraska and New Jersey.

Allowing and even facilitating the transfer of a franchise from a noncompliant franchisee to an approved transferee can be an important tool in resolving disputes relating to standards deficiencies. One point of contention, however, can arise when the franchisor and noncompliant franchisee disagree as to the information that should be disclosed to the prospective transferee. While a noncompliant franchisee is motivated to get the highest price available for his franchise or assets, the franchisor has a strong interest in avoiding a surprised, unhappy new franchisee. Types of information that a franchisor may insist be disclosed include the fact that the franchisee has been terminated or that litigation is pending, standards deficiencies and any impending upgrades. A franchisor will likely also insist that the franchisee convey truthful information regarding its lease and any disputes with the landlord. To avoid claims of tortious interference and even trade libel, franchisors must ensure that all information disclosed to a prospective transferee is objectively truthful and accurate; moreover, they should avoid putting themselves between a franchisee and a third party (*e.g.*, the landlord).

In *J.K.P. Foods, Inc. v. McDonald's Corp.*, 2006 WL 689521 (E.D. Ark. Mar. 14, 2006), the franchisee understated the costs of upgrade by $375,000. When the franchisor informed the transferee of the actual upgrade costs, the deal fell through, and the franchisee sued. The court held that, because it had the right to withhold its approval, the franchisor was not a "stranger" to the deal and therefore, under state law, could not be liable for tortious interference. To avoid liability on a tortious interference claim, the franchisor should limit its communication with the prospective transferee to objective, material facts. See *Manufacturer Direct LLC v. DirectBuy, Inc.*, 2006 WL 2095247 (N.D. Ind. July 26, 2006) (court dismissed tortious interference claim against franchisor because franchisee failed to demonstrate that decision to withhold consent to transfer lacked a legitimate business justification).

Discrimination

Although franchisees have no common law right to be treated the same as other franchisees, seven states – Arkansas, Hawaii, Illinois, Indiana, Minnesota, Washington and Wisconsin – have statutory provisions prohibiting discriminatory treatment of franchisees. Courts in three other states – California, Connecticut and Michigan – have interpreted their statutory prohibition of "unfair" treatment to include disparate treatment.

Before any enforcement action is taken, counsel should ensure that it will comply with any applicable laws. As a general rule, a franchisor will not be held to have acted discriminatorily with respect to a franchisee if it can articulate a rational business justification for distinguishing it from other franchisees in similar circumstances.

Post-Termination Enforcement

Once the decision is made to terminate a noncompliant franchisee, the franchisor must demand de-identification as well as full compliance with all post-termination covenants, including covenants not to compete and covenants to indemnify. Before the termination becomes effective, franchisors may seek to exercise their rights under the franchise agreement to take an assignment of the lease and to purchase the franchisees' equipment, to ensure that the franchisees do not attempt to open up an "independent" shop on the premises. This is also a good time to review the terms of the restrictive covenant and ensure that it is enforceable under the applicable laws. If the restrictive covenant is overbroad, the franchisor should consider reducing its scope and whether the franchise agreement and applicable law permit it to do so.

As soon as the termination is effective, the franchisor must inspect the premises to ensure that the premises have been fully de-identified; this should include contact with the telephone company to ensure that all telephone numbers (which are often owned by the franchisor) have been disconnected or transferred to the franchisor's control.

If a franchisee fails to de-identify or to comply with post-termination covenants, the franchisor should file an action for injunctive relief as quickly as possible. As these violations go to the heart of the franchisor's business, any delay in enforcing its rights can render suspect a franchisor's pleas of immediate and irreparable harm.

Terminated franchisees occasionally attempt to evade restrictive covenants by transferring their business to a third party – usually a family member, and often one who has been involved in the franchised business – who is not a signatory to the franchise agreement. Such attempts are usually rejected handily by courts. In *Merry Maids, LP v. WWJD Enterprises, Inc.*, No. 06-CV-36 (D. Neb. June 20, 2006), a terminated franchisee gave his wife assets, customer lists and cash. The court held that the restrictive covenant was enforceable against the wife, who was a former employee of the franchised business and had access to proprietary information, finding that she and the former franchisee acted in concert in breaching the covenant. See also *ServiceMaster Residential/Commercial Services, L.P. v. Hooker*, No. 05-2755 (W.D. Tenn. April 21, 2006) (wife and won assisted in violating restrictive covenant). In *H&R Block Tax Services, Inc. v. Sheets*, 2006 U.S. Dist LEXIS 8437 (E.D. Ky. Mar. 3, 2006), the court applied successorship law and found that the corporation operating an "independent" tax service – using the same telephone and customer list and holding itself out as a continuation of the franchised business – was a mere continuation of a former (expired) franchisee and therefore liable under the restrictive covenant. In *Maaco Enterprises, Inc. v. Ingram*, No. [CITE] (E.D. Pa.), a franchisee attempted to transfer an expired business to his wife and son while he continued to operate a second franchised location. A lawsuit filed by the franchisor, and accompanied by a motion for injunctive relief, settled once the franchisor pointed out that an assignment agreement provided that all officers and employees of the franchisee were bound to abide by the

covenants in the franchise agreement, and that this included the wife (an officer) and son (an employee).