Compliance Audits Rule!

Mary Beth Gettins

It is irrelevant how, when, and why franchise compliance audits are completed. Findings of a franchise compliance audit can be grounds for termination of the franchise agreement and a wide range of claims. It is immaterial if a compliance audit is done by sampling, onsite inspection, or comparative analysis. Pretext, discrimination, duress, waiver, and franchisor misconduct defenses will not rule over compliance audit findings. This article discusses these issues, and what court rulings have had to say about compliance audits.

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I. How Are Compliance Audits Conducted?

There are many types of compliance audits. Typically, franchisors rely on traditional onsite inspections to check brand standards. Compliance audits that inspect brand standards include such things as reviewing how food items are prepared and staged. This entails checking equipment temperatures, employee practices, premise conditions, and cleanliness.

For example, franchisor Burger King Corporation completes Quality Compliance Standards (QSC) inspections, which includes inspecting equipment, food processing, holding and preparation, hygiene, and employee practices. Following the QSC inspections, the franchisee is given a score, which reflects any deviations from Burger King standards. Deviations noted in the QSC inspection must be corrected to a minimal level of acceptability within a reasonable time. Failure to correct the deviations in reasonable time is a material default of the franchise agreement.[1] McDonald's likewise completes QSC inspections that review food safety, equipment temperatures, and employee safety checklists. Results of the QSC inspection, if severe, may be a material default of the franchise agreement.[2]

In comparison, franchisors are relying on technology to inspect franchisee revenue reporting. Technology allows franchisors to identify potential red

1. Burger King Corp. v. Stephens, CIV. A. No. 89–7691, 1989 WL 147557, at *9 (E.D. Pa. Dec. 6, 1989).
2. McDonald's Corp. v. Robertson, 147 F.3d 1301 (11th Cir. 1998).

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flags and to complete comprehensive compliance audits remotely from their headquarters. Revenue reporting compliance violations most commonly involve unreported or non-reported franchisee consumer sales.

For example, in one case, 7-Eleven initially identified a franchisee's revenue inaccuracies using a point of sale (POS) comparative algorithm that ranked all stores within regional zones for high-risk transactions, such as item voids, non-scanned sales, canceled age verification, no sale, change makers, and penny sales.[3] When the particular franchisee ranked first and second in several high-risk rankings, 7-Eleven engaged in further auditing and inspections using a comparative analysis of the franchise's physical inventory, inventory purchases, and sales recording data generated via the POS.[4] 7-Eleven also compared repeated secret shopper purchasers with POS sales reports.[5] Finally, compliance officers watched the in-store security tapes.[6]

Other franchisors also use comparative analyses, similar to the methods employed by 7-Eleven, of inventory purchases and sales records. For example, franchisor Noble Roman's completed an almost ten-year audit from 2004 to 2014 of a franchisee's inventory purchases compared to gross sales.[7] Based on inaccuracies between purchases and reported sales, Noble Roman's tendered a demand for underpayment under the franchise agreement.[8] The franchisee refused to pay the alleged unpaid royalties and stopped offering Noble Roman's services to customers.[9]

II. When Are Compliance Audits Done?

The methods, means, and scope of compliance are expansive. When a franchise compliance audit is conducted is equally expansive. Compliance audits may be prompted by routine analysis and onsite visits, or they may be initiated based on consumer complaints or other specific events. The frequency of compliance audits is unfettered, and compliance audits may be announced or unannounced.

A. *Illegal Activity*

The event that gives rise to a compliance audit need not be proximate in time to the compliance audit itself. For example, two years after a franchisee's temporary workers were arrested and discovered to be illegal aliens, franchisor Manpower completed an onsite inspection of the franchisee's I-9 forms.[10] The inspection revealed so many incomplete and missing I-9 forms for temporary

3. 7-Eleven, Inc. v. Upadhyaya, 926 F. Supp. 2d 614, 620 (E.D. Pa. 2013).
4. *Id.*
5. *Id.* at 621.
6. *Id.* at 621–22.
7. Noble Roman's, Inc. v. Puzzles Fun Dome, Inc., Bus. Franchise Guide (CCH) ¶ 15,496, at 2 (S.D. Ind. Mar. 16, 2015).
8. *Id.*
9. *Id.*
10. Manpower Inc. v. Mason, 405 F. Supp. 2d 959 (E.D. Wis. 2005).

workers that the auditor deemed the results of the inspection to be "the most egregious she had seen in her sixteen years at Manpower."[11] This inspection occurred nearly three years after Manpower wrote a letter to the franchisee in September 2001 reporting the franchisee's numerous deficiencies:

- poor judgment as evidenced by expressing his disagreement about pricing policies with visiting Manpower personnel in front of a customer;
- dishonesty—a visiting Manpower employee observed franchisee's son take and copy confidential materials from a competitor's office located in a customer's facility;
- repeatedly doing business outside the franchise's territory;
- failing to follow directions and to cooperate with Manpower;
- making many unfounded complaints about Manpower;
- immaturity as evidenced by throwing tantrums and making vulgar remarks to female employees; and
- rudeness as evidenced by treating Manpower staff in a hostile manner.[12]

In addition, there were ongoing territorial violations. The franchisee's son actively advertised, solicited, and provided temporary workers beyond the franchisee's territory, contrary to numerous conversations with the franchisor.[13] The franchisee's son also established a consulting firm, holding it out as a division of the Manpower.[14] After the franchisee's son engaged in some inappropriate behavior at a franchisee convention in 2004,[15] Manpower decided to conduct the audit. Based on all of these findings (illegal conduct, territorial violations, misusing the franchisor's name, etc.). Manpower sent the franchisee a letter on July 25, 2005, rescinding the Manpower franchise agreement.[16]

B. *Customer Complaints*

Franchisors also conduct audits in response to customer complaints. For example, a customer contacted franchisor Aamco regarding a warranty compliant.[17] The customer produced receipts evidencing work completed,[18] but

11. *Id.* at 967–68.
12. *Id.* at 965.
13. *Id.* at 965–67.
14. *Id.* at 968.
15. The son was operating the franchisee's business at the behest of his father, the owner. In 2003, at Manpower's national convention in San Antonio, police handcuffed the franchisee's son in connection with an altercation that began when he tried to enter a stranger's car. *Id.* In 2004, at Manpower's national convention in Orlando, the franchisee's son was again involved in an altercation, this time with hotel employees after locking himself out of his hotel room in his underwear while intoxicated. *Id.*
16. *Id.*
17. AAMCO Transmissions, Inc. v. Trovato, Bus. Franchise Guide (CCH) ¶ 14,702, at 2 (S.D. Cal. Sept. 28, 2011).
18. *Id.*

the receipts were not Aamco receipts. This prompted an onsite compliance audit ten days later.[19] During the onsite audit, the auditors discovered two non-Aamco receipt books.[20] The franchisee refused to allow the auditors to inspect or copy the receipt books.[21] In response to the franchisor's demand to copy and inspect the receipt books, the franchisee's attorney sent a letter stating that Aamco had no right to inspect the franchisee's private records.[22] Aamco filed a complaint seeking termination of the franchise agreement and monetary damages for breach of contract based on the franchisee's failure to report and pay royalties as well as failure to allow inspection of books and records.[23]

C. *Reacquisition of Franchise*

Franchisors may also conduct audits when a location changes hands. For example, in another case, 7-Eleven completed a changeover audit of the physical inventory and reported sales following termination of a franchise agreement and reacquisition of the franchise.[24] When the audit revealed several deficiencies, 7-Eleven filed a complaint against the former franchisee demanding monies owed based on claims of fraud.[25] The court granted summary judgment in favor of 7-Eleven and entered a judgment against the former franchisee in the amount of $567,930.64.[26]

III. Franchisee Perspective On Compliance Audits

When confronted with the deficiencies found in compliance audits, franchisees frequently argue that the stated purpose for the compliance audit was a pretext and that the audit was in fact conducted for an undisclosed, improper purpose. Although franchisees often raise these claims in litigation, these protests are usually unsuccessful.

A. *Forced Relocation*

In a case of alleged pretextual compliance auditing, McDonald's offered a franchisee the opportunity to relocate the franchise to a recently purchased McDonald's-owned property one block away.[27] When the franchisee declined relocation, McDonald's offered to purchase the franchisee's franchise.[28] The franchisee again declined McDonald's offer, and McDonald's conducted a

19. *Id.*
20. *Id.* at 3.
21. *Id.*
22. *Id.*
23. *Id.*
24. 7-Eleven, Inc., v. Chaudhry, Bus. Franchise Guide (CCH) ¶ 12,414, at 2 (D. Mass. Aug. 15, 2002).
25. *Id.* at 3.
26. *Id.*
27. McDonald's Corp. v. Robertson, 147 F.3d 1301, 1304 (11th Cir. 1998).
28. *Id.* at 1305.

compliance audit two months later.[29] McDonald's had already completed an audit just days before it made the initial offer to relocate the franchise.[30] In fact, McDonald's had conducted many compliance audits of the franchisee over the preceding years, including ten unannounced audits and follow-up audits between February 1995 and August 1997.[31] McDonald's found deficiencies in all ten of the compliance audits. The franchisee alleged that McDonald's took action to terminate the franchise agreement based on compliance audits only after franchisee's rejection of offers to relocate and to sell the franchise.[32] The Eleventh Circuit rejected this argument, noting that the deficiencies discovered in the compliance audits were sufficient to warrant termination of the franchise agreement, even if McDonald's conducted the audits as a pretext after the franchisee refused to sell the franchise.[33]

B. *Exit from Inner City*

A Burger King franchisee likewise asserted a defense of pretext when Burger King terminated its franchise agreement based upon compliance audit deficiencies.[34] Burger King's new ownership allegedly no longer wanted Burger King restaurants in inner city areas.[35] In addition, the franchisees contended that similar operating conditions had been tolerated in white-owned and operated franchises, that the new standards targeted minority operators, that the franchisee's health and safety violations did not result in citation of violations of the health code, and that the compliance audit was conducted as retaliation for a class action against franchisor Burger King, in which the franchisee was a member.[36] The court summarily rejected all the franchisee's defenses because it was undisputed that the franchisee was not in compliance.[37]

C. *Racial Discrimination*

When a compliance audit revealed unrecorded revenues, 7-Eleven terminated the franchise agreement and filed a civil complaint against the franchisee.[38] The franchisee had not paid royalties or sales tax on the unreported

29. *Id.*
30. *Id.* at 1304–05.
31. *Id.*
32. *Id.* at 1309.
33. *Id.* ("Even assuming, arguendo, that this allegation is correct, however, we find that the Robertsons' failure to comply with McDonald's QSC and food safety standards constituted a material breach of the franchise agreement sufficient to justify termination, and thus, it does not matter whether McDonald's also possessed an ulterior, improper motive for terminating the Robertsons' franchise agreement.").
34. Burger King Corp. v. Stephens, CIV. A. No. 89–7691, 1989 WL 147557 (E.D. Pa. Dec. 6, 1989)
35. *Id.* at *5.
36. *Id.* at *11.
37. *Id.* at *13.
38. 7-Eleven, Inc. v. Sodhi, Civil Action No. 13-3715 (MAS) (JS), 2016 WL 3085897, at *3 (D.N.J. May 31, 2016).

revenues.[39] 7-Eleven's complaint was met by a counterclaim by the franchisee alleging racial discrimination.[40] The court held that New Jersey Law Against Discrimination does not cover discrimination during the ongoing execution of the contract; therefore, the franchisee's claims of discrimination failed as matter of law.[41]

IV. What Courts Have To Say About Compliance Audits

If a material default of the franchise agreement is discovered during a compliance audit, courts have overwhelmingly ruled in favor of the franchisor. Franchisees rarely contest the franchisor's ability to conduct audits, and courts rarely question franchisors' right to inspect and complete compliance audits. Instead, courts focus on the franchisee's duties and obligations as set forth in the franchise agreement, including the duty to follow brand standards and the duty to report revenues and pay royalties.[42] When franchisees fail to do so, courts will side with the franchisor.[43]

As previously discussed, a franchisor's ulterior motive in conducting a compliance audit is no defense,[44] and the same is true of acquiescence and waiver. For example, in response to being terminated for violations of McDonald's health and safety deficiencies, one franchisee stated in an affidavit: "I became increasingly surprised by these findings, since I was operating my restaurant in the same manner and according to the same high standards for food, safety, and service that I had maintained for the past twenty-six years as a McDonald's owner/operator."[45] The court was not persuaded. The franchisee had in fact been given notice of previous deficiencies discovered during compliance audits.[46] Past unenforced breaches are no defense to

39. *Id.*

40. *Id.* at *7.

41. *Id.*

42. Dunkin' Donuts Inc. v. Patel, 174 F. Supp. 2d 202 (D.N.J. 2001) ("Defendants [franchisees] are required to maintain their shops in compliance with Plaintiff's standards, including those standards for health, sanitation, and safety."); 7-Eleven, Inc. v. Upadhyaya, 926 F. Supp. 2d 614 (E.D. Pa. 2013) ("The Franchise Agreement provides that Milind, Minaxi, and Enterprises [franchisees] were required to, *inter alia*, use electronic equipment to scan all products which can be scanned, report all sales to 7-Eleven, and otherwise provide 7-Eleven with truthful, accurate, and complete information regarding the operation of the store.").

43. *See* 7-Eleven, Inc. v. Sodhi, Civil Action No. 13-3715 (MAS) (JS), 2016 WL 3085897, at *5 (D.N.J. May 31, 2016) (collecting cases).

44. This is particularly true where unpaid royalties and sales tax are discovered. This is best illustrated in a recent case involving 7-Eleven in which the court summarized the issue as follows:

> The Court finds that Mr. Sodhi's [7-Eleven franchisee] failure to pay and/or withhold applicable payroll and income taxes, in addition to being against the law, is a material breach of the Franchise Agreements. Thus, any purported ulterior motive of 7-Eleven, even if shown, is irrelevant to finding that 7-Eleven had good cause to terminate the Franchise Agreements. Thus, construing the facts in the light most favorable to Defendants, no reasonable juror could find that 7-Eleven did not have good cause to terminate the Franchise Agreements.

Id. (citations omitted).

45. McDonald's Corp. v. Robertson, 147 F.3d 1301, 1308 (11th Cir. 1998).

46. *Id.*

current material breaches of the franchise agreement.[47] McDonald's was free to change its health and safety standards and free to change its practices of enforcement.

In cases where material defaults uncovered in compliance audits are in the realm of criminal wrongdoing, a criminal conviction is not required.[48] If the franchise agreement requires compliance with the law, a simple showing that franchisee failed to follow the law is sufficient.[49] Further, even if the criminal wrongdoing is corrected, that does not erase the fact that the franchisee committed a crime.[50] Accordingly, the crime can still form the basis of a material breach of the franchise agreement.[51]

Similarly, it does not follow that violations of the franchisor's standards are a material default only if they are a violation of state or local health and safety regulations. "[A] franchiser is free to establish health, sanitation, and safety standards that exceed those of the municipality in which the franchised store is located."[52] If the franchisee does not follow the franchise standards, it is in default under the franchise agreement, irrespective of what the law requires.

V. Conclusion

A franchisor's right to inspect and audit is unfettered. Courts repeatedly rule that following brand standards, reporting revenues, and paying royalties goes to the core of the franchise relationship. Failure to follow the franchisor's brand standards irreparably harms the goodwill of the franchisor and the franchise system. This sentiment is articulated by the court in this way:

> The public's knowledge of the uniformity of operation and quality of product draws business to Burger King restaurants. Therefore, the name "Burger King" constitutes a trademark of great value to BKC and to the franchisees. BKC's inability to protect and insure the maintenance of the high quality of service that the marks represent would cause irreparable injury to BKC's business reputation and goodwill.[53]

Courts find that a franchisee's failure to report revenues and pay royalties is not only a breach of the franchise agreement but also fraud that goes to the heart of the trust in the franchise relationship. The court in the *Upadhyaya* case explained it this way:

> The Court thus concludes that 7-Eleven has proven all elements of fraud by clear and convincing evidence and that the fraudulent actions of the defendants constituted a breach going to the essence of the contract. Defendants' fraudulent actions

47. *Id.*

48. Chevron U.S.A., Inc. v. SSD & Assocs., Bus. Franchise Guide (CCH) ¶ 13,206, at 3 (N.D. Cal. Nov. 7, 2005) ("The law does not require a conviction to justify termination, only 'fraud or criminal misconduct.'").

49. *Id.*

50. *Id.* at 4.

51. *Id.*

52. Dunkin' Donuts Inc. v. Patel, 174 F. Supp. 2d 202, 210 (D.N.J. 2001).

53. Burger King Corp. v. Stephens, 1989 WL 147557, at *10 (E.D. Pa. Dec. 6, 1989).

> served to destroy all trust between themselves and 7-Eleven, and the Court finds that requiring notice before termination under such circumstances would be a useless gesture, as such a breach may not reasonably be cured. Consequently, the September 28, 2012 termination of the Franchise Agreement without any notice or opportunity to cure was proper, and the Agreement was terminated as of that date.[54]

Practitioners should know that courts look to intangibles. Courts will consider brand goodwill, harm to public reputation, and the trust between the franchisor and franchisee when determining whether a franchise compliance audit is sufficient grounds for termination of the franchise relationship.[55]

54. 7-Eleven, Inc. v. Upadhyaya, 926 F. Supp. 2d 614, 629 (E.D. Penn. 2013) (citations omitted).

55. As previously discussed, the case law discusses primarily egregious compliance violations. But what is the outcome with lesser compliance violations? What rises to the level of harming goodwill, public reputations, and the trust between the franchisor and franchisee? Although there is no bright line articulated in the case law, it appears that courts place a high value on the express terms of the franchise agreement and the core trust in the franchise relationship.