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WORKSHOP 1:
"THAT'S NONE OF YOUR BUSINESS"
HOW TO ENFORCE SYSTEM STANDARDS AND CONTRACTUAL TERMS IN FRANCHISE NETWORKS

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1. Introduction

Regardless of the respective jurisdiction, franchise agreements are characterized by the fact that their provisions are determined unilaterally by the franchisor. The terms of a franchise agreement are, therefore, generally not negotiated between the contracting parties. And unlike other contractual relationships, such as those between buyer and seller, principal and agent, etc., where the terms of the contract are either negotiated individually or can be unilaterally stipulated by one party (seller) or the other (buyer), depending on who is in the stronger position, the terms of a franchise agreement are without exception stipulated by the franchisor.

As a result, franchise agreements are generally prepared from the perspective of the franchisor, irrespective of possible statutory regulations on franchise agreements in the various legal jurisdictions. Franchising itself is also usually described from the perspective of the franchisor. This can already be observed in the definitions that franchise associations, for example, use for the concept of franchising. Not only the International Franchise Association, but also numerous other franchise associations describe the franchise relationship in such a way that the focus is on the fact that franchising is a form of distribution and an expansion strategy:

> *"Franchising is a method for expanding a business and distributing goods and services through a licensing relationship. In franchising, franchisors (a person or company that grants the license to a third party for the conducting of a business under their marks) not only specify the products and services that will be offered by the franchisees (a person or company who is granted the license to do business under the trademark and trade name by the franchisor), but also provide them with brand and support*."[1]

The franchisor has invested considerable resources and time in developing a concept and a brand that it then grants (many) third parties the right to use on its terms. It, therefore, comes naturally to take the franchisor's perspective when drafting a franchise agreement. The main objective is to protect this concept and the brand with regard to the investment already made, to meet customer expectations, and to earn money in the future by replicating it. This, in turn, requires the concept to be implemented precisely as specified by the franchisor.

The franchisee's main obligation is to meet all the conditions stipulated by the franchisor in its standardized franchise agreement. Only then can the franchisee rely on the franchisor's undertaking to grant the franchisee the opportunity to run a financially successful franchise business by transferring the rights to use the brand and concept. If the contractual relationship with the franchisor ends, the basis of this business existence built up over many years also ends. Without the right to use the brand and concept, the franchisee's operating business loses considerable substance.

The comprehensive obligation to implement the system requirements means that the franchisee's freedom is restricted, both in financial and entrepreneurial terms (e.g., through the obligation to purchase certain inventory, to invest continuously in advertising and marketing, to offer only products of a certain quality, to comply with specific standards in terms of appearance and quality, etc.).

The restriction of entrepreneurial freedom is part of the price that a franchisee pays for sitting in a "made nest" to a certain extent: someone else (the franchisor) has tested the concept and developed considerable know-how that can (or must) now be used. The franchisee does not have to reinvent the wheel;

[1] "What is a Franchise?" International Franchise Association, https://www.franchise.org/franchising-overview/what-is-a-franchise/ (last visited Apr. 4, 2025).

it can make the franchisor's experience and know-how its own. Ideally, the franchisor has also already identified what is important for customers and is continuously developing the concept in line with this in order to remain competitive.

However, if you look at the contractual relationship from the franchisee's perspective, the following also applies: the considerable investment that a franchisee has to make (by giving up a large part of its entrepreneurial freedom) in order to obtain the right of use must be worthwhile. The franchisee's expectation is somewhat: "*I want to make a living on this business. If I make a long-term commitment to implement everything as specified by the franchisor and also pay a lot of money for this, then it should be guaranteed that I will be economically successful if I adhere to the system specifications.*"

The franchisee has very few opportunities to keep the franchise business competitive. It is essential for the success of the franchisee's business that the franchisor, for its part, continually invests in the competitiveness of the system. If the system is not competitive and successful, the individual franchisee cannot be either. This often requires a change to the system, including an adaptation of the system standards to new challenges.

In other words, the franchisor bears a high level of responsibility for ensuring that the investment made by its franchisees is rewarded. Conversely, the lack of compliance of a single franchisee with system requirements harms the entire network. And this is precisely where issues arise that often lead to disputes in court or arbitration:

- How far does the franchisor's right to intervene in the operations of a franchisee extend?
- What happens if the franchisee adheres to the specifications, but these prove to be unsuitable for operating profitably?
- What options does a franchisor have to determine whether quality standards are being complied with?
- What options does a franchisor have to define, monitor, and enforce (quality) standards?
- Are deviations from the specifications permissible under certain circumstances and, if so, under what conditions?
- What happens if the franchisor has established a fundamentally competitive and successful concept, but fails to update it in order to remain competitive? What options does a franchisee then have?

The above questions are just some of those that regularly arise in connection with compliance and enforcement of system standards. The above questions already make it clear that franchising brings together different views and expectations of what is required for a commercially successful contractual relationship. Both contracting parties are entrepreneurs and want their respective businesses to be successful. If one is successful, the other should be too. Failure of one also leads to failure of the other. In view of this close interdependence, the one-sided approach to the drafting of their underlying franchise agreement seems surprising. Apparently, the basic assumption that the franchisor best knows what conditions must be met for a franchisee to be commercially successful is not questioned.

The parties to the franchise agreement usually agree to a long period of operation, and the agreement typically does not undergo any changes during the fixed term of 3, 5 or 10 years. However, in view of the ever faster-moving world, it can become a problem for the parties to adhere to the rigid implementation of contractual provisions. At the very least, if the individual franchisee suffers competitive disadvantages or economic losses despite having adhered to the system specifications, the franchisee will demand changes and criticize the franchisor: "That's none of your business!"

In the following pages, the authors of this paper will look at the function of system standards, how they are typically integrated into individual franchise systems, how compliance with them can be monitored, what options are available for enforcement and how it can be ensured that the inherent tensions in franchising do not escalate into conflict, but that the interests of both sides can be reconciled. After all, franchising is a partnership of equals and not a relationship of subordination. The authors of this paper come from different jurisdictions (England, Australia, U.S.A. and Germany), in each of which franchising is regulated differently (or not at all). However, the experiences they have as long-time practitioners of franchise law in relation to the issues at hand are universal in nature and can be applied to all franchise partnerships, regardless of the country in which they exist. And fairness is a universal concept in any case.

2. Role and Sources of System Standards

2.1. Role of System Standards

System standards play a multifaceted role in franchising, primarily focusing on ensuring quality and uniformity in franchise operations. These standards encompass a wide range of operational elements, including product quality, service standards, store layout, employee training, and customer experience. By ensuring that franchisees adhere to these standards, franchisors can ensure that customers receive the same level of quality and experience, regardless of the location they visit. This consistency builds brand loyalty and fosters customer satisfaction, which in turn drives repeat business and positive word-of-mouth recommendations.

System standards also ensure operational efficiency and effectiveness by defining specific processes and procedures. Such an approach helps streamline operations, reduce costs, and minimize the risk of errors or inconsistencies. Additionally, system standards facilitate knowledge sharing and best practices among franchisees, fostering a collaborative environment that benefits the entire franchise network.

A case involving the Australian 'owned and operated' arm of the global 7-Eleven business illustrates the importance of system standards and their consistent application by franchisors. 7-Eleven's legal troubles began in 2015 after a joint media investigation found that franchisee store staff, many of whom were migrants, were being paid less than statutory minimum conditions.[2] The media coverage led to an inquiry by the Australian Fair Work Ombudsman and, ultimately, a finding by the Ombudsman that (relevantly) the franchisor's lack of compliance monitoring and its profit model had fostered a 'culture of complicity' in which stores' systemic and substantial non-compliance with wage obligations inflated their profitability.[3] These findings ultimately led the franchisor to enter into an agreement with the Ombudsman to introduce AUD$50 million worth of operational improvements across its network, backpay AUD$176

[2] "How 7-Eleven is ripping off its workers," *The Sydney Morning Herald*, https://www.smh.com.au/interactive/2015/7-eleven-revealed/ (last visited Apr. 14, 2025).
[3] Fair Work Ombudsman (Cth), *A Report of the Fair Work Ombudsman's Inquiry into 7-Eleven Identifying and addressing the drivers of non-compliance in the 7-Eleven network,* Report (Apr. 2016).

million in wages, interest and superannuation to over 4,000 franchisee employees[4], and settle two franchisee-led class actions for AUD$98 million.[5]

In the following paragraphs, we examine the possible benefits of clear and measurable system standards:

(i) Consistency and Quality

System standards ensure that franchisees provide a uniform customer experience, delivering consistent products and services across all locations. This consistency fosters trust and loyalty among consumers, as they know what to expect from the brand regardless of where they interact with it.

By adhering to system standards, franchisees maintain high-quality products and services, which enhances the brand's reputation for reliability and excellence. From the franchisor's perspective, this quality control is crucial for safeguarding the brand against inconsistent or subpar experiences.

(ii) Brand Identity and Recognition

System standards help establish a cohesive brand identity by ensuring that all franchise locations align with the brand's vision and values. This consistency reinforces the brand's image and makes it recognizable to consumers.

Consistency in operations and customer experience fosters brand loyalty. When consumers consistently receive high-quality products and services, they are more likely to return and recommend the brand to others, further strengthening its reputation.

Ongoing adherence to system standards builds trust and reliability with customers. When customers consistently receive high-quality products and services from a business, they are more likely to return and recommend the brand to others.

(iii) Risk Management

Maintaining high system standards minimizes a franchisor's exposure to litigation and potential damage to the brand's goodwill. Non-compliance with critical standards, particularly in health and safety, can lead to employee and consumer harm, related legal issues and reputational damage.

By enforcing system standards, franchisors can protect their brand from inconsistencies that might

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[4] "*7-Eleven partnership improves compliance,"* Fair Work Ombudsman (Cth), Media Release (30 October 2020), https://www.fairwork.gov.au/newsroom/media-releases/2020-media-releases/october-2020/20201030-7-eleven-compliance-partnership-report-media-release (last visited Apr. 14, 2025). *See also Fair Work Ombudsman v Xia Jing Qi Pty Ltd & Anor* [2019] FCCA 84 (18 Jan. 2019); *Fair Work Ombudsman v Xia Jing Qi Pty Ltd & Anor* [2019] FCCA 83 (18 Jan. 2019); *Fair Work Ombudsman v Bosen Pty Ltd and Others* (Industrial) [2011] VMC 81 (21 Apr. 2011); *Fair Work Ombudsman v Haider Pty Ltd & Anor* [2015] FCCA 2113 (30 July 2015); *Fair Work Ombudsman v Amritsaria Four Pty Ltd & Anor* [2016] FCCA 968 (29 Apr. 2016); *Fair Work Ombudsman v Hiyi Pty Ltd & Ors* [2016] FCCA 1634 (1 July 2016); *Fair Work Ombudsman v Viplus Pty Ltd & Anor* [2018] FCCA 741 (29 Mar. 2018); *Fair Work Ombudsman v Viplus Pty Ltd & Anor and Fair Work Ombudsman v Vipper Pty Ltd & Anor* [2017] FCCA 1669 (20 July 2017); *Fair Work Ombudsman v Mai Pty Ltd & Anor* [2016] FCCA 1481 (17 June 2016); *Fair Work Ombudsman v JS Top Pty Ltd & Anor* [2017] FCCA 1689 (21 July 2017); *Fair Work Ombudsman v S & A Enterprises Pty Ltd (QLD) & Anor* [2017] FCCA 3332 (11 Dec. 2017).

[5] *Davaria Pty Ltd and Another v 7-Eleven Stores Pty Ltd and Another* (2020) 281 FCR 501; *Pareshkumar Davaria & Ors v Galactic Seven Eleven Litigation Holdings LLC* (Federal Court of Australia, VID182/2018, commenced 20 Feb. 2018); *Galactic Seven Eleven Litigation Holdings LLC v Davaria* (2024) 302 FCR 493.

lead to negative reviews or loss of customer trust. Consistent adherence to these standards helps maintain a strong brand reputation and customer loyalty.

(iv) Operational Efficiency

System standards streamline franchise operations by defining specific processes and procedures. This operational efficiency reduces errors, costs, and the risk of inconsistencies, further enhancing the brand's reputation for quality, consistency and reliability.

Standards may also facilitate knowledge sharing among franchisees, promoting a collaborative environment where best practices are shared and implemented across the network. This collaboration contributes to a stronger brand image and improved customer satisfaction.

By defining specific procedures, system standards help minimize errors and inconsistencies in service delivery. This reduction in errors leads to higher customer satisfaction and loyalty.

(v) Enhanced Customer Experience

System standards should include comprehensive training programs for franchise staff. Well-trained employees deliver superior customer service, which directly enhances the overall customer experience and satisfaction.

Standards related to store cleanliness, layout, and ambiance contribute to a welcoming environment that enhances the customer experience. Consistent adherence to these standards ensures that customers feel comfortable and valued at every location.

2.2. Sources of System Standards

System standards in franchising are primarily sourced from two key documents: the franchise agreement and the operations manual. However, these documents can also reference other rules, guidelines, and regulations that are drawn from both within and without the franchise business. System standards can also be communicated to franchisees through other means, such as training programs, conferences, online and road-shows.

(i) Franchise Agreement

A franchise agreement typically includes provisions that explicitly outline the scope of system standards and their importance in ongoing business operations. They should define the franchisor's role in supporting franchisees with training, ongoing assistance, and updates to system standards. Importantly, they should also clearly establish the consequences of non-compliance, such as (in extreme cases) the termination of the agreement. By including system standards within the agreement, franchisors can enforce consistency and quality across the franchise network, protecting the brand's reputation and consumer trust.

(ii) Operations Manual

The operations manual should be a comprehensive document that outlines the specifications, standards, and procedures with which franchisees must comply to operate their businesses consistently with the franchisor's brand promise. In the best of worlds, it acts as a reference tool for franchisees, empowering them with the requisite knowledge to run the franchised business effectively. Clearly written, well-structured and easy-to-understand operations manuals are essential for ensuring uniformity of customer experience and quality control across locations. They frequently also serve as a training tool for new franchisees and provide evidence that the franchisee is an independent contractor, which can be crucial in legal disputes.

Importantly, operations manuals are not usually a formal part of the franchise agreement, such that they can be modified by the franchisor without the permission of each and every franchisee. This flexibility permits the franchisor to respond to market changes quickly, introduce new goods and services, and require the introduction of new equipment or systems – all of which can (and should) then be supported by updated standards as needed.

(iii) Training Programs

Training programs are a crucial source of service and brand standards in franchising. These programs are designed to educate franchisees and their staff on the franchisor's brand identity, values, and operational standards. Comprehensive training should cover various aspects such as business operations, marketing, customer service, equipment maintenance, and financial management. By providing intensive training, franchisors ensure that franchisees understand and implement the required standards consistently across all locations. This consistency is essential for maintaining a strong brand image and delivering a uniform customer experience.

(iv) Brand Guidelines and Style Guides

Brand guidelines and style guides serve as detailed documents that outline how the brand should be represented across all franchise locations. These guides specify the use of logos, typography, color palettes, imagery styles, voice, and tone to ensure a cohesive brand identity. By adhering to these guidelines, franchisees can maintain a consistent visual and verbal brand image, which is vital for building trust and familiarity with customers. Consistency in branding elements helps reinforce the brand's mission, values, and unique selling propositions, setting it apart from competitors.

(v) Approved Supply Chain and Vendor Relationships

Approved supply chains and vendor relationships are another important source of service and brand standards. Franchisors often establish relationships with approved suppliers to ensure that franchisees source products and equipment that meet specific quality standards. This approach ensures consistency in the products and services offered across all locations, which is critical for maintaining brand integrity and customer satisfaction. By controlling the supply chain, franchisors can protect their brand's competitive advantage and unique selling propositions, ensuring that franchisees consistently deliver high-quality service to customers.

(vi) Industry Guidelines

Franchisors may incorporate industry-specific guidelines and regulatory requirements into their system standards to ensure compliance and maintain a competitive edge. Industry guidelines and regulations play a significant role as a source of service and brand standards in franchising. These guidelines and regulations help ensure that franchisors maintain high standards across their network, protecting both the brand's reputation and consumer interests.

Industry associations often publish best practices that franchisors can follow to ensure consistency and quality. These guidelines may cover aspects such as customer service, employee training, and operational efficiency, helping franchisors maintain a strong brand image. For instance, in Australia, the Franchise Council of Australia publishes members' standards to provide guidelines that are intended to promote excellence in franchising, enhancing public perceptions and safeguarding investments.

(vii) Laws and Regulations

In heavily regulated industries, such as food service or healthcare, franchisors (and their franchisees) must comply with specific regulations that dictate operational standards. More generally, laws directed towards consumer protection, workplace safety or minimum conditions of employment require businesses to meet certain government mandated standards determined by elected officials or civil public service. Frequently, franchisors will specify that their franchisees must comply with "all relevant laws" or specific regulations to ensure that the franchise system, franchisor and its franchisees maintain, meet or exceed community standards by (for example) providing accurate promotional or advertising information, producing safe and healthy food and by preventing worker exploitation. Compliance with these regulations is essential for maintaining brand integrity and ensuring consistent service quality across all franchise locations.

3. Ways of Monitoring Franchisee Compliance with System Standards

There is little point in having well-drafted, comprehensive legal provisions in the franchise agreement dealing with the setting and enforcement of quality controls and brand standards unless these are actually enforced in practice by the franchisor. As stated above, ensuring the franchise network's compliance with the franchisor's system and brand standards is critical to maintaining the consistency and integrity of the franchise brand. The most common methods used by franchisors to monitor and assess compliance by franchisees include training, quality assurance evaluations, mystery shopping, surveys, feedback, and reporting non-compliance.

3.1. Training

Ongoing training is an essential aspect of ensuring franchisees understand what is expected of them. This is the first step in setting and communicating quality and brand standards. Providing franchisees with comprehensive and then continuous training is an essential element of the support that a franchisor should be providing to a franchisee. It helps ensure that franchisees fully understand the system's standards, operational procedures, and performance expectations. One of the core principles in franchisee compliance is that ignorance cannot be an excuse. However, this only applies if franchisees have been equipped with the knowledge and skills to operate within the system's prescribed guidelines. If the franchisor fails to provide adequate training at the outset and takes a hands-off approach during the term of the agreement in monitoring compliance, then it sets itself up for a claim that the standards do not matter and cannot be enforced as a material term of the agreement.

Robust training programs are usually structured to not only cover the basics of operational standards but also the performance metrics and key performance indicators ("KPIs") that the franchisee is expected to meet. This could include areas such as customer service, customer reviews and ratings, product quality and food safety (including any party certifications), and operational efficiency. Franchisors should ensure that franchisees are well-informed in order to minimize disputes related to non-compliance, as franchisees will be aware of the standards and the consequences for failing to adhere to them. Additionally, offering refresher courses and regular updates on industry best practices can help franchisees stay aligned with evolving brand standards and regulations. This training should be incorporated into the franchise agreement, ensuring that the franchisee acknowledges the importance of maintaining compliance and the repercussions for non-compliance.

3.2. Franchisor Inspections and Quality Assurance Evaluations

Regular quality assurance evaluations and on-site inspections are another key method for monitoring franchisee compliance. By setting clear performance metrics and establishing a robust performance management system, franchisors can track how well franchisees are meeting expectations. KPIs should be defined and clearly communicated, ensuring that franchisees understand the benchmarks for success.

On-site inspections can be critical for assessing franchisee adherence to operational procedures and identifying areas where improvements may be needed. These evaluations can cover a wide range of factors, such as food safety standards, employee training, cleanliness, inventory management, and customer service. A checklist for audits should be carefully crafted to ensure that it addresses all relevant areas, including the franchise agreement compliance (e.g., food safety manuals), operational compliance, health and safety regulations, customer feedback, inventory management, and financial records.

A key consideration when conducting evaluations is whether to utilize independent third-party auditors or conduct inspections internally. Third-party auditors can provide an unbiased and impartial evaluation, which may be important in mitigating potential arguments of favoritism or bias. However, there are also advantages to in-house inspections, as franchisors may have more control over the process and deeper insight into the nuances of brand standards.

The frequency of audits should be aligned with the nature of the business. For quick-service restaurant (QSR) concepts, quarterly audits may be more appropriate given the fast-paced and high-turnover environment. In other sectors, annual audits may suffice. The goal of these inspections is to provide franchisees with a clear understanding of the areas in which they need to improve and to offer corrective guidance when necessary.

3.3. Mystery Shoppers

Mystery shoppers are another valuable tool for assessing franchisee compliance. These shoppers, either internal or external, assess the customer experience from (hopefully) a neutral perspective and can highlight issues that may not be apparent during formal inspections.

To ensure the mystery shopping process is effective, the franchisor must decide who will conduct these evaluations. This could be external personnel hired specifically for this purpose, or internal employees trained to assess compliance. The use of body cameras or other discreet recording methods could provide valuable documentation of the shopper's experience. However, the use of such tools must be carefully managed to respect privacy concerns and legal constraints.

It is also essential to include provisions in the franchise agreement that outline the right to conduct mystery shopping. Franchisees should be aware that they may be evaluated in this manner and that failure to comply with brand standards during these evaluations could result in consequences. The franchise agreement or operations manual should clearly define the mystery shopping process, including frequency, expectations, and the criteria used for evaluation.

3.4. Franchisee Surveys and Feedback

Surveys and feedback mechanisms are valuable tools for gauging franchisee compliance. By regularly collecting feedback from franchisees, franchisors can identify potential issues before they become systemic problems. Surveys can cover various topics such as operational challenges, employee satisfaction, and customer service.

Franchisee feedback can also offer valuable insights into how well the franchise system is functioning on the ground. Franchisees who feel their concerns are heard and addressed are more likely to maintain a commitment to the brand's standards. Regular surveys can also highlight areas where additional training or support may be needed, fostering better collaboration between the franchisor and franchisees.

3.5. Reporting and Documenting Non-Compliance

Developing a robust framework for reporting and documenting non-compliance is crucial for maintaining accountability and ensuring that issues are addressed promptly. Tools such as scorecards can be used to track compliance over time, allowing franchisors to build a comprehensive picture of a franchisee's adherence to brand standards.

Whenever a franchisee is found to be non-compliant, it is essential to document the incident thoroughly. This includes recording the findings of audits, mystery shopper reports, or other evaluations, as well as any communications with the franchisee regarding the issue.

All steps, including remedial training and support provided, must be carefully documented to create a clear record of compliance or failure and to help demonstrate good business judgment was being used.

4. Strategies and Options to Enforce System Standards

Suppose a quality assurance evaluation or on-site inspection revealed a cleanliness issue at a franchisee gym that was not in compliance with the franchisor's system standards, or the franchisor's mystery shopper assessment revealed poor customer service practices at a franchisee restaurant – what strategies does the franchisor have to enforce compliance? Generally, enforcement mechanisms are meant to address deviations from system standards and to protect the franchise brand. A franchisor has several options in its enforcement toolkit, from rewards-based or positive reinforcement of system standards compliance (i.e., "carrots"), to punishment or negative reinforcement used to encourage compliance with system standards (i.e., "sticks"). Typically, a franchisor will try the "carrot" approach first and, if the franchisor is unsuccessful in enforcing system standards, move to one of the "sticks" in an effort to secure compliance. This section addresses the strategies available to a franchisor in enforcing system standards.

4.1. Rewards-Based or Positive Reinforcement Strategies to Encourage Compliance ("Carrots")

(i) Best-Practice Sharing

One way of ensuring that franchisees comply with system standards is through the sharing of best practices through the franchise network. A franchisor can encourage such dialogue at the franchisor's annual convention or other periodic meetings of franchisees. In addition, the franchisor can permit best-practice sharing on the franchisor's intranet – whether formally, whereby the franchisor gathers the information from franchisees and posts it on the intranet itself, or informally, through establishing a franchisee-only chat area within the intranet. Franchisees can learn from each other's experiences and reinforce the importance of complying with the franchisor's system standards. In this way, the franchisor can create a culture of compliance with its system standards and reduce the need for the franchisor to intervene in the franchisee's business to enforce compliance with system standards.

(ii) Counseling and System Communications

When a franchisor believes or has evidence that a franchisee is not complying with system standards, franchisor-led counseling and training can be useful tools to remedy the incidents of non-compliance. Most franchise agreements provide a mechanism for the franchisor to compel franchisees to attend such counseling or training sessions, whether through a remedial training or additional training provision or being placed into a more formal escalation process. This enforcement mechanism also allows the franchisor to dig deeper and identify the source of the non-compliance issues, such as a lack of understanding or a lack of motivation, which can assist the franchisor in determining the best approach to foster compliance in the future with the franchisee, or franchisees in general.

The importance of communication in the franchisor-franchisee relationship when it comes to system standards cannot be overstated. When a franchisor clearly and timely communicates the exact system standards, the reason for implementing the system standards, and the benefits of the system standards to the franchisee and the overall franchise network, the franchisor may head off a fair amount of franchisee non-compliance in the first place. Routine communication from the franchisor is essential in enforcing compliance with system standards.

(iii) Incentives

If a franchisor determines – through counseling and training, or otherwise – that a franchisee's non-compliance is largely due to a lack of motivation, the franchisor may try offering a franchisee an incentive to foster compliance and additional motivation to comply with system standards in the future. Incentives are also useful when a franchisor is adopting a new system standard that it requires franchisees to start complying with in the operation of each franchisee's franchised business, particularly when this new system standard requires the franchisees to incur additional capital expenditures. These incentives can take the form of royalty or advertising fund contribution reductions for a period of time or, if a new system standard requires the purchase of certain equipment or technology, a grace period for adoption. The right incentives can have a material impact on franchisee compliance.

4.2. Punishment or Negative Reinforcement Strategies to Encourage Compliance ("Sticks")

(i) Interim Remedies

Interim remedies help to protect the franchise brand and assist the franchisor in avoiding having to resort to termination, which can be time-consuming and quite expensive.

- *Meetings with Franchisor Leadership*

If the franchisor has tried various "carrot" approaches to enforcing system standards that have not resulted in an increase in the franchisee's compliance, the franchisor may consider first requiring the franchisee to meet with members of the franchisor's leadership team to discuss the franchisee's issues in complying with system standards and a possible solution. This approach should signal to the franchisee the seriousness of the matter and that the franchisor expects a swift resolution.

- *Performance Plans*

Another remedy available to the franchisor is the performance plan. The franchisor and the franchisee, in consultation, may develop a plan that would set clear, measurable expectations and action items for complying with system standards. The plan should provide for a regular monitoring mechanism for the franchisor, with regular check-ins for the franchisor to provide constructive feedback. The ultimate aim of the performance plan is to get the franchisee back on track in complying with the franchisor's system standards.

- *Restrict Access to Services*

Prior to termination, the franchisor may consider restricting a franchisee's access to services or products that the franchisor provides, such as removing information concerning the franchisee's outlet from the franchisor's website, and suspending or terminating the franchisee's participation or access to customer loyalty or retention programs, technology (such as mobile applications), nation-wide or regional marketing campaigns, supply arrangements, or national accounts. Generally, the franchisor would communicate its intention to withhold services in a notice of default sent to the franchisee, and should not withhold services until the cure periods under the franchise agreement and applicable law have passed.

If the franchise agreement does not expressly permit a franchisor to withhold services in the event of a default by the franchisee, in the United States and also in Australia, the franchisor may face claims that it breached the duty of good faith and fair dealing by withholding services or that the withholding of services constituted a constructive termination of the franchise agreement. If a franchisee prevails on these claims, the franchisor may be liable for damages (including recission) under certain state franchise relationship laws in the United States and also in Australia. The same argument could be brought by a franchisee in Germany, too.

(ii) Non-Compliance Fees

As an alternative to default and termination notices, a franchisor may charge non-compliance fees when the franchisee has failed to comply with system standards, provided the franchise agreement allows the franchisor to charge such fees.[6] These fees incentivize franchisees to comply with system standards and help franchisors to recover the cost of conducting audits, investigations and other measures taken to secure compliance with the franchisor's system standards. Non-compliance fees are generally charged on a per day basis until such time that the franchisee remedies its failure to comply with system standards. Often, these fees can also escalate – e.g., $500 per day in the first week, $1,000 per day in the second week if the default continues for successive days, etc. Below is a sample non-compliance fees provision from a U.S. franchise agreement:

> *Franchisee acknowledges the importance of operating the Outlet in full compliance with this Agreement and the System Standards set forth in the Operations Manual or otherwise communicated to Franchisee. Franchisee further acknowledges that Franchisee's deviation from any contractual requirement, including any System Standard, is a violation*

[6] In Australia, unless the fees are a genuine pre-estimate of the franchisor's loss, there is a risk that such fees will be regarded by the Courts as unenforceable "penalties." This risk increases if the fee is disproportionate to the harm to the franchisor judged at the time that the franchise agreement was entered into.

of this Agreement and will require Franchisor to incur incalculable administrative and management costs to address the violation (separate and apart from any damages Franchisee's violation might cause to the System, Franchisor's business opportunities, and the goodwill associated with the Marks). Therefore, Franchisee agrees that, in order to compensate Franchisor for Franchisor's incalculable administrative and management costs due to Franchisee's operational violations, Franchisee must pay Franchisor, at Franchisor's option, Two Hundred Fifty Dollars ($250) for each deviation from a contractual requirement, including any System Standard, cited by Franchisor (the "Non-Compliance Fee"). However, if Franchisor discovers that the same (or a substantially similar) deviation on one or more consecutive, subsequent visits to or inspections of the Outlet, the Non-Compliance Fee will, at Franchisor's option, be Five Hundred Dollars ($500) for the first repeat deviation and One Thousand Dollars ($1,000) for the second and each subsequent repeat deviation. (The Non-Compliance Fee does not apply to payment defaults for which Franchisor may charge late fees and interest.) The Non-Compliance Fee, should one be charged, is deemed by Franchisor and Franchisee to be a reasonable estimate of Franchisor's administrative and management costs and is not a penalty. Franchisor may debit Franchisee's account for Non-Compliance Fees, or set off monies otherwise due and payable to Franchisee, to cover the payment of Non-Compliance Fees. Non-Compliance Fees are due and payable to Franchisor within five (5) days after Franchisor notifies Franchisee that Franchisor is charging Franchisee the Non-Compliance Fee due to Franchisee's violation. Franchisor need not give Franchisee a cure opportunity before charging the Non-Compliance Fee. Charging the Non-Compliance Fee does not preclude Franchisor from seeking to recover damages to the System, Franchisor's business opportunities, or the goodwill associated with the Marks due to Franchisee's violation, seeking injunctive relief to restrain any subsequent or continuing violation, formally defaulting Franchisee and terminating this Agreement, or exercising any of Franchisor's other rights under this Agreement.

As a best practice, the franchisor should notify the franchisee of any such default, and the franchisee should have the ability to cure any material non-compliance and/or breach, if curable, before any default charges are assessed. It is also recommended that the franchise agreement provide that the franchisor's exercise of this right will not constitute an actual or constructive termination of the franchise agreement, nor will it be the franchisor's sole or exclusive remedy for the franchisee's default.

(iii) Default Notices

If the interim remedies have not had the intended results, the franchisor may issue a default notice to the franchisee, assuming the non-compliance with system standards is a default of the franchise agreement. The default notice formally informs a franchisee that it must comply with system standards and address any deviations from those standards, or confront termination. Procedurally, the franchisor should assess the substantive requirements of the franchise agreement and, in the United States, the requirements of any applicable state franchise relationship laws that would restrict or otherwise limit the franchisor's actions. In Australia, the national Franchising Code of Conduct prescribes certain minimum requirements for default and breach notices under a mandated dispute resolution regime.

The content of the default notice should specify the conduct constituting the default and tie the default to specific provisions of the franchise agreement or operations manual. The notice should also specify the actions necessary to cure the enumerated default(s). The notice should further state how long the franchisee has to cure the default, if curable. Finally, the default notice should clearly state and identify the consequences if the franchisee fails to comply, and include an express reservation of rights and claims by the franchisor.

As referenced above, approximately 19 U.S. states, plus Puerto Rico and the Virgin Islands, have enacted franchise relationship laws that govern default and termination of the franchise relationship by the franchisor.[7] It is important to note that the notice of default content and timing must comply with any applicable state relationship law provisions, if the state law applies to the relationship, regardless of what the franchise agreement provides. Additionally, many state relationship laws provide that the franchisor must have good cause to terminate, and any notice of default should ensure it sets out a default that meets the definition of good cause, which varies among the state laws. Finally, many state relationship laws also set out the time periods required to be provided by a franchisor to a franchisee to cure a default, which also vary among the states having such laws.

(iv) Termination

If a franchisor has utilized all available enforcement mechanisms without the intended result, the franchisor may come to the conclusion that the only way to protect the franchise brand is by terminating the franchise relationship. When a franchisor proceeds with a termination based upon a termination provision in the franchise agreement, the franchisor should determine whether termination may be effected immediately upon notice or, particularly when there is an opportunity to cure, what length of notice must be provided in advance of termination.

The termination notice should reiterate the default the franchisee committed in respect of system standards and, if the franchisee was afforded a cure period in a previous default notice, that the franchisee has failed to cure the default. The termination notice should also set forth the specific termination date. A termination letter affords the franchisor the opportunity to remind the franchisee of its various post-termination obligations under the franchise agreement, including, among other things, payment of all amounts owed, de-identification of the franchisee's location, and return of the franchisor's confidential materials.

Most franchise agreements contain notice provisions that set forth the available methods for delivery of notices, as well as the designated recipient of notices. A franchisor should review the provision to confirm that it delivers the termination notice in accordance with the permissible forms of delivery. Taking the time to ensure that the termination notice is delivered properly, according to the terms of the franchise agreement, prevents the franchisee from using the argument of impermissible delivery later on to challenge the termination.

As noted above, a number of U.S. states that have franchise relationship laws specifically address matters that affect the franchisor's termination process, including the permissible grounds for termination, whether a franchisee has a right to cure, as well as timing and notice requirements. In Australia, there are similar limits on the powers of franchisors to terminate a franchise agreement that arise under the Franchising Code of Conduct, as well as the overriding obligations to act in good faith and not to act unconscionably. Where such laws apply to the termination, a franchisor must ensure compliance with the statutory provisions and previous court decisions as well as the terms of the franchise agreement.

In Germany, where no codified franchise relationship laws exist, the courts also rely on general

[7] While there is no federal franchise relationship law in the United States at this time, bills intended to regulate certain aspects of franchise relationships have been introduced into Congress on several occasions during the past two decades, none of which have been enacted. It is impossible, however, to predict whether the enactment of such legislation will eventually occur.

legal principles of contract law when assessing whether an extraordinary termination due to violations of system standards is justified. For example, in a decision on Burger King, the Munich Higher Regional Court in 2014 confirmed the legitimacy of an extraordinary termination of the franchise agreement by the franchisor due to a violation of various system standards, even though there was neither a direct threat to health, nor was one of the violations in itself sufficient to justify the extraordinary termination.[8] The assessed violations included rather minor infringements such as the failure to wear a head covering by an employee in the kitchen, the wearing of a private blouse instead of the clothing prescribed by the system, the wearing of a private tie (instead of an official tie), repeated inaccuracies when handling the temperature measurement of the minced meat slices, the repeated lack of supply of still water, the advertising of (sold out) summer desserts in winter and others.

The court held that each of the identified violations had to be included in the overall assessment and it came to the conclusion that the violations constituted a breach of the uniformity of the system and a risk of damage to reputation:

> *The reason for termination ultimately arises from the continued lack of accuracy on the part of the plaintiff in complying with the requirements of the franchise system and the standards rightly expected by the defendant and the guests.* [9]

A franchisor does not have to accept a threat to the brand image, even taking into account the interests of the franchisee (e.g., amortization of its investments). This applies even more if the remaining term of the contract is still long (in this case approximately 11 years), as the longer the remaining term, the more unacceptable the continuation of the contractual relationship becomes if there are grounds for termination.

5. Enforcement of System Standards from the Franchisee's Perspective

It takes two to tango. And you dance with each other and not next to each other or even against each other. And although the franchisor is the one who defines and enforces the standards, the franchisor should follow a few basic rules that apply to dancing, as well as franchising:

- Don't hurt anyone (which can happen when you're too enthusiastic or lack control).
- Ask your partner which style they like.
- Give your partner space.
- Keep learning.

5.1. Culture of Compliance

From the franchisee perspective, the enforcement of system standards presents competing issues with respect to the desirability of their formulation and enforcement. On the one hand, franchisees most certainly have an interest in ensuring that system standards are enforced. Conversely, those system standards need to be objectively reasonable, material, and fairly enforced. Franchisors who stray too far outside of those parameters (either in lax enforcement or in strict enforcement of non-material or

[8] OLG München, judgment dated October, 2014 – 7 U 2604/13.
[9] OLG München, 7 U 2604/13, BeckRS 2014, 19514, margin number 32.

unreasonable standards) will likely cause significant issues within the franchise system.

To be sure, no one is more interested in having system standards enforced than existing franchisees. Franchisees that do not comply with system standards, particularly those standards that are customer-facing (e.g., cleanliness, customer service, product quality, etc.), risk becoming “brand detractors” that, if left unpoliced, can hurt the business of other franchisees in the same system. Indeed, franchisees often join a system because of the uniformity that is exhibited “on the street” to customers and the consuming public.

5.2. The Big Three: Reasonableness, Materiality, Fairness

However, from a franchisee perspective, system standards should not be used as a coercive measure, a club, or as a way to force franchisees out of the system when non-compliance has no real bearing on the operation of the enterprise. Accordingly, franchisors and franchisees have a common interest in ensuring that all system standards are objectively reasonable, material, and fairly enforced. An exploration of each of these requirements is in order.

Perhaps the most difficult of the three of these requirements to define is ensuring that system standards are “objectively reasonable.” On its face, this requirement means that system standards and a franchisee’s compliance with the standards should be able to be objectively measured, and if the requirement is not necessarily capable of objective measurement (e.g., “provides friendly customer service”) is found to be measured in some manner that is not simply the opinion of one (or a small number of) individual(s). For instance, whether a franchised location is open a sufficient number of hours and whether the location is clean (measured by photographs and eye-witness accounts of the condition of the location) should be able to be objectively measured.

Failure to have objective measurements of system standards often allows franchisors the ability to abuse the standards in coercive ways in policing the franchisees’ conduct of their businesses. Such an approach is likely to cause the franchisor and franchisee significant conflict and exposes the franchisor to the charges of acting in bad faith when issues arise.

In addition to being objectively reasonable, system standards need to be material. While it might be easy to measure something like the number of employees on duty at any one given time, such a measurement would only be material if the business was suffering because that number is not met. Indeed, if no one is coming into a franchised location between 10:00 p.m. (22:00) and midnight, does it matter whether or not there are three or four staff members at the location at that time? Probably not. The authors of this paper are sure the reader can imagine some even less material system standards that they have seen over the years. The number of immaterial system standards, particularly as a system continues to grow and franchisor control of unit operations expand, can become somewhat ridiculous.

Like the requirement of objectivity, standards that are non-material will likely cause disputes between the franchisor and the franchisee and, to the extent the franchisor attempts to enforce them, lead to charges of discrimination and/or bad faith.

Finally, these objective and material standards need to be fairly enforced. This is probably where most system standard disputes between franchisors and franchisees erupt—i.e., when some franchisees are held to different standards than others.

5.3. When Standards Are Used as a Pretext….

For franchisees, the number one issue with system standards is the misuse or abuse of these standards by franchisors as a way to coerce franchisees' conduct and/or to drive franchisees out of the system—either through forced sales or outright termination.

While the law is inconsistent on this front, a very valid argument can be made by franchisees that a franchisor is not acting in good faith when it enforces system standards against some, but not all, franchisees—particularly if those standards are customer-facing. Franchisors that want to avoid such charges should be certain that their field staff make no exceptions in the way they administer the examination of franchisee compliance with system standards.

5.4. "You Just Want Me Out"

A recent example may help demonstrate all of these points. A two-store operator of a well-known fast casual restaurant chain has been getting pressure from the franchisor to sell its restaurants to corporate for a few years, as its locations are in the center of a market that is otherwise dominated by corporate locations. The operator has shown no interest in selling.

In what appears to be a blatant attempt to ramp up the pressure to get this franchisee out of the system, and these locations in the hands of corporate, the franchisee was sent a message from the president of the company advising as follows:

> *"I just received the attached photograph. I have never seen a worse piece of cheese toast. This is just the latest in a series of issues.*
>
> *We are meeting in two weeks to discuss your future in our system."*

Threatening to push someone out of the system over, literally, a piece of burnt toast meets none of the tests that should exist. What qualifies as "burnt" does not seem objective and measurable, and is certainly not material. If no other operator in the system is being threatened because one-half of one side of one piece of toast was over-cooked, then this will be problematic. Frankly, this type of conduct is emblematic of the abuse that can occur when "system standards" are used for the wrong reasons.

Nothing here is rocket science. Having fair, material, and reasonable standards will keep the franchise relationship in good stead, while at the same time giving the franchisor the tools it needs to keep brand detractors from hurting everyone in the system.

6. Conclusive Strategies and Advice

The interest and rights of a franchisor to set certain standards for the system it has designed and to monitor and enforce compliance with them is undisputed. However, the above discussion shows that not every unilaterally set standard can justify an infringement of the franchisee's entrepreneurial freedom on the grounds that it is necessary to ensure uniformity or quality standards. The franchisor is responsible for clear communication when setting standards, offering training, monitoring adherence to the defined standards, explaining why they are important, and sanctioning franchisees who fail or refuse to comply.

However, at the latest, when the termination of an inconvenient franchisee is sought on the grounds of a breach of unilaterally defined standards, the question arises as to whether this would be justified in the circumstances or whether there might not be other, less drastic options. In this regard, there are certain key differences between the individual jurisdictions: while a violation of a provision in the franchise agreement in one country may justify extraordinary termination, this may not be sufficient in a contract subject to the law of another country.

Despite these differences, the following fundamental principles apply in any case, regardless of the respective legal system, pertaining to compliance with and enforcement of system standards:

- The extent and selection of the mandatory system standards must be implemented with a sense of proportion.
- When a system standard is defined or newly introduced, the underlying purpose must be apparent to the franchisee (e.g., compliance with legal requirements, safety, quality, uniformity, brand protection, competitiveness, etc.).
- System standards require clear communication to the franchisee so that the franchisee is aware of them and can implement them.
- The franchisee must be trained and be put in a position to implement the standards.
- The franchisor must make it clear in advance how it will deal with possible violations.
- The adherence to system standards must be monitored, and if violations occur, the franchisor must – depending on their severity – make use of the sanctions available to the franchisor in the circumstances.
- System standards are not an empty shell, and their lack of implementation must not be used to justify unreasonable or unconscionable franchisor behavior.

If both sides observe these principles and, from time to time, put themselves into the other party's shoes, then there is no reason for either party to say to the other, "That's none of your business."

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Biographies

Dagmar Waldzus is a partner in the Hamburg office of BUSE Rechtsanwälte, a full-service law firm with 100+ lawyers in 7 offices in Germany. As the head of the firm's Distribution and Commercial Law Practice Group Dagmar's work focuses on franchise, sales, commercial agency, and distribution law. She has extensive experience in advising franchisors (inbound and outbound) in relation to all legal aspects arising from the internationalization and adaptation of their concepts and documentation. Dagmar currently serves as the Vice-Chair for the IBA's International Franchising Committee and is an associated expert with the German Franchise Association (DFV) where she is a member of its Think Tank on Digitalization. She regularly serves as a speaker and publishes articles on topics related to franchising, e-commerce, digitalization, competition law, and data privacy. Dagmar has been recognized in BestLawyers Germany for Corporate Law and as leading franchise practitioner in the Lexology ranking (formerly "Who's Who Legal") in the category of Thought Leaders Global Elite for franchising for many years.

Stephanie Zosak is a partner in the Franchise & Distribution Group of DLA Piper LLP (US), based in the firm's Chicago office. Stephanie has extensive experience in advising clients in the retail, food and beverage, and hospitality industries on their international expansion through various franchise and distribution models, including in Canada, Mexico, the Middle East, the CIS, Europe, Asia, and South and Central America. Stephanie also has assisted several large franchisors in the food service and automotive sectors with franchise securitization transactions. Stephanie currently serves as the Conference Quality Officer for the International Bar Association's International Franchising Committee. Stephanie earned her BA in Political Science and International Studies from Northwestern University, MSc in Human Rights from the London School of Economics and Political Science, and JD from Northwestern University Pritzker School of Law. Following law school, Stephanie was a Pro Bono Legal Advisor in the International Criminal Court and International Criminal Tribunal for the Former Yugoslavia in The Hague, the Netherlands.

Nicola Broadhurst is a partner and heads up the franchise practice at Stevens & Bolton LLP a full service commercial law firm based just outside London in Guildford UK. Advising on franchise legal issues for over 23 years she has in depth experience assisting businesses to scale up and expand through franchising and licensing as well as distribution and agency. Much of her work is international with a particular focus on the casual dining, hospitality and fashion sectors. Nicola is an acknowledged legal expert in the franchise sector. She is the current chair of the British Franchise Association's legal committee and immediate past chair of the American Bar Association's Franchise Forum's international division. As well as being an officer of the IBA's International Franchise Committee she is a member of the IBA's Advisory Board for the European Regional Forum. She is regularly asked to judge industry awards including the Elite Franchise Awards for the past three years and the Western Australia Franchise Awards. She writes for leading trade journals and speaks at industry specific events. She is ranked as a Thought Leader Global Elite for franchising in Lexology Index (formerly Who's Who legal), top ranked by Chambers UK legal directory and recently awarded Hall of Fame status for her franchise expertise in the Legal 500.

Shaun Temby is regarded as one of Australia's leading consumer markets and franchise lawyers. He has specialist expertise advising on franchise strategy and disputes involving the Franchising Code of Conduct, as well as competition and consumer law matters for franchisors. He acts for a range of consumer markets clients, covering the automotive, food and beverage, health and wellness, FMCG and luxury good industries. Shaun also regularly acts for clients in investigations by the Australian Competition & Consumer Commission (ACCC), technology disputes and large scale commercial and contractual disputes. Most recently, Shaun has been awarded Partner of the Year – Dispute Resolution & Litigation and Litigator of the Year by Lawyers Weekly, as well as Australia's Most Influential Lawyer by Australasian Lawyer. He also recognised by Best Lawyers Australia for Alternative Dispute Resolution and Franchise Law and is recommended by Who's Who Legal for Franchising.

Ronald K. Gardner, a founding partner of the firm of Dady & Gardner, P.A., limits his practice to the representation of franchisees, franchisee associations, dealers and distributors, focusing most frequently on his clients' disputes with their franchisors, manufacturers and suppliers. Dady & Gardner, P.A. has an international reputation for helping their franchisee, association, dealer and distributor clients to resolve their disputes through negotiation, mediation, and when necessary, litigation and arbitration. Ron is a member of the American, Minnesota, Hennepin County and Rice County Bar Associations, an active member of the ABA Forum on Franchising, and a Past Chair of the Forum (the first "franchisee lawyer" to be elected Chair). Ron is also a member of the North American Securities Administrator Association Franchise Project Advisory Group, which helps to promulgate franchise regulations and train state franchise regulators in the nuances of franchise law. Ron is an author and a highly sought-after lecturer on topics related to franchise/distribution law. He is listed as a Best Lawyer in America, has been named one of Minnesota's Top 100 Super Lawyers seven times (including 2023), and has been recognized by Chambers USA as "the premier franchisee lawyer" in America. He was recognized as "Franchise Lawyer of the Year" in Minnesota by Best Lawyers for 2015, 2019, and again in 2023.