

**American Bar Association
32nd Annual Forum on Franchising**

**Sourcing Products And Services For The System:
Efficiencies And Traps In Supply Chain Management**

**Chesley K. "Bud" Culp III
Moye White LLP**

and

**Rochelle B. Spandorf
Davis Wright Tremaine LLP**

October 14 - 16, 2009
The Westin Harbour Castle
Toronto, Canada

TABLE OF CONTENTS

	Page
I. INTRODUCTION	1
II. THE FRANCHISE SUPPLY CHAIN	2
III. THE LEGAL FRAMEWORK GOVERNING THE FRANCHISE SUPPLY CHAIN.....	7
IV. BENEFITS ARISING FROM FRANCHISOR CONTROL OVER AND INVOLVEMENT IN THE SOURCE OF PRODUCTS AND SERVICES.....	22
V. TENSIONS ARISING FROM FRANCHISOR CONTROL OVER AND INVOLVEMENT IN THE SOURCE OF PRODUCTS AND SERVICES.....	25
VI. DISCLOSING AND ADDRESSING SOURCING RESTRICTIONS IN THE FRANCHISE AGREEMENT: BEST PRACTICES	30
VII. PROCUREMENT AND VENDOR AGREEMENTS: BEST PRACTICES	34
VIII. CONCLUSION.....	41

SOURCING PRODUCTS AND SERVICES FOR THE SYSTEM: EFFICIENCIES AND TRAPS IN SUPPLY CHAIN MANAGEMENT

I. INTRODUCTION

It has been observed that “[t]he strength of franchise systems typically does not lie in the *absolute* quality of the products offered . . . [but] in the capacity of the franchised chain to offer a *uniform* product at a reasonable price.”¹ “Customers know what to expect when they patronize an outlet in a franchised chain, and it is important for the chains to successfully meet these expectations time after time.”² Product uniformity also brings operational advantages, allowing the franchisor to use all of the buying power of the chain in order to increase opportunities for economies of scale in procurement and distribution.³

To address the need for product uniformity and to allow the franchise system to take advantage of the buying power of the chain, many franchisors seek to strictly control the source of products and/or services used or obtained by their franchisees, often by designating approved products, services, suppliers, or organizing supply chain functions through outsourcing or direct management. Some franchisors use precise contractual language within the franchise agreement regarding the products and services its franchisees can use.⁴ Others may seek to assure uniform product quality by imposing a requirement that franchisees buy supplies only from the franchisor.⁵ However these arrangements are structured, franchisor input purchase requirements are a means of preserving the level and uniformity of quality of the products sold to the customer.⁶

While such restrictions are common, they do not remove certain individual franchisee’s economic incentive to reduce or modify product quality for their private gain. They merely police the problem. As a result, such restrictions typically must be monitored through audits and mystery shopper programs with sanctions levied for noncompliance.⁷ The franchisor’s control over the source of products and services may also come under attack by franchisees who complain about the price at which the products and services are offered. This can be particularly true when, as is often the case, the franchisor, as part of the overall return on its investment in the brand, receives remuneration from sourcing products to the system. In some

¹ ROGER D. BLAIR & FRANCINE LAFONTAINE, *THE ECONOMICS OF FRANCHISING* 117 (2005).

² *Id.*

³ Patrick J. Kaufmann & Sevgin Eroglu, *Standardization and Adaption in Business Format Franchising*, 14 J. BUS. VENTURING 69-64 (1998).

⁴ For example, a McDonald’s franchisee may serve “only those food and beverage products now or hereafter designated by McDonald’s” using “food and beverage ingredients” that meet McDonald’s specifications. 2006 Franchise Agreement, McDonald’s USA, LLC ¶¶ 12(a), 12(i).

⁵ See, e.g., *Krehl v. Baskin-Robbins Ice Cream Co.*, 664 F.2d 1348 (9th Cir. 1982) (holding that the franchisor could impose a requirement that its franchisees buy all of their ice cream from Baskin-Robbins).

⁶ See Roger D. Blair & David L. Kaserman, *A Note on Incentive Incompatibility Under Franchising*, 9 REV. INDUS. ORG. 323 (1994).

⁷ BLAIR & LAFONTAINE, *supra* note 1, at 128.

instances, franchisees may organize their own buying group to achieve volume discounts for themselves or seek to substitute their group as the purchasing agent for the entire system.

This paper provides an general overview of the franchise supply chain, the benefits provided by franchisor involvement in and control over the sourcing of products and services, and the tensions that may arise as a result. Readers will also learn the best practices in procurement and structuring franchise supply arrangements, and how to address these arrangements in the franchise agreement.

II. THE FRANCHISE SUPPLY CHAIN

A. Overview

“A supply chain consists of all stages involved, directly or indirectly, in fulfilling a customer request.”⁸ In its simplest form, it is composed of a company and the suppliers and customers of that company. When its constituent parts are broken down further, “a supply chain not only includes the manufacturer and suppliers, but also transporters, warehouses, retailers and customers themselves . . .”⁹

“Supply chain management is the coordination of production, inventory, location, and transportation among the participants in a supply chain to achieve the best mix of responsiveness and efficiency for the market being served.”¹⁰ Effective supply chain management tends to focus on five aspects or drivers.¹¹ The first driver is production: what products does the market want, how much, and by what date. The second is inventory. Inventory serves as a buffer against uncertainty in the supply chain; however, holding inventory is expensive, so it must be held at optimal levels. The third driver is location. A company must determine the most cost efficient location for both production and inventory storage. The fourth driver is transportation. A company must determine how the inventory should most efficiently be moved from one supply chain location to the next. The final driver is information. Daily information between each participant in the supply chain is necessary for it to function. Information is also needed to forecast the company’s future product, transportation and distribution needs.

Each organization attempts to maximize its supply chain management performance through a combination of outsourcing, partnering, and in-house experience. Today, in the fast-moving global markets of the modern economy, most companies tend to focus on their core competencies in supply chain management and outsource the rest. Franchisors are no different.

⁸ SUNIL CHOPRA & PETER MEINDL, SUPPLY CHAIN (2d ed. 2003).

⁹ *Id.*

¹⁰ MICHAEL HUGOS, ESSENTIALS OF SUPPLY CHAIN MANAGEMENT 4 (2d ed. 2006).

¹¹ *Id.* at 5-6 (discussing the five drivers).

B. Elements of the Supply Chain

1. Producers (Manufacturer or Vendor)

At the beginning of the supply chain are the producers. These are the manufacturers or vendors that make the product or provide the service. "This includes companies that are producers of raw materials and companies that are producers of finished goods."¹² A producer can also provide an intangible product such as music, software or designs, or a producer can provide services, such as landscape maintenance or office cleaning. Increasingly, the producers of tangible, industrial products are moving to areas of the world in which labor is less costly, while producers of intangible items or services are located in North America, Europe and parts of Asia.

2. Logistics Provider (Inbound Freight)

The next link in the franchise supply chain are the logistics providers. These are the transportation companies that deliver the product inbound from the manufacturer to the next participant in the supply chain, often a regional distribution center. Traditionally, there were four modes of transport from which a logistics provider could choose: (1) shipping, which is very cost efficient moving product overseas transport, but is also the slowest mode of transport; (2) rail, which is also very cost efficient, but is restricted to use between locations served by rail lines; (3) trucks, which are a relatively quick and flexible mode of transport, but prone to price fluctuations with the cost of fuel; and (4) air, which is very fast and very responsive, but is the most expensive mode of transport. Additionally, today increasingly a fifth mode of transport, electronic, is being used by all manner of producers of intangible goods.

The job of the supply chain manager is to design routes and networks to move the products in accordance with the needs of the system. As a general rule, the higher the value of the product (such as electronic components or pharmaceuticals), the more the transportation network should emphasize responsiveness; the lower the value of a product (such as bulk commodities and staples with a long shelf life), the more the network should emphasize efficiency.¹³

3. Distributor (Outbound Freight)

Distributors take inventory in bulk from producers and deliver a bundle of related products to customers. Product is shipped from the supplier to the distribution center or warehouse. In the case of single source distributing, the products received from the manufacturer are then combined with all of the products required by the franchisee. The franchisee can then order from the distributor from a single order guide, and the products are delivered by the distributor to the franchisee on the most efficient basis, typically one to two deliveries a week.

Distributors can either take ownership of the inventory or simply broker the product between the producer and the franchisee without taking ownership. In either case, as the needs of the franchise system evolve and the range of available products changes, the distributor

¹² *Id.* at 24.

¹³ *Id.* at 15.

tracks those needs and matches them with the products available.¹⁴ The distributor may also help to buffer producers from fluctuations in product demand by stocking inventory and performing inventory management.¹⁵

4. Retailer (Franchisee)

Retailers stock inventory and sell in smaller quantities to the general public. In the franchise context, the retailer is the franchisee. The retailer uses some combination of price, product selection, service and convenience in order to attract customers. Quick service restaurants, for example, typically rely upon low price and convenience as their primary draw. The retailer tracks the preferences and demands of the customers. In the franchising context, this information is then relayed to the franchisor, so that it can make and modify its purchasing decisions from manufacturers according to local customer preferences, starting the franchise supply chain anew.

5. Customer

The final link in the supply chain is the customer. A customer may purchase a product in order to incorporate it into another product that they, in turn, sell to another customer. However, in the franchising context, a customer is typically the final user of the product who purchases the product in order to consume it.

C. Level of Franchise System Participation in the Supply Chain

1. Minimal Involvement: Broadline Distribution

When a franchise system begins, it generally outsources all aspects of supply chain management to a large broadline distributor with a large catalogue of merchandise available to supply the system. Broadliners are involved in, and make money from, virtually all aspects of the supply chain. They negotiate purchases from manufacturers. They contract with logistics providers to transport the product and aggregate the orders of multiple individual customers and franchise systems in order to secure for network members the lowest prices available. Broadliners store the product in centralized distribution centers, often times which they own. They also distribute products to the retailers, *i.e.* the franchisees, again in trucks which they own. Examples of broadliners in the food supply chain include Sysco and US Foods.

Franchise systems pay for the broadliner's wide-ranging inventory and supply chain management expertise. The franchise system benefits because it is not required to develop the expertise of supply chain management in-house. Nor does the system have to make the financial outlay to pay for the inventory needed by the franchise system or take responsibility for inventory shortages, unsold inventory or returns.

At the same time, because the broadliner purchases for many customers, it is generally unable to develop or supply specialized or proprietary products to the franchise system. If the franchise system needs roasted turkey breast, that is what the broadliner provides, and the quality the franchisee receives will vary depending on the underlying supplier and geographic region where procurement occurs. Conversely, competing purchasers who are located with the

¹⁴ *Id.* at 25.

¹⁵ *Id.* at 24-25.

same geographic region and purchase from the same broadliner will often receive identical products, *viz.*, the product the broadliner has available at that time in that distribution center, limiting the ability of competing retailers within the geographic region to differentiate themselves from one another to consumers.

Consequently, when a franchisor outsources its supply chain management to a broadline distributor, only those products deemed critical to the brand will be restricted to a specific vendor or supplier, and only then if the franchise system has enough purchasing power to require the broadliner to make purchases from a single or group of manufacturers producing products according to the franchisor's specifications. Otherwise, the franchisor will provide for all of its supply needs by purchasing "off the rack" from a menu of available broadline stock.

2. Intermediate Involvement: Cost Plus Distribution

As franchise systems evolve, they typically develop confidential specifications for more of the products offered to the customer. Confidential specifications are developed to ensure that high and uniform quality is maintained, thus promoting the image and reputation of the product offered by the franchise system as compared to its competitors. Confidential specifications also enable a franchise system to differentiate itself from its competitors. With increasingly proprietary product specifications, the franchisor's need to control the source of products and services used or obtained by its franchisees increases as well. As the franchisor develops exclusive relationships with vendors manufacturing products to its specification, the number of approved sources for products becomes more restricted.

In order to meet this need, a franchisor may partner exclusively with a system-wide dedicated logistics and supply chain manager, *e.g.*, Perseco (McDonald's) or it may bring some or all of the tasks previously outsourced to broadline distributors in-house. For example, the franchisor (or its exclusive supply chain partner) may begin to negotiate directly with vendors and manufacturers, relying on the increasing size and purchasing power of the franchise system to supplant the need for the aggregate purchasing power formerly supplied by the broadline distributor. Direct negotiation with vendors often leads to better logistics management, as the franchisor can select vendors that are conveniently located to its retail outlets, thereby allowing the franchisor to reduce the costs of inbound freight to the distribution center. Finally, the franchisor may negotiate directly with distributors, choosing warehouse locations that are centrally located within a radius of franchised outlets. The resulting cost savings of this strategy has been amply demonstrated by Walmart, which implemented a strategy of first building its distribution facilities in a central area within a geographic market that could support several regional outlets, and then building its retail stores around the distribution center.¹⁶

This intermediate level of involvement in supply chain management is sometimes referred to as "cost plus" distribution. In other words, the franchisor negotiates with the various participants in the supply chain, obtains a price from the manufacturer, logistics provider or distributor based on that participant's cost, then adds a margin to cover the expense of this service incurred by the franchisor. By contracting in this manner, either in-house or with the assistance of a system-dedicated supply chain partner, a franchisor can potentially substantially reduce the mark up which are profits of the individual supply chain participants, but are costs to the franchisor and its franchisees. As discussed below, in addition to the potential savings reaped from the supply chain, bringing aspects of supply chain management in-house may also

¹⁶ *Id.* at 19.

allow the franchise system to realize a host of additional benefits, including greater quality control, increased safety and brand protection, price stabilization, and more rapid response to franchisee problems with the supply chain and the changing needs of the system.

3. Heavy Involvement: Ownership of Manufacturer/Distributor

“In the slower moving mass markets of the industrial age it was common for successful companies to attempt to own much of their supply chain.”¹⁷ This is known as vertical integration. “The aim of vertical integration was to gain maximum efficiency through economies of scale.”¹⁸ For example, in the first half of the 1900s, Ford Motor Company owned virtually its entire supply chain.¹⁹ It owned and operated mines that extracted iron ore. It owned the steel mills and plants that fabricated components. It even owned farms where it grew flax to make into linen car tops. It was a profitable way to do business, but it also led to a one size fits all product. Famously, when Henry Ford was asked about the number of different car colors a customer could request, he reputedly said, “they can have any color they want as long as it’s black.”

Today, companies rarely seek to vertically integrate the entire supply chain. Instead, companies focus on the activities they do best. “Where companies once routinely ran their own warehouses or operated their own fleet of trucks, they now have to consider whether those operations are really a core competency or whether it is more cost effective to outsource those operations to other companies that make logistics the center of their business.”²⁰ Instead of vertical integration, companies now practice ‘virtual integration,’ partnering with others for various aspects of the supply chain.

The level of franchise system ownership of the supply chain is largely driven by the format of franchising employed, traditional (or product or trade name franchising) or business-format franchising. Traditional franchising is characterized by franchised dealers who concentrate on one product line and identify their business with that company, such as automobile dealerships, gasoline stations and soft-drink bottlers; whereas, business-format franchising sells a way of doing business, including the product, trademark, marketing strategy and operating manual, such as most restaurant franchises.²¹

Unlike Henry Ford, traditional franchisors today generally do not aspire to own the entire supply chain. However, they do typically own the facilities that manufacture and sell finished or semi-finished products to its dealers/franchisees. In contrast, in the case of business-format franchising, most franchisors do not have the option of selling a finished product to its franchisees because production takes place downstream, *e.g.*, the customer’s meals are produced at the franchisee’s restaurant, not at the franchisor’s head office. However, some business-format franchisors do own some aspect of the supply chain. For example, according to its 2006 Prospectus, the Canadian Quick Service Restaurant (“QSR”) icon, Tim Horton’s,

¹⁷ *Id.* at 20.

¹⁸ *Id.*

¹⁹ *Id.* at 22 (providing the information supporting the text’s discussion regarding Ford).

²⁰ *Id.* at 23.

²¹ BLAIR & LAFONTAINE, *supra* note 1, at 6.

owns 50% of the bakery that makes essentially all of the baked goods sold by its franchisees. Tim Horton's also owns its regional distribution centers and its own fleet of trucks to deliver baked goods inbound to the distribution centers, and deliver its suite of food and paper products to its franchisees.

III. THE LEGAL FRAMEWORK GOVERNING THE FRANCHISE SUPPLY CHAIN

A. Franchise Regulatory Issues

1. Federal and State Disclosure Obligations

a) The Scope of Item 8

When the Federal Trade Commission ("FTC") overhauled the original Franchise Rule effective July 1, 2008, it chose to adopt the UFOC Guidelines' treatment of sourcing-related issues contained in UFOC Item 8, with one significant deviation. The Amended Rule expanded Item 8 beyond the Guidelines by requiring a franchisor to identify any supplier in which an officer of the franchisor has more than a de minimis interest.²² For franchisors who offered and sold franchises before July 1, 2008, the Amended Rule did not fundamentally alter their past disclosure practices or policies applicable to supply chain issues and sourcing relationships.

The tensions between franchising parties created by sourcing restrictions were well exposed during the FTC's 12-year rule-making process leading up to the Amended Rule's enactment. To franchisee advocates, the duty to purchase goods or services from a particular designated source threatens the franchisee's independence and profitability. Sourcing restrictions epitomize the inherent conflict between the franchisor's professed desire to see franchisees maximize unit level profits and the franchisor's opportunity to extract additional revenue from the franchise relationship by selecting suppliers only if they agree to "kick back" revenue or other benefits as the quid pro quo for giving the suppliers access to a captive franchise network. Particularly infuriating to franchisee advocates was the lack of regulation over the franchisor's right to impose sourcing restrictions on purchases of purely fungible goods without having to guarantee that chosen suppliers would extend competitive pricing or other benefits to franchisees. Franchisee advocates urged the FTC to declare it an unfair trade practice for franchisors to forbid a franchisee from obtaining non-proprietary supplies on more

²² The FTC's 2007 Compliance Guides expound on the new features of the Amended Franchise Rule. With respect to the new disclosure about officers who own an interest in any supplier, the Compliance Guides instruct that "an interest" should be read broadly to mean "any percentage of direct ownership from which the officer derives income or other financial benefits" regardless of how small. After releasing the 2007 Compliance Guides, the FTC issued FAQ 18 to clarify that "an interest" means any interest significant enough to be "material" to a prospective franchisee's investment decision. Rather than excuse disclosure when an officer's ownership interest in a supplier is less than a specific threshold level, the FTC advises franchisors to err on the side of disclosure in assessing materiality in each instance. The objective of the new disclosure is to expose information that might reflect a conflict of interest in the franchisor's approval or choice of particular suppliers. The FAQ clarifies that new Item 8 does not require franchisors either to identify the officer who owns the interest or the extent of the officer's interest. However, new Item 8 does require the franchisor to disclose the *identity of the supplier* in which the unnamed officer owns an undisclosed interest. Ironically, when it comes to other Item 8 disclosures about optional and mandatory suppliers, the disclosure rules do not require franchisors to identify the suppliers by name. For example, franchisors do not have to name the particular suppliers from whom they or their affiliates directly or indirectly receive revenue on account of franchisee purchases. Federal Trade Commission, Amended Franchise Rule FAQ's, <http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml> (last visited July 29, 2009).

favorable terms from alternative sources who offered more competitive pricing than the franchisor's designated suppliers.²³

By the end of the 12-year rule making process leading up to the Amended Rule, the FTC, while certainly sympathetic to franchisee concerns, stuck with its approach of addressing any unfairness in sourcing restrictions by mandating robust pre-sale disclosures. To the FTC, the UFOC Guidelines' Item 8 disclosures were significantly more expansive than the Original FTC Rule, so adopting the UFOC Guidelines' approach to Item 8 seemed adequate enough reform:

“Item 8 strikes the right balance between pre-sale disclosure and compliance costs and burdens. It is sufficient to warn prospective franchisees about source restrictions, purchase obligations, and approval of alternative suppliers, without requiring franchisors to disclose their past practices regarding approving alternative suppliers (which may be irrelevant to their current practices) or their future intentions (which may be proprietary information or misleading if the franchisor abandons the intended direction).”²⁴

By all accounts, with the exception of also adding the new disclosure about officer ownership of a supplier, the states did not alter the scope of Item 8 beyond what the North American Securities Administrators Association (NASAA) has required since 1993. When NASAA adopted its Amended and Restated Guidelines in 2008, a year after the federal Amended Franchise Rule took effect, NASAA purportedly adopted the Amended Rule's Item 8 disclosures and underlying policies in toto.²⁵ Indeed, Item 8 in the Amended Rule and NASAA's 2008 Guidelines read identically.

Interestingly, however, in the FTC's 2007 Compliance Guides, the FTC explains that the Amended Rule's Item 8 “covers only” those restrictions that compel a franchisee to purchase supplies from a specific supplier or limited group of suppliers. This interpretation seems considerably narrower than the Amended Rule itself which uses the disjunctive “or” in directing franchisors also to disclose restrictions that confine a franchisee's selection of supplies to those conforming to the franchisor's specifications even when franchisees are free to purchase specified items from any source of their own choosing.²⁶

NASAA, too, in its Commentary to the 2008 Guidelines, explains the intended scope of its Item 8 more narrowly than the express language in the 2008 Guidelines would otherwise

²³ Bus. Franchise Guide (CCH) ¶ 6062, Statement of Basis and Purpose (SBP) discussion of Item 8 and note 451 (2007), available at <http://www.ftc.gov/os/2007/01/R511003FranchiseRuleFRNotice.pdf>.

²⁴ *Id.*

²⁵ See Bus. Franchise Guide (CCH) ¶ 5705, North American Securities Administrators Association (NASAA) 2008 Franchise Registration and Disclosure Guidelines, available at <http://www.nasaa.org/content/Files/2008UFOC.pdf>.

²⁶ Compare the 2007 FTC Commentary (“Item 8 covers only required purchases and leases of goods and services that are source-restricted, meaning that the franchisee must make the purchases from a specific supplier or limited group of suppliers.”) (emphasis added) with the 2008 NASAA Commentary (“Disclose the franchisee's obligations to purchase or lease goods, services, ... either from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor's specifications.”) (emphasis added).

suggest. “Item 8 requires disclosure of all restrictions on the freedom of the franchisee to obtain goods, real estate, services, etc. from sources of the franchisee's choosing, and of all means by which a franchisor may derive revenue as a result of franchisee purchases or leases of goods and services.”²⁷ This interpretation also seems to ignore the disjunctive “or” phrase in the 2008 Guidelines that directs franchisors to disclose restrictions that confine a franchisee’s choice of supplies to those conforming to the franchisor’s specifications regardless of whether the franchisor restricts the franchisee’s choice of supplier or derives any revenue from franchisee transactions.

If one looks strictly at the FTC’s and NASAA’s explanations of their own Item 8, a franchisor, for example, would not have to disclose that a franchisee must use Quicken Deluxe financial accounting software if (i) the franchisee may buy the software from anyone in the universe of suppliers selling it, and (ii) the franchisor derives no revenue on account of the franchisee’s transaction. However, under the express language in the Amended Rule and the 2008 Guidelines, the franchisor would have to identify Quicken software as a sourcing restriction since the franchisor specifies a particular brand of financial accounting software that the franchisee must use.

The main relevance of this distinction between the FTC’s and NASAA’s commentary, on the one hand, and the express language of new Item 8, on the other, concerns three other Item 8 disclosures. These pertain to the duty to make disclosures about *required* purchases and leases. Item 8 requires a franchisor to disclose (i) the franchisor’s revenue from all *required* purchases and leases of products and services; (ii) the percentage of a franchisor’s total revenues that are from *required* purchases or leases; and (iii) the estimated proportion that *required* purchases and leases bear to a franchisee’s overall costs to establish and operate the franchised business. The threshold question is whether a franchisor must count as *required* those supplies that a franchisee must use that conform to the franchisor’s specifications when the franchisee may purchase or lease the supplies from any source of its own choosing without having to obtain prior written approval of the supplier and when the franchisor derives no revenue from the transaction. If despite the language in the Amended Rule and 2008 Guidelines, a purchase or lease is *required* only if the franchisor must approve the supplier or directly or indirectly derives revenue from a franchisee’s transactions with a particular supplier, then the duty to use Quicken Deluxe brand financial accounting software would not count as *required* if the franchisee is free to purchase it from Best Buy, Amazon or any of the dozens of other retailers that sell it. If one goes by the precise language in the Amended Rule and 2008 Guidelines, however, Quicken software would count as *required* even absent restrictions on the franchisee’s choice of supplier or revenue stream. The differences in the two interpretations could lead to materially different disclosures about the magnitude of a franchisor’s sourcing restrictions.

No one has yet asked the FTC to clarify what it meant by the qualifying phrase “covers only” in the 2007 Compliance Guides, or asked NASAA to explain if its focus on revenue generation is meant to narrow the actual language in Item 8.²⁸ The point discussed in this

²⁷ Bus. Franchise Guide (CCH) ¶ 5706.

²⁸ The scope of Item 8 has been a source of confusion for state examiners, franchisors and franchise attorneys since NASAA revised it in 1993. In 1999, NASAA issued commentary to clarify the scope of Item 8 although those particular clarifications do not touch on the precise issue raised in the text of this paper, i.e., whether a franchisor must identify as a sourcing restriction the duty to purchase or use supplies that meet the franchisor’s specifications even when the franchisee has complete freedom to chose the supplier and no revenue or other benefits stream to the franchisor on account of the franchisee’s purchases of those supplies. The 1999 commentary

section may be overly subtle. In the end, we think it is unlikely that the FTC meant to endorse a narrower Item 8 disclosure than NASAA. For both practical and legal reasons, practitioners should follow the text in the Amended Rule and NASAA's 2008 Guidelines and not be confused by each agency's commentary. As a practical matter, when a franchisor derives no revenue on account of a franchisee's purchases from suppliers of its own choosing, then the revenue and percentages that the franchisor must disclose in Item 8 from *required* purchases or leases remain unchanged. The proportionate percentages of *required* purchases or leases to start-up and ongoing operating expenses may change, but presumably not materially. In either event, since the percentages are just estimates, the franchisor should disclose a higher estimated upper range if there is any doubt about what to count as a *required* purchase or lease.

b) The Elements of Item 8 Sourcing Disclosures

There are 11 distinct areas of disclosure that FDD Item 8 must cover, some with multiple subparts. Practitioners should refer to the exact language in the Amended Rule and NASAA's Amended and Restated Guidelines, which are only summarized here. Despite some subtle language differences noted above, this part of our paper assumes that federal and state laws mandate identical Item 8 disclosures.²⁹

(1) If the franchisor imposes sourcing restrictions either by (i) designating the supplier; (ii) forbidding the franchisee to purchase supplies except from suppliers who are approved by the franchisor in advance; or (iii) imposing comprehensive specifications for the particular goods or services that the franchisee may or must use, then the franchisor must make a separate disclosure for each good or service. Item 8 covers restrictions applicable to anything relevant to operating the franchise business, which spans the gamut from "goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items." Although the disclosure guidelines applicable to Item 8 require the franchisor to specify each good and service for which specifications are imposed, even the sample disclosures in the commentaries issued by the FTC and NASAA identify source-restricted supplies categorically in the broadest terms, e.g., a franchisor may disclose "restaurant equipment" without itemizing the components by brand, type or supplier. The franchisor need not disclose goods/services which the franchisor furnishes as part of fees which the franchisor discloses in Items 5 or 6, such as initial training provided as part of the initial franchise fee, or intellectual property for which the consideration is the franchisee's payment of ongoing royalties or service fees.

(2) To expose any potential conflicts of interest, Item 8 must disclose if the franchisor or its affiliates are among the suppliers that the franchisor will approve for a particular good/service or if they are the only approved supplier of a particular good/service.

addressed a different issue: whether Item 8 covers the situation where the franchisee chooses to buy generic supplies, i.e. supplies for which the franchisor issues no specifications, from the franchisor (answer: no). The example in the 1999 commentary concerned a fast-food franchisee's voluntary decision to buy generic drinking straws from the franchisor. The issue raised in the text of this paper is whether a franchisor must identify as a sourcing restriction a requirement that the fast-food franchisee use blue drinking straws of a certain length, width and material if the franchisee is free to buy the blue drinking straws from any source capable of meeting the franchisor's specifications and derives no revenue from the franchisee's purchases of blue drinking straws.

²⁹ For Item 8 of the Amended Rule, see Bus. Franchise Guide (CCH) ¶ 6015. For NASAA's version of Item 8, see Bus. Franchise Guide (CCH) ¶ 5705.

(3) As noted, the franchisor must disclose any supplier in which an officer of the franchisor owns an interest. The franchisor need not identify the officer or the amount of the ownership interest, but must name the supplier. The franchisor may wish to indicate when the supplier is a public company or if the officer's ownership interest is less than a controlling interest.

(4) If the franchisor permits the franchisee to purchase or lease supplies from other sources besides suppliers that the franchisor may designate or recommend, referred to in Item 8 as "alternative suppliers," then the franchisor must disclose the fees payable and process involved to obtain approval.

(5) If the franchisor issues specifications and standards for goods/services, then the franchisor must disclose how it provides this information to franchisees. Typically, a franchisor would supply this information in updates to a confidential operating manual, which would be all that a franchisor would have to say in Item 8 to meet the disclosure obligation.

(6) The franchisor must disclose the "precise basis" by which the franchisor or its affiliates will, or may, derive revenue or other material benefits from "required" purchases or leases of goods/services. "Required" purchases and leases are those from designated or approved suppliers whether or not affiliated to the franchisor. "Other material benefits" need not be cash, but could be preferred financing terms or discounts extended by an approved supplier even when the benefit has no immediate cash equivalence. Revenue must be disclosed in two different ways: (i) the aggregate dollars received during the last fiscal year from all direct or indirect franchisee transactions with designated or approved suppliers, and (ii) as a percentage of the franchisor's total revenues from all sources whether or not related to franchise activities.³⁰ Revenue includes payments from all sources on account of franchisee transactions whether denominated as a rebate or something else. Reportable revenue includes "pass-through" sales to franchisees; i.e., revenue the franchisor receives on its own direct sales of supplies to franchisees with or without profit or mark-up, since the revenue appears on the income side of the franchisor's audited financial statement despite the countervailing expense offset for the cost of goods sold. Revenue data must be separately disclosed for the franchisor and each affiliate that receives revenue on account of franchisee transactions with suppliers. The franchisor's revenue data must be pulled from the franchisor's most recent audited financial statements. However, affiliate revenue data may be pulled from the affiliate's unaudited financial statements when the affiliate lacks its own audited financial statements.

(7) The franchisor must disclose the magnitude of sourcing restrictions on a franchisee's operating expenses by estimating the percentage of *required* purchases and leases to the franchisee's overall cost to establish the franchise business disclosed in Item 7, and to monthly operating expenses. These two percentages may be quite different. For example, while the purchase of expensive restaurant equipment from a designated supplier might comprise a significant percentage of a franchisee's start-up costs, the franchisee's ongoing expenses to maintain the equipment would probably be just a negligible percentage of its overall monthly operating expense. At the same time, the purchase of start-up inventory might comprise a small percentage of a franchisee's start-up costs, but a more significant percentage of its monthly operating expense. Both percentages may be estimates. A franchisor with affiliate-owned outlets comparable to franchisee operations should take its own operating

³⁰ Since most franchisors form a separate business entity to administer the franchise network, reportable supplier revenue would be measured against revenue from franchise activities.

results into account in formulating these estimates whether or not it has current, reliable franchisee data.

(8) If a designated supplier will make payments to the franchisor from franchisee purchases, the franchisor must disclose the payment either as a percentage of a franchisee's purchase or as a flat amount, or disclose the cash equivalent benefit, e.g., the discount that it receives from suppliers in its own purchases of similar goods/services.

(9) The franchisor must disclose the existence of any purchasing or distribution cooperatives and whether they are administered by the franchisor or an affiliate or by a franchisee-owned group.³¹ The disclosure is intended to cover any organized group purchasing arrangements, including franchisee-organized cooperatives, so that the franchisee can evaluate the benefits of belonging to the franchise network. A cooperative is a distinct business organization which is owned and controlled by the individuals who use the organization's goods/services. Although the Amended Rule uses the phrase "cooperative organizations" in referring to one of the four non-franchise relationships that the FTC continues to exclude from the Amended Rule's coverage, Item 8 refers to "cooperatives" in a non-technical sense. Nothing in the FTC's 2007 Compliance Guides or in NASAA's 2008 Commentary indicates that Item 8 disclosures about cooperatives are limited to purchasing or distribution arrangements conducted by a specific type of dedicated business entity owned and controlled by its members.

(10) The franchisor must disclose if it negotiates purchasing arrangements with suppliers, including price incentives for network members. Item 8 need not disclose the price or other purchase terms. The disclosure is not expressly confined to a contractual duty to negotiate purchasing arrangements in the same way that Item 11 is confined to a franchisor's pre-opening and post-opening obligations to provide assistance. Therefore, the Item 8 disclosure may be framed in terms of the franchisor's intentions, e.g., purchasing assistance that the franchisor "may" provide. Unless a start-up franchisor knows that it will never provide purchasing assistance or a seasoned franchisor has never in the past provided purchase assistance despite claiming that it might do so one day, the franchisor should not be guilty of negligent misrepresentation or fraud should it disclose the possibility of providing assistance in this area sometime in the future, but fall short of delivery.

(11) The franchisor must disclose if it conditions material benefits, for example renewal or granting additional franchises, based on a franchisee's decision to purchase particular goods/services or use particular suppliers. Presumably "material benefits" encompasses other favors, such as credit terms on purchases.

c) Identity of Suppliers

Although sample disclosures in the FTC's 2007 Compliance Guides and in NASAA's 2008 Guidelines identify designated suppliers, neither the Amended Rule nor the 2008 Guidelines specifically require franchisors to identify by name its designated suppliers, suppliers who pay rebates or suppliers with whom the franchisor has negotiated special purchasing

³¹ When buying groups are formed by potential competitors, a variety of antitrust issues may arise. Franchisee-led buying groups fall within this category since neighboring franchisees who may collaborate as buying group members on issues like marketing programs, pricing and vendor agreements may also compete with each other at the retail level for customers. For an excellent review of the potential antitrust issues, see Michael A. Lindsay, *Antitrust and Group Purchasing*, 2009 A.B.A. SEC. ANTITRUST 66.

arrangements. NASAA clarified this in 1994 in commentary to the 1993 UFOC Guidelines. Nothing issued by either the FTC or NASAA since then indicates a policy change.

d) Alternative Suppliers

Although not specifically defined, an alternative supplier is a supplier, other than a designated supplier, from which a franchisee may not complete a purchase unless and until the franchisor approves the supplier. Typically, approval considers two separate issues: (i) the quality of goods/services that the supplier has to sell and whether they meet prescribed specifications; and (ii) the supplier's trade reputation and financial condition. Sometimes a franchisor will condition its approval on the supplier's ability to demonstrate the ability to meet the purchasing needs of neighboring franchisees or the entire chain.

e) Revenue from Franchisee Transactions

As noted, the franchisor must disclose its revenue from franchisee purchases stated both as aggregate dollars and as a percentage of total revenue from all sources. The franchisor must also disclose if it receives non-revenue material benefits, such as volume discounts or other preferred purchasing terms, on account of a franchisee's purchases.

f) Remedies for Franchise Disclosure Violations

While there is no private right of action for violation of the Amended Rule's disclosure requirements, which only the FTC may enforce, private parties may have remedies under state unfair trade laws based on violations of the federal disclosure law, as addressed further in Section IIIB.3. The FTC has broad enforcement powers to punish franchise law violators and may freeze assets, order restitution, issue cease and desist orders, ban violators from selling franchises, and recover substantial penalties.

Violation of state franchise sales laws carry significant penalties even if the franchisor has no intent to violate the law. Not only is it a felony to sell a franchise without complying with pre-sale disclosure or other requirements of a state franchise sales law, but state franchise agencies have comparable enforcement authority to the FTC with equivalent remedies. Franchisees have private remedies for state franchise law violations. Besides compensatory damages and, in some states, attorney's fees, an injured franchisee may (i) rescind a franchise agreement for disclosure and registration violations, including fraud in connection with a franchise sale, and/or (ii) recover damages or restitution. Federal and state franchise laws impose personal, joint and several liability on the franchisor's management and owners even when the franchisor is a legal entity unless they can prove that they lacked knowledge of the conduct constituting the violation and should not have known about it.

g) *Tubby's #14, Ltd. v. Tubby's Sub Shops, Inc.*³² – A Case Study in the Pitfalls of Sub-Par Disclosures

For franchisors, the nuisance value of litigation over pre-sale disclosures cannot be overstated. This is particularly true considering that avoiding liability for pre-sale disclosures may be as simple as disclosing pre-contract in the broadest of terms that the franchisor may

³² No. 04-70918, 2006 U.S. Dist. LEXIS 69553 (E.D. Mich. Sept. 27, 2006).

control supply sources, impose compulsory purchasing programs, profit from these programs and modify all of these arrangements during the franchise term.

A good example of a disclosure lawsuit's nuisance is the Tubby's case. Franchisees of Tubby's Sub Shop sued their franchisor over allegedly not disclosing its profits from a mandatory distribution program. The franchisees claimed Tubby's selected mandatory suppliers based on their willingness to pay Tubby's a kick-back. Additionally, Tubby's set up a subsidiary, SDS, to purchase products from selected suppliers and resell them to franchisees at a significant mark-up, thereby profiting yet again from franchisee purchases. The franchisees maintained that Tubby's had failed to adequately disclose its plans to profit from these supplier arrangements. While Tubby's disclosure document identified SDS's warehousing and distribution services, Item 8 failed to disclose the revenues which Tubby's and SDS each derived from franchisee purchases of supplies. The court denied Tubby's motions for summary judgment finding that not only did the allegations support a claim under the Michigan Franchise Investment Law for disclosure violations, but the facts were independently actionable as an unfair and deceptive practice and common law fraud.

The court also refused to summarily dismiss the plaintiffs' common law contract claim based on a franchise agreement provision which plaintiffs argued limited Tubby's rebates from suppliers to 2% of product sales to franchisees. Plaintiffs alleged that Tubby's rebates greatly exceeded the 2% limit.

The reported history of the case, which was originally filed in 2004, extends through 2007 with the second denial of Tubby's motions for summary judgment. By the time of the final reported episode of this case, two of Tubby's officers and directors had been reinstated as defendants under the individual personal liability sections of the Michigan Franchise Investment Law, which meant that, alone or together, they could have been held responsible for the corporate franchisor's offenses. This significantly raised the stakes of the case and in all likelihood propelled Tubby's to reach some type of out-of-court settlement three years and likely tens of thousands of dollars later in attorney fee expenses.³³

2. Sourcing Restrictions in State Franchise Relationship Laws

Of the approximately 24 states that have some form of franchise relationship law applicable to franchises generally (and not limited to a specific type of product or industry), only four, Hawaii, Indiana, Iowa and Washington, have provisions directed at sourcing restrictions.

³³ Coincidentally, other franchise sandwich chains have found themselves litigating similar issues involving the quality of their Item 8 disclosures. In *C.K.H., L.L.C. v. Quizno's Master, L.L.C.*, No. 04-RB-1164, 2005 U.S. Dist. LEXIS 42347 (D. Colo. 2005), franchisees unsuccessfully tried to predicate a breach of contract claim on Quizno's UFOC Item 8 disclosure, which stated that Quizno's negotiates "arrangements with suppliers for the benefit of Franchisees, which often include volume discounts." *Id.* at *11. Plaintiffs argued that the UFOC disclosure was tantamount to a contract which Quizno's had breached by not passing on supplier rebates to franchisees. The court dismissed the count based on another UFOC disclosure in which Quizno's expressly reserved the right to receive revenue on account of franchisee-supplier transactions. The court also dismissed plaintiff's fraud claim based on the same facts. In *SubSolutions, Inc. v. Doctor's Assocs.*, 436 F. Supp. 2d 348, 355 (D. Conn. 2006), discussed *infra*, the franchisor of the Subway chain ultimately prevailed in defending the adequacy of its pre-contract disclosures in which it reserved the right to change its product requirements and approved vendors and specified that it could, in its discretion, require its franchisees to purchase products from particular vendors. In *Schlotzsky's, Ltd. v. Sterling Purchasing and Nat'l Distribution Co., Inc.*, 520 F.3d 393 (5th Cir. 2008), a terminated distributor excluded from future business with Schlotzsky's franchisees unsuccessfully challenged the franchisor's sourcing restrictions not on the basis of the franchisor's pre-sale disclosures, but as an illegal tying arrangement. *Id.* at 404-05.

The Hawaii³⁴, Indiana³⁵, Iowa³⁶ and Washington³⁷ statutes each contain provisions that address “tying” arrangements by prohibiting or limiting a franchisor’s ability to require a franchisee to buy goods or services from designated sources. There is relatively little case law interpreting the sourcing restrictions enacted by these states.

The Hawaii statute allows franchisors to designate suppliers if the restrictive purchasing arrangement is reasonably required for a purpose “justified on business grounds.” There do not appear to be any reported cases that offer guidance as to the meaning of “reasonably necessary” or justifiable business grounds. Hawaii’s relationship law also forbids a franchisor from deriving money or anything else of value on account of third party supplier transactions with franchisees unless the franchisor “advises the franchisee in advance of the franchisor’s intention to receive such benefit.”³⁸ An Item 8 disclosure would therefore remove the risk of independent liability under Hawaii’s relationship statute.

The Indiana law makes it unlawful for a franchisor to require franchisees to buy supplies or services exclusively from the franchisor or another designated source when items of comparable quality are available from other sources. Indiana’s law expressly allows sourcing restrictions with respect to a franchisor’s “principal” goods and services. In *Stevens v. Physicians Weight Loss Centers of America, Inc.*,³⁹ a franchisee sued its franchisor under this statute based on the required purchase of various goods. The court differentiated among the products which were subject to the franchisor’s sourcing controls, finding that the franchisee could be compelled to purchase the franchisor’s brand of nutritional supplements because these trademarked goods were an “inseparable and mandatory” part of the business. However, the court ruled the other way on the forced purchase of a specific brand of carpet, finding that, in contrast to the nutritional supplements, carpeting could not be considered a “principal good.”⁴⁰

The Indiana law also bars franchisors from coercing franchisees to “order or accept delivery of any goods, supplies, inventories, or services which are neither necessary to the operation of the franchise, required by the franchise agreement, required by law, nor voluntarily ordered by the franchisee.” In *Carrel v. George Weston Bakeries Distribution, Inc.*,⁴¹ the court

³⁴ HAW. REV. STAT. tit. 26, ch. 482E, § 482E-6(2)-(2)(B).

³⁵ IND. CODE tit. 23, art. 2, ch. 2.7, § 1(1).

³⁶ IOWA CODE tit. XIII, ch. 523H, § 523H.12(1).

³⁷ WASH. REV. CODE tit. 19, ch. 19.100, § 19.100.180(2)-(2)(b). The closest a court appears to have come to analyzing Washington’s restrictive sourcing law is *Nelson v. National Fund Raising Consultants, Inc.*, 842 P.2d 473 (Wash. 1992), Bus. Franchise Guide (CCH) ¶ 10,179. The case involved a related provision, Washington Revised Code, Title 19, Chapter 19.100, § 19.100.180(2)(d), which prohibits selling, renting, or offering to sell to a franchisee “any product or service for more than a fair and reasonable price.” The court held that the defendant violated this provision by charging a markup on required supplies. *Id.* at 475-477. The trial court had found a violation of the sourcing restriction provision, § 19.100.180(2)(b), in this same behavior, but the Washington Supreme Court declined to reach the issue because it decided the matter based on the overcharges. *Id.* at 475.

³⁸ Section 482E-6(2)(D).

³⁹ Bus. Franchise Guide (CCH) ¶ 10,739, Nos. 5:91 CV 0272, 5:91 CV 0495 (N.D. Ohio Aug. 21, 1995).

⁴⁰ *Id.*

⁴¹ 2007-2 Trade Cas. (CCH) ¶ 75,934, No. 1:05-CV-1769-SEB-JPG, 2007 U.S. Dist. LEXIS 72353 (S.D. Ind. Sept. 25, 2007).

denied summary judgment for the defendant and allowed a distributor's claim to go forward based on evidence that the bakery manufacturer's "plussing up" practice forced distributors to buy excess inventory that the distributors had not ordered.

Indiana law also forbids a franchisor from obtaining anything of value, "other than for compensation for services rendered by the franchisor" on account of a third party supplier's transactions with a franchisee "unless the benefit is promptly accounted for, and transmitted to the franchisee."⁴² Unlike similar laws in Hawaii and Washington, the franchisor gains no defense to liability by disclosing the arrangement to the franchisee.⁴³ The specific section has apparently not yet been the subject of reported judicial interpretations.

At least on its face, the Iowa statute seems to be the most restrictive of the four. It prohibits sourcing restrictions where goods or services of comparable quality are available from other sources. A franchisor may only require its franchisees to purchase "reasonable quantities" of supplies, including display and sample items, from the franchisor or its affiliate when the supplies are "central" to the franchise business and are either "actually manufactured or produced by the franchisor or its affiliate" or incorporate the franchisor's trade secret." Like the other states with relationship laws addressing sourcing restrictions, Iowa's statute allows franchisors to maintain quality standards and targets restrictive purchasing arrangements. There do not appear to be any cases interpreting Iowa's restrictive sourcing prohibitions.

Washington's statute is similar to Hawaii's in that it allows restrictive purchasing agreements as long as they are reasonably needed for business purposes, although Washington adds that such restrictions cannot "substantially affect competition." Washington's law does not apply to the franchise's "initial inventory," and it notes that federal antitrust law should provide guidance for interpreting the state's rules. Washington's law also forbids franchisors from receiving anything of value on account of a third party supplier's transactions with a franchisee unless the franchisor discloses the arrangement. Although not articulated in the statute, the Washington Supreme Court interpreted this section to mean that, to be effective, the disclosure must occur before the franchise is sold.⁴⁴ A recent law review article states that the clear intent of Washington's restrictive sourcing statute is to forbid only those arrangements "that would constitute an illegal tie-in" under the federal Sherman or Clayton Antitrust Acts, and that in practice it "will have little impact on supply restrictions."⁴⁵

⁴² IND. CODE tit. 23, art. 2, ch. 2.7, § 1(4), CCH BFG ¶ 4140.01.

⁴³ The only reported decision that we have found addressing this section of the Indiana Deceptive Franchise Practices Act is *Kinnard v. Shoney's, Inc.*, 100 F. Supp. 2d 781 (M.D. Tenn. 2000), in which the facts did not give rise to a claim under § 23-2-2.7-2(6) in that the court found that the rebates which the franchisor received from third party suppliers were not the direct result of supplier-franchisee transactions. The court did note that the section required the franchisor to provide an accounting of benefits or money received from third party supplier-franchisee transactions. *Id.* at 797. The case did not need to discuss the kind of services a franchisor might perform to legitimize the supplier restrictions.

⁴⁴ Section 19.100.180(2)(e); *Nelson v. National Fund Raising Consultants, Inc.*, 120 Wn.2d 382, 391 (Wash. 1992) (noting that "[d]isclosure of a contract's terms, to be meaningful, must occur before contract formation, not after the parties have become contractually bound," citing the Restatement (Second) of Contracts).

⁴⁵ Douglas C. Berry, et al., *State Regulation of Franchising: The Washington Experience Revisited*, 32 SEATTLE U. L. REV. 811, 877-78 (2009).

B. Antitrust Law and Sourcing Restrictions

1. General Overview

The antitrust issue most directly implicated by franchisor-imposed sourcing controls is tying claims, which are addressed by Section 1 of the Sherman Act,⁴⁶ Section 3 of the Clayton Act,⁴⁷ and Section 5 of the FTC Act.⁴⁸

In the classic tying arrangement, a seller conditions the sale of one product or service (the “tying product”) on the buyer’s purchase of a separate product or service (the “tied product”). In challenging sourcing restrictions as illegal tying arrangements, franchisees have typically argued that the franchisor has unfairly used its dominant position as trademark licensor to force the plaintiffs to buy goods or services that they either do not need or want, or would prefer to buy from another source on better terms, leaving them competitively disadvantaged. To prevail on a tying claim, a plaintiff must show that the defendant had over a 30% share of the market in the tying product. Though sourcing restrictions can be pro-competitive in that they enable an individual franchisee to leverage the buying power of the chain, they can also have a deleterious polarizing effect on a franchise network when franchisees receive no real economic benefit from the restrictions either through lower prices or improved access to the tied supplies.

Generally, most of the practices that have been characterized as tying arrangements involve exclusive dealing, an independently actionable claim under the Sherman, Clayton and FTC Acts.⁴⁹ Efforts to challenge franchise sourcing restrictions as illegal exclusive dealing arrangements have generally failed.⁵⁰ In the classic exclusive dealing, a buyer commits to purchase goods or services solely from one seller to the exclusion of the seller’s competitors for an extended time period foreclosing competing suppliers from access to the buyer. To prevail on an exclusive dealing claim, the plaintiff must also show that the defendant had over a 30% market share in the relevant market to establish a presumption that the arrangement lessened competition. Courts often confuse tying and exclusive dealing doctrines despite clear differences.⁵¹ Unlike an exclusive dealing arrangement, a tying arrangement requires a tied-up purchaser to buy unwanted goods as a condition to purchasing the tied product, but does not specifically forbid the purchaser from selling a competitor’s goods. Unlike a tying arrangement, an exclusive dealing arrangement does not require a purchaser to buy unwanted goods; but forbids the purchaser from buying equivalent goods from the seller’s rivals. While the most

⁴⁶ Sherman Antitrust Act, 15 U.S.C. §§ 1-7.

⁴⁷ Clayton Antitrust Act, 15 U.S.C. §§ 12-27; 29 U.S.C. §§ 52-53.

⁴⁸ Federal Trade Commission Act, 15 U.S.C. §§ 41-58.

⁴⁹ See 11 PHILLIP E. AREEDA, ANTITRUST LAW ¶ 1800b. (2007) (comparing judicial treatment of tying and exclusive dealing claims in the context of licensing arrangements).

⁵⁰ See Michael J. Lockerby, *Franchising After Leegin: A License to Fix Prices?*, 27 FRANCHISE L.J. 112 (2007).

⁵¹ See AREEDA, *supra* note 49, at ¶ 1800b. (noting that courts sometimes confuse the two legal doctrines).

frequent plaintiff in a tying case is the tied-up buyer, in an exclusive dealing case it is the excluded rival.⁵²

While tying and exclusive dealing cases both limit supplier choices of affected franchisees, if the market in which affected franchisees resell their products or services remains competitive, the ultimate consumer remains unaffected. As a result, most franchise tying or exclusive dealing cases can, or should, be dismissed at the pleading stage due to the absence of a necessary element of proof: demonstrable consumer injury.⁵³ This outcome seems appropriate considering that “it is not the purpose of the antitrust laws to regulate the content of distribution contracts except in the unusual case when competition is impaired.”⁵⁴

When it comes to complaints about sourcing restrictions, the franchisee’s real gripe is not about being held captive to deal exclusively with the franchisor or its designated supplier, but about compulsory tie-ins. We direct the reader to other papers which elaborate on the application of exclusive dealing claims in the context of sourcing controls and focus the rest of this Section on tying arrangements.⁵⁵

Other antitrust issues arise in franchise relationships, but do not directly grow out of sourcing controls. A franchisor may insist that franchisees adhere to specific retail pricing or price floors or ceilings even when they are permitted to buy all of their supplies from third parties of their own choosing. Claims charging the franchisor with discriminating among, or against, franchisees in the price of goods sold, promotional allowances or vendor rebates in violation of the federal Robinson-Patman Act⁵⁶ can arise absent any sourcing restrictions, where franchisees may purchase goods from third party approved suppliers, but choose instead to buy them from the franchisor or its affiliate.

2. Tying Arrangements

Since modern franchising’s explosive growth starting in the 1960s, judicial hostility to restrictive purchasing arrangements has all but disappeared. In the early years, courts were

⁵² *Id.* at ¶ 358a. (“Although the health of foreclosed suppliers and the vitality of competition in their market is the central concern of tying law, the immediate victim of the restraint is the customer who is forced to take a product it does not want. That customer is the usual plaintiff ...”). Occasionally, the plaintiff in a tying case is an excluded supplier. See *Schlotzsky’s, Ltd. v. Sterling Purchasing & Nat’l Distribution Co., Inc.*, 520 F.3d 393, 404-05 (5th Cir. 2008) (in which the court rejected the terminated distributor’s tying claim based on the finding that the franchisor had exercised its contractual right to control the supply sources). While the terminated distributor fashioned a tying claim against Schlotzsky’s, it reads more like an exclusive dealing challenge.

⁵³ See AREEDA, *supra* note 49, at ¶ 1800b.

⁵⁴ *Id.*

⁵⁵ See, e.g., Erika Amarante & Mark McLaughlin, *The Top 10 Things Every Franchise Company Needs to Know About Antitrust and Competition Law: Everything from Pricing to the Supply Chain*, presented at the 42nd Annual Legal Symposium of the International Franchise Association (2009); Patrick J. Maslyn & W. Andrew Scott, *Contractual and Business Aspects of Structuring Supplier Agreements*, presented at the 30th Annual Forum on Franchising (2007); Michael K. Lindsey & Suzanne E. Wachsstock, *A Practical Guide to Franchising and Antitrust*, presented at the 29th Annual Forum on Franchising (2006).

⁵⁶ Robinson-Patman Act, 15 U.S.C. §§ 13-13b, 21a.

receptive to franchisee tying claims challenging franchisor-imposed sourcing restrictions.⁵⁷ Franchisors were presumed to have the requisite economic power to compel franchisees to buy unwanted goods based on their ownership of the licensed brand name, the franchise system's cornerstone.⁵⁸

However, the judicial pendulum has since clearly swung in the other direction. Two cases, in particular, deserve responsibility for nearly knocking out tying claims in the franchise context. The 1984 Supreme Court decision in *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*,⁵⁹ a non-franchise case, ruled that a plaintiff must demonstrate that a defendant enjoys at least a 30% share of the tying product market in order to establish a tie-in arrangement's per se illegality.⁶⁰ As a result of *Jefferson Parish*, tying contest became an initial battle over the proper definition of the relevant market. Efforts to define the relevant market as a single franchise brand nearly always failed.⁶¹ For all intents and purposes, *Jefferson Parish* doomed the franchise trademark case: "Virtually no franchisor's franchise offering enjoys anything close to a 30% share of any sensibly defined relevant market."⁶²

Eastman Kodak Co. v. Image Tech. Servs.,⁶³ a non-franchise case, briefly revived franchise tying cases by allowing franchisees to demonstrate their franchisor's substantial market power as a brand-specific relevant market.⁶⁴ The Supreme Court found that even though Kodak lacked market power in the tying product, Kodak copiers, it had market power in the tied-product, branded replacement parts. When Kodak adopted a restrictive policy that hurt the ability of independent service providers of Kodak copiers to purchase replacement parts, the independent providers sued, alleging that Kodak's opportunistic policies forced them out of business. Their customers who owned Kodak copiers were locked in and disinclined to switch to another brand of copier at that point given that the initial cost of purchase was prohibitively high. In the post-contract period, Kodak could exploit its dominance over the independent service providers even though it lacked market power in the tying product, copiers. The Supreme Court, therefore, rejected Kodak's motion for summary judgment and thereby breathed new life into franchise tying claims.

⁵⁷ Arthur I. Cantor & Peter J. Klarfeld, *An Unheralded Stake Through the Heart of Siegel v. Chicken Delight and a New Climate for Franchise Tying Claims*, 28 FRANCHISE L.J. 11, 12 (2008).

⁵⁸ *Siegel v. Chicken Delight, Inc.*, 448 F.2d 48 (9th Cir. 1971) is the leading example of the hospitable climate for tying claims in the early years of modern franchising. The Ninth Circuit unanimously affirmed a tying decision against the franchisor, ruling that the franchisor would be presumed to have the requisite market power based on ownership of the licensed trademark.

⁵⁹ 446 U.S. 2 (1984).

⁶⁰ *Id.* at 16.

⁶¹ See, e.g., *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430, 433 (3d Cir. 1997); *Schlotsky's, Ltd. v. Sterling Purchasing & Nat'l Distribution Co., Inc.*, 520 F.3d 393, 404-05 (5th Cir. 2008).

⁶² Cantor & Klarfeld, *supra* note 57.

⁶³ 504 U.S. 451 (1992).

⁶⁴ *Id.* at 461.

Kodak's revival of franchise tying claims was short lived. Five years later, *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*⁶⁵ dealt a knock-out punch by sanitizing sourcing restrictions when the franchisor discloses them to prospective franchisees before they buy the franchise, regardless of whether the tying goods or services possess unique qualities or suitable alternative suppliers exist capable of selling the same or comparable goods at lower prices. In deciding *Queen City*, the Third Circuit identified the source of the franchisor's economic power as the franchise agreement. It was the contract, not the marketplace, which gave Domino's the absolute right to establish specifications for all pizza ingredients, beverage products, cooking materials, containers, and everything else that franchisees needed to operate their business. The contract similarly gave Domino's the right to insist that franchisees purchase these items exclusively from Domino's or approved suppliers, which Domino's could limit in number. When Domino's refused to share its specifications with suppliers selected by franchisees, the plaintiffs sued, alleging a variety of antitrust claims. The court rejected the plaintiffs' claims, finding that Domino's had acted entirely pursuant to its contractually reserved rights. Its authority emanated from the franchise agreement, not because of its market share, which undisputedly was under 30%. Absent the requisite level of market power, the plaintiff's tying claims had to be dismissed.⁶⁶

Of course, *Queen City* did not put an end to new franchise tying cases. Plaintiffs since *Queen City* have tried to fashion their claims within the specific contours of *Kodak* as post-contract sourcing restrictions by asserting a very narrow market definition limited to the franchise brand.⁶⁷ They have tested the quality of the franchisor's pre-contract disclosures about sourcing controls and the franchisor's intentions regarding profiting from franchisee-supplier transactions.⁶⁸ As explained in Section VI, which addresses best practices in drafting franchise agreement provisions pertaining to sourcing restrictions, if franchise tying cases remain viable at all, the crucial issue will be the quality of pre-contract disclosures.

⁶⁵ 124 F.3d 430 (3d. Cir. 1997). Plaintiffs brought separate claims for monopolization under Sherman Act Section 2, exclusive dealing under Sherman Act Section 1, and illegal tying under Sherman Act Section 1. As for the tying claim, the court affirmed the lower court's analysis: "Plaintiffs do not and cannot purchase ingredients and supplies from alternative suppliers not because Domino's dominates the ingredient and supply market or because Defendant is the market's only supplier, but because the franchisee-plaintiffs are contractually bound to purchase only from suppliers approved by Defendant. It is economic power resulting from the franchise agreement, therefore, and not market power, that defines the 'relevant market' Plaintiffs allege in support of their antitrust claims." *Id.* at 435.

⁶⁶ For a recent franchise tying case that echoes this point, see *Arnold v. Petland, Inc.*, No. 2:07-cv-01307, 2009 U.S. Dist. LEXIS 31377 (S.D. Ohio Mar. 26, 2009).

⁶⁷ See Allan P. Hillman, *Franchise Tying Claims: Revolution Or Just A "Kodak Moment"?* 21 FRANCHISE L.J. 1 (2001). Hillman discusses *Kodak*, *Queen City*, and post-*Queen City* tying cases based on Kodak's rescue of franchisee tying claims "from the dustbin of history." *Id.* at 46. "Clearly, the massive precontractual disclosures required of franchisors compares favorably to the lack of precontractual disclosure in *Kodak*. Every circuit court considering the matter has agreed that, had Kodak's policy been known precontract, the result would have been different." *Id.* at 45. See also BLAIR & LAFONTAINE, *supra* note 1, at 157 (discussing the pre-contract and post-contract perspectives after *Kodak*.)

⁶⁸ See Hillman, *supra* note 66. The author laments: "According to decisions like *Queen City*, the power to exploit franchisees economically during the life of a contract typically stems from the contractual relationship rather than from dominance in a unique market, such as the market for Kodak parts or services. Yet this rationale, an almost blanket rejection of franchise tie-ins, asks too much and cannot be reconciled with [post-*Queen City* cases] *Wilson*, *Little Caesar*, *Collins*, or *SubSolutions*, much less with *Kodak* itself." *Id.* at 45.

Legal challenges addressing sourcing restrictions imposed by a franchisor after the contract's formation have also been seriously eroded. The 2006 Supreme Court decision in *Illinois Tool Works, Inc. v. Independent Inv., Inc.*⁶⁹, a non-franchise case, overruled prior Supreme Court decisions holding that patents should be presumed to signify a patent owner's market power for purposes of tying analysis. In so ruling, the Supreme Court eliminated the analogical basis on which early franchise tying cases found that franchisors, as trademark licensors, had presumptive market power. Since legally cognizable market power cannot arise out of the franchise contract itself, a plaintiff needs to be able to prove that a single franchise brand enjoys a 30% market share in order to sustain a tying claim under the Sherman Act, a threshold which no franchise network, even the largest, enjoys today.⁷⁰

3. State "Little" FTC Acts

Deficient disclosures about sourcing restrictions may also be redressed under state little FTC Acts when a plaintiff can demonstrate that the disclosure misrepresented the true facts and therefore was deceptive under the standards set by these statutes. Alternatively, if the deficiency violates the Amended Franchise Rule, many state little FTC Acts incorporate by reference the deceptiveness standard established by the FTC. Through this type of analytical "bootstrapping," a private plaintiff may be able to state a claim under a state little FTC Act based on disclosures that are deceptive or fail to meet the federal disclosure guidelines even though the private plaintiff would have no private right of action for violation of the Amended Franchise Rule itself. This "bootstrapping" approach has had mixed results in state courts.⁷¹

Additionally, in the dozen or so states that regulate franchise sales, deficient and deceptive disclosures about sourcing restrictions are actionable as a violation of the state franchise sales law giving rise to civil, criminal and administrative remedies. The same deceptive disclosures may also support common law fraud claims. Fraud-type claims are not sure winners especially when allegations of deception emanate from post-contract changes in sourcing arrangements and not from untrue statements made in the disclosure document delivered pre-contract. To prevail in a claim for statutory fraud under a franchise sales law, a franchisee must prove some degree of reasonable reliance on the inaccurate information in the disclosure document that mislead its decision to buy the particular franchise. To prevail on a common law fraud claim, the plaintiff must prove the franchisor's intended to deceive, which may be impossible to establish if the franchisor's disclosure is, in fact, truthful when made.

⁶⁹ 547 U.S. 28 (2006).

⁷⁰ See Comment, *Intellectual Property Tying Arrangements: Has The Market Power Presumption Reached The End Of Its Rope?*, 57 DEPAUL L. REV. 539, 564-66 (2008). The article maintains that the presumption of market power in trademark cases should be eliminated now that the courts have abandoned the presumption in patent cases.

⁷¹ Compare, for example, *SDMS, Inc. v. Rocky Mt. Chocolate Factory, Inc.*, 2008 U.S. Dist. LEXIS 90276 (S.D. Cal. Nov. 6, 2008) (dismissing claims for disclosure violations brought under California's little FTC Act and state unfair competition law) and *Randall v. Lady of Am. Franchise Corp.*, 532 F. Supp. 2d 1071 (D. Minn. 2007) (allowing claims under the Minnesota Franchise Act, the Florida Franchise Act (forbidding misrepresentations in the sale of franchises) and Florida's little FTC Act based on alleged deficient disclosures, omissions and unregistered earnings claims).

While courts have suggested that franchise-related tying claims may be brought under state little FTC Acts,⁷² these causes of action should not survive if the same underlying conduct fails under a state or federal antitrust law. In *Chavez v. Whirlpool Corp.*,⁷³ a California Court of Appeal held that if “the same conduct is alleged to be both an antitrust violation and an ‘unfair’ business act or practice for the same reason – because it unreasonably restrains competition and harms consumers – the determination that the conduct is not an unreasonable restraint of trade necessarily implies that the conduct is not ‘unfair’ toward consumers.”⁷⁴ Given that California courts consider a tying arrangement disclosed in advance through a franchise agreement to be “part of a negotiated business relationship” and “not a restraint of trade,” it would appear that the arrangement cannot be an unfair business practice as a matter of law.⁷⁵

IV. BENEFITS ARISING FROM FRANCHISOR CONTROL OVER AND INVOLVEMENT IN THE SOURCE OF PRODUCTS AND SERVICES

A. Quality Control

The primary benefit arising from franchisor control over the source of products and services is uniform product quality. As Nancy Kruse, from the restaurant consulting firm, Technomic, notes: “Travelers love to see fast food chains at airports. Even if they’re 2000 miles from home, they can go into an airport McDonald’s, order a Big Mac, and know exactly what they’re getting and more or less what it’s going to cost.”⁷⁶ Similarly, the founder of Ember’s America points out: “If Big Macs were different from McDonald’s to McDonald’s, people wouldn’t stop at McDonald’s very often.”⁷⁷ In other words, “customers become loyal if the experiences they enjoy at diverse units of a chain routinely meet their expectations.”⁷⁸

Since, by definition, a franchisor doesn’t own and operate all of its outlets directly, it is required to maintain uniform product quality through contractual provisions. These include specific performance clauses, product specifications and input purchase requirements. Subway franchisees, for example, must agree to adhere to Subway’s quality control standards regarding the goods and services sold to the customer.⁷⁹ McDonald’s franchisees must serve only

⁷² See *Carquest of Hot Springs, Inc. v. General Parts, Inc.*, 238 S.W. 3d 916, 919 (Ark. 2006) (leaving open the question of whether tying claim could be brought under Arkansas Deceptive Trade Practices Act); see also James L. Petersen & Angela M. Fifelski, *State Tying Claims: Do You Know What May Be Lurking?*, 21 FRANCHISE L.J. 118, 124 (2002).

⁷³ 93 Cal. App. 4th 363 (2001).

⁷⁴ *Id.* at 375.

⁷⁵ *Exxon Corp. v. Superior Court of Santa Clara County*, 51 Cal. App. 4th 1672, 1686 (1997). See also *SubSolutions, Inc. v. Doctor’s Assocs., Inc.*, 436 F. Supp. 2d 348, 357 (D. Conn. 2006) (dismissing franchisee’s claims under Connecticut little FTC Act because it “produced no evidence beyond the alleged tying arrangement itself,” which formed the basis for the antitrust claims that the court had already rejected.)

⁷⁶ BLAIR & LAFONTAINE, *supra* note 1, at 117 (quoting *Frequent Flyer*, March 1991).

⁷⁷ Tim Johnson, *Revitalization of the Mom & Pops*, FRANCHISE TIMES, Feb. 1998, at 15-16.

⁷⁸ BLAIR & LAFONTAINE, *supra* note 1, at 117.

⁷⁹ *Id.* at 130.

designated food and beverage products that meet McDonald's specifications.⁸⁰ Franchisees may also be required to purchase all of their goods and services from approved vendors, or, in some cases, from the franchisor itself. However it is accomplished, all franchise restrictions on the source of products and services are fundamentally designed to provide a uniform quality product to the customer.⁸¹

Sourcing restrictions also achieve the correlative benefit of eliminating franchisee free-riding, a problem endemic in franchising.⁸² Free-riding describes franchisee behavior which deviates from brand standards in order to reduce personal operating costs without regard for the brand damage that such behavior might cause. "Individual franchisees have an incentive to cut costs and supply low-quality products and services because they do not bear the full cost of any resulting deterioration in the trademark's value."⁸³ Sourcing restrictions are an efficient means to deter post-contractual free-riding opportunism by franchisees.⁸⁴

B. Competitive Pricing

Franchise system control over product sourcing also allows the franchisor to reduce the cost of delivering supplies to its franchisees. These cost savings are primarily derived from two participants in the supply chain: vendors and distributors.

By restricting the purchase of goods and services to approved vendors, the franchisor can leverage all of the system's buying power and negotiate the lowest possible prices. First, during contract negotiations, the franchisor can accurately represent its total purchasing volume to potential vendors based on system-wide sales, thereby receiving the best possible price. Second, the franchisor can fulfill its contractual purchasing obligations to the vendor, the terms of which often include a minimum sales volume in order for the franchisor to receive the vendor's best price. Third, by directly negotiating with vendors, rather than outsourcing this function to brokers or a broadline distributor, franchisors can reduce product costs by contracting with multiple vendor sources for the same product, e.g., Coca-Cola and PepsiCo for beverages. This not only has the effect of keeping product prices low, it tends to concurrently improve upon key non-price performance measurements, such as customer service, on-time deliveries and invoice accuracy.

Franchisor involvement in distribution can also exact significant cost savings for franchisees. For example, most QSR franchisors will designate an exclusive distributor for each region and, to the extent possible, source all product through that distributor ("single source distribution"). As most QSRs use under 100 ingredients per restaurant, the product line is limited and it is easy for one distributor to guarantee supply. By designating a single distributor within a region and sourcing all product through that distributor, the franchisor is able to

⁸⁰ See 2006 Franchise Agreement, McDonald's USA, LLC ¶¶ 12(a), 12(i).

⁸¹ Blair & Kaserman, *supra* note 6, at 323.

⁸² See Uri Benoliel, *The Expectation of Continuity Effect and Franchise Termination Laws: A Behavioral Perspective*, 46 AM. Bus. L.J. 139, 143-4 (2009) ("According to the law-and-economics perspective, the free-riding problem typifies franchise contracts.")

⁸³ *Id.* at 144-45.

⁸⁴ BLAIR & LAFONTAINE, *supra* note 1, at 165.

negotiate the lowest possible delivery cost on a per product basis. This is because (1) the distributor is able to maximize the number of drops per distance driven by each truck, (2) the distributor is able to minimize the cost of inbound freight, as a greater number of full truckloads are dispatched to a single distribution center, rather than splitting loads, and (3) the distributor is better able to manage and track inventory, with greater velocities allowing it to optimize purchases of short lived products.

In short, by taking advantage of economies of scale on both procurement and distribution, the franchise system can provide the lowest delivered price on products and services for its franchisees.

C. Safety and Brand Protection

Franchisor involvement in the supply chain also increases accountability for the safety of the products distributed. While vendors may be subject to various federal and state health and safety requirements, franchisor vendor contracts typically require heightened protections above and beyond these regulations, including immediate vendor reporting of unsafe products to the franchisor, vendor and/or independent product testing, and product recall. This allows the franchisor to place an early firewall between a potential dangerous product (e.g. meat contaminated with Lysteria) and distribution of the product to the system.

Whether a franchisor procures product directly from a vendor or it chooses to outsource this function, strict control over the source of products and services also lessens the opportunity for harmful products to enter the system. For example, during the recent salmonella scare, which focused erroneously on tomatoes (the source of the outbreak was later linked to chili peppers), franchisors with (i) mandatory produce suppliers and (ii) a high level of system compliance by their franchisees were able to ensure that the tomatoes they provided to their franchise customers did not originate in the geographical area associated with the outbreak. This allowed the franchise system to continue to supply consumer products made with tomatoes with minimal risk of customer injury or harm to the brand.

D. Commodity Smoothing

After years of price stability, beginning in 2007, the Producer Price Index (PPI) increased dramatically, with fuel/power and farm products being impacted the most. Spurred by rapid increases in producer prices, the price of flour nearly tripled year over year. For franchisors in the restaurant sector, this resulted in a substantial increase of the cost of food purchased by their franchisees. In its 2008 10K, for example, Dominos reported a year over year increase in food and paper costs of 5.7 percent, a substantial amount in an industry in which food and paper expenses are typically a franchisee's largest variable cost. QSR franchisees are particularly vulnerable to such increases because it is often difficult for the franchise system to pass them along to the customer, who has been conditioned to expect products at a specific price point, whether \$5 Footlongs or food from the Dollar Menu.

Consequently, one of the principal benefits franchisors can provide by involving themselves in the supply chain is to bring price stability for their franchisees. Franchisors primarily accomplish this through "forward contracts" with vendors, in which they lock in commodity purchases over a lengthy period of time. Franchisors also accomplish price smoothing by purchasing "insurance" in the form of a hedge for commodities such as cheese, soybean oil or hard red spring wheat. While such measures can rarely guaranty the lowest priced products at all times, they do allow a franchise system to lock in a steady supply of

products critical to franchise operations at a reasonable price, thereby lessening the business risk to franchisees who would otherwise have little protection from price spikes for key inputs for their business.

E. On-going Product Availability

Franchisor involvement in the supply chain also provides greater assurance of product availability. While a broadline distributor has vast resources, they may not always have the products the system needs, particularly for promotions, limited time offers and new product development. Franchisors can address this issue by setting up redundant vendor capacity and by taking ownership of and responsibility for inventory. By putting its own balance sheet on the line, managing its own inventory, and accepting the risk of loss on over-buys and product returns, the franchisor can increase supply chain accountability to its franchisees, ensuring that they always have the products they need, when they need them.

F. Knowledge Management

Supply chain *management* requires a high-level of information sharing and coordination among the constituent members of the supply chain..⁸⁵ By centralizing sourcing, franchisors can serve in the pivotal role of managing the knowledge flow among the supply chain participants and the supplier's customers, i.e., the franchisees, and allow franchisors to integrate their own market research to optimize successful supply chain execution.

G. Localized Expertise and Rapid Response

The principal beneficiary of a well managed franchise supply chain may be the franchisee. Franchisees need not become experts in negotiating, purchasing, managing delivery costs and coordinating buying. Nor need franchisees be bothered by sales people coming to their retail outlet at any hour they please in order to discuss new products. Instead, franchisees can receive precisely the products that they need delivered to their store in a single delivery, allowing the franchisee to dedicate his time to his business and to customer service. When problems do arise, whether due to product quality or missed or incorrect deliveries, the franchisee can address these problems directly with the franchisor, whose direct contractual relationship with the vendor, logistics provider and distributor, coupled with the purchasing power of the entire chain, allows the franchisor to obtain a more rapid response than any franchisee could likely achieve working alone.

V. TENSIONS ARISING FROM FRANCHISOR CONTROL OVER AND INVOLVEMENT IN THE SOURCE OF PRODUCTS AND SERVICES

A. Franchisee Purchases of Substandard or Unapproved Products

Most franchisees recognize the importance of product uniformity, and they will complain about other franchisees who purchase substandard or unapproved products and will request that the franchisor intervene.⁸⁶ These franchisees understand that a "franchisee who reduces

⁸⁵ Russell T. Crook et al., *Antecedents And Outcomes Of Supply Chain Effectiveness: An Exploratory Investigation*, J. OF MANAGERIAL ISSUES, June 22, 2008 (discussing how knowledge sharing across all participants in the supply chain improves performance).

⁸⁶ Jeffrey A. Tannenbaum & Stephanie N. Mehta, *Bias at a Single Store Can Taint Franchise Chain's Image*, WALL ST. J., Mar. 6, 1997, at B2.

the quality of products he offers for a given price might increase his profits, yet by disappointing buyer's expectations he could reduce by a greater amount the net returns to the common intangible goodwill asset – maintained by the franchisor and used jointly by his other franchisees.⁸⁷ Nonetheless, the purchase of substandard or unapproved products is a perennial problem for many franchise systems.

The root of the problem is that an individual franchisee's incentives may not be aligned with those of the franchisor. "Thus, a donut shop owner might reduce costs, and so enhance profits, by selling rather than throwing away donuts that are not completely fresh."⁸⁸ This problem can be particularly acute when a franchisee's customers are transient, such as those with store locations in airports or adjacent to rural interstate highways, who, unlike stores frequented by knowledgeable local customers, will continue to receive store traffic based on the strength of the brand. "Franchisees can also hurt the franchise system, not by using lower cost products, but by catering too much to the needs of their local market . . .".⁸⁹ "[I]f McDonald's franchisees offer 'Cajun burgers' in New Orleans, 'teriyaki burgers' in Honolulu, and 'Tex-Mex burgers in San Antonio," customers will not know what to expect at other locations, which may result in lower system-wide sales.⁹⁰

As a result, even the gold standard of product uniformity, McDonald's, once grappled with franchisees "purchasing inferior food supplies in order to get a cheaper price" and those "experimenting with new products, new procedures and new (and higher) prices."⁹¹ For example, McDonald's "first true owner-operator husband and wife franchisee team, the Agates – whose undeniable success in the business led a number of their peers to become franchisees themselves and helped [Ray Kroc, the founder of McDonald's System Inc., to] identify good prospects at a critical juncture in the chain's development, became known as 'price buyers' – franchisees who substituted cheaper products from non-approved suppliers"⁹². Ray Kroc understood the importance of product uniformity. Consequently, after the Agates signed a deal to sell Pepsi in their restaurant rather than the approved cola at McDonald's, Coca-Cola, Kroc denied the Agates the opportunity to buy additional stores. Agate became known "as the one punished by Kroc for switching from Coke to Pepsi," and no other franchisee ever tried to make that switch again.⁹³ In the end, by refusing to renew licenses, refusing to grant new franchises to existing franchisees, and suing franchisees for breach of contract (the latter of which was virtually unheard of in franchising at the time), McDonald's set numerous precedents and convinced the courts that for franchising to function properly, franchisors must be allowed to control the products served to their customers.⁹⁴

⁸⁷ Richard E. Caves & William F. Murphy, *Franchising: Firms, Markets, and Intangible Assets*, 42 S. ECON. J. 577 (1976).

⁸⁸ BLAIR & LAFONTAINE, *supra* note 1, at 119.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ JOHN F. LOVE, MCDONALDS: BEHIND THE ARCHES 68, 76 (1986).

⁹² BLAIR & LAFONTAINE, *supra* note 1, at 130.

⁹³ LOVE, *supra* note 91, at 85.

⁹⁴ BLAIR & LAFONTAINE, *supra* note 1, at 126-127.

However, as the McDonald's experience makes clear, merely specifying product standards and requiring franchisees to purchase such products from approved vendors will not eliminate some franchisees' individual incentive to deviate from proscribed behavior. Product specifications must routinely be monitored, through audits, mystery shopper programs and the like, and sanctions issued for noncompliance.⁹⁵ As illustrated by a detailed account of the business practices of five U.S. franchise systems, franchisors typically respond to the use of substandard or unapproved products with a proportional response.⁹⁶ Noncompliance on "generic" items, such as the stir sticks and sugar packets offered by a donut franchisee, may be ignored. As one Pizza Hut executive stated, "you don't want to burn your goodwill bothering franchisees with little things. There are too many big issues that we have to deal with – like convincing them to install new ovens – to get caught up in the little ones."⁹⁷ When faced with more important deviations, however, franchisors will escalate their response, from engaging in "coaching", issuing defaults, suggesting that the franchisee leave the system, and, ultimately, terminating the franchise.⁹⁸

B. The Price of Approved Products

1. Beating the Street Every Day

Even when franchisees agree to buy specified products from the franchisor or its approved vendor, they will often complain that the prices they are charged are too high. While the franchisor generally can offer good value to the system, franchisors can rarely offer the lowest price on every product every day. Consequently, after they have gained some experience in the business, franchisees may discover that some inputs, particularly less critical products for which the franchise system has lower purchasing volumes, can sometimes or even always be purchased from someone other than the franchisor at a lower price. For example, large scale retailers as well as retailers with a business model based on big lots, overstocks and discount purchases such as Costco and Sam's Club, may offer limited time "blue light specials" which may be lower than comparable product delivered by the franchisor every day.

While the items offered by such retailers may not always be in stock or be available system-wide, and these retailers generally do not include the cost of delivery of the product to franchisees (which can be a significant portion of the delivered cost of a product), their existence can create resentment among individual franchisees. Franchisees may come to believe that they are being overcharged, while failing to appreciate that by refusing to purchase all of the specified products through the approved supplier and cherry picking only those products that they want to purchase, the franchisee is decreasing the franchise system's purchasing power, increasing its distribution costs, and driving higher prices for the remaining products that the franchisee desires. In order to combat this problem, many franchisors affix

⁹⁵ *Id.* at 128.

⁹⁶ JEFFREY L. BRADACH, *FRANCHISE ORGANIZATIONS* (1998).

⁹⁷ *Id.* at 102.

⁹⁸ For example, if a McDonald's franchisee "knowingly sell[s] food or beverage products other than those designated by McDonald's or which fail to conform to McDonald's specifications for those products, McDonald's at its election, may terminate the franchise." 2006 Franchise Agreement, McDonald's USA, LLC ¶ 18(j).

their trademark to products for which reasonable substitutes may be available, thereby transforming “generic” products into products unique to the system.⁹⁹

C. Beating the Street Everywhere: Urban vs. Rural Costs of Delivery

While some retail price variance may occur by region, most franchise systems that aspire to becoming a nationwide brand must provide products to their customers at the same or a relatively similar price regardless of the franchised location. In reality, however, the cost of delivering products to the franchisee may differ dramatically by geographic region and the franchisee’s locations within that region. Consequently, when sourcing products and services, some franchisees must essentially cross subsidize the delivered cost of products purchased by other franchisees within the system in order to create a uniform product price. The degree to which each franchisee’s product pricing is subsidized or mitigated will depend on the nature of the product, the location of the supplier, the distribution costs for the product within each geographic region, and the location of the franchisee within that region.

Two simple examples illustrate the problem. Consider the “country mouse” franchisee with a restaurant in Idaho. His restaurant is located near the source of production of one of the constituent products on the menu, the Idaho potatoes that are used to make French fries; yet, the Idaho franchisee will typically pay the same price for the delivered product, French fries, as the franchisee in downtown Manhattan. In essence, the Idaho franchisee is subsidizing the production cost of French fries for his urban counterpart. Conversely, consider the “city mouse” franchisee in Manhattan. His high density urban location has far lower distribution costs than his fellow rural franchisees because his distributor has far more deliveries over less mileage. The urban franchisee is subsidizing the delivery costs of his rural counterpart.

Of course, whether the ultimate delivered cost of any given product will be subsidized by any given franchisee will vary by product, the source of its production, the cost of inbound freight from that facility to the distributor, the cost of distribution, and the velocity of the product (*i.e.*, the sales volume) within each distribution area. Consequently, determining whether the delivered cost of a given product is actually being subsidized or mitigated by any given franchisee is more complex than the examples provided above. Moreover, delivered cost pricing variances will vary from product to product, meaning that the overall cost subsidization or mitigation incurred by any given franchisee on the panoply of products offered by the franchise system may well balance out. However, for the Arkansas based chicken QSR franchisee paying the same cost for chicken as his counterpart in Philadelphia, this knowledge may provide scant comfort.

D. Franchisor Remuneration from Sourcing Products and Services

Many franchisees may believe that the initial franchise fee and ongoing royalty they pay to the franchisor is, or should be, the extent of the franchisor’s compensation. While the vast majority of franchise systems do charge an initial franchise fee¹⁰⁰ and receive a royalty on

⁹⁹ See, *e.g.*, 2006 Franchise Agreement, McDonald’s USA, LLC ¶ 12(i) (requiring franchisees to “use only containers, cartons, bags, napkins, other paper goods and packaging *bearing the approved trademarks . . .*.”) (emphasis added).

¹⁰⁰ BLAIR & LAFONTAINE, *supra* note 1, at 56-61 (“Very few franchisors, only 9 out of 1,125 [surveyed], charge no such fee.”).

sales,¹⁰¹ in reality, most major franchise systems have complex business models that go well beyond these two forms of revenue. Instead, typical franchise models involve a combination of corporate owned retail locations, rental income from retail sites, and remuneration from selling supplies and services to the franchisees.

In the QSR space, for example, based on disclosures contained within their respective Franchise Disclosure Documents, franchisors with corporate owned units include Domino's, Jack in the Box, Sonic, Chipotle, Chick-Fil-A, Pizza Pizza, Wendy's, Arby's, McDonald's and the various retail outlets associated with Yum Brands. Franchisors receiving rent from franchisee retail locations include Tim Horton's, Jack in the Box, Chick-Fil-A, Wendy's, IHOP and McDonald's. Franchisors receiving income from the supply chain include Domino's, Chick-Fil-A, Pizza Pizza, Wendy's, Quiznos and IHOP. Finally, some franchisors receive income through partial vertical integration (*i.e.*, ownership) of the supply chain, such as Papa John's and Tim Horton's. While financial conventions make it difficult to gain complete visibility into the economics of these arrangements, it is apparent that these additional sources of income can be equal or greater than the income the franchisor receives from the initial franchise fee and continuing royalties. For example, McDonald's charges a sliding percentage rent based on sales, which averages about 12% for a typical \$1.1M restaurant.¹⁰²

Tim Horton's provides a good example of the way in which a franchisor combines sources of income to receive an aggregate return on its investment. According to its 2006 Prospectus, 96.7% of Tim Horton's locations are franchisee owned. Like most franchisors, Tim Horton's receives an initial franchise fee and a continuing royalty on franchisee sales. However, Tim Horton's also receives substantial revenues from sales of food and equipment to its franchisees. Tim Horton's also charges sublease rent on 81% of its franchised sites, resulting in rental revenue of between 8.5% and 10% of gross franchise revenue. The result is an overall return on investment for Tim Horton's that is thought to be one of the best in the QSR sector.

The form and manner in which a franchisor receives remuneration from the supply chain is particularly varied. For example, franchisors may receive annual payments from suppliers and distributors based on the number of retail locations served. Franchisors may also receive upfront payments from participants in the supply chain. Often referred to as an "exclusivity fee" when received from a manufacturer or vendor or as a "sourcing fee" when received from a distributor, exclusivity fees can be a substantial inducement received by a franchisor in return for providing a long term commitment to purchase from a specific vendor.

During the course of a franchisor's relationship with a supplier, the franchisor may also receive marketing fees, often from major consumer brands such as Coca-Cola, PepsiCo and salty snack providers such as Frito-Lay. Such marketing fees are intended to highlight the vendor's product line at the franchise retail location, but they also have the effect of providing a significant source of revenue for advertising to drive traffic to retail locations. Franchisors may also receive payments from vendors and manufacturers based on the volume of sales of the vendor's products. Referred to by vendors and franchisors as "rebates" and derisively by some franchisees as "kickbacks," these escalating payments based on increased sales can be a significant additional revenue stream for a franchise system. For example, in its March 2002

¹⁰¹ As of 2001, 92% of franchisors received on going sales royalties. BLAIR & LAFONTAINE, *supra* note 1, at 68.

¹⁰² 2006 Uniform Franchise Offering Circular, Item 6.

UFOC, Wendy's reported receiving rebates of between 1% and 15% of the value of goods purchased by its franchisees. Similarly, in its April 2006 UFOC, Subway disclosed vendor rebates of between 2% to 37% of sales dollars to be used in the franchisor's sole discretion for the benefit of its franchisees. Finally, franchisors that directly insert themselves into the supply chain and take title to the supplies being sold receive a profit margin on the products they sell. For example, Domino's,¹⁰³ and Quiznos¹⁰⁴ report revenues from such a "buy-sell margin."

More than other sources of remuneration, the revenues a franchisor receives from the supply chain can become a strong point of contention with franchisees. Franchisees have challenged franchisor remuneration from the supply chain on multiple fronts. Franchisees have asserted that requiring them to purchase supplies from the franchisor amounts to unlawful tying of the purchase of the franchise to the purchase of supplies, in violation of the antitrust laws.¹⁰⁵ Franchisees have also claimed that the franchise agreement does not require them to purchase a particular product from a franchisor's approved supplier.¹⁰⁶ Franchisees have even asserted that profits derived from sourcing products and services amount to federal racketeering.¹⁰⁷

In response to such challenges, some franchisors have fought vigorously to enforce their contractual right to remuneration from the franchise supply chain, while other franchisors have sought to take the issue off the table. For example, Domino's Pizza has agreed to share 50% of its pre-tax food distribution profits with its franchisees in exchange for the franchisees' commitment to purchase all of their food from Domino's for 10 years.¹⁰⁸ Similarly, Dairy Queen agreed to specific contributions to its advertising fund from the revenue derived from the sale of supplies to its franchisees.¹⁰⁹ Most fundamentally, some franchisors, such as Subway, have transferred ownership of the franchise supply chain to cooperatives owned by the franchisees themselves.

VI. DISCLOSING AND ADDRESSING SOURCING RESTRICTIONS IN THE FRANCHISE AGREEMENT: BEST PRACTICES

One of *Queen City's* legacies is to bifurcate the analysis of franchisor sourcing restrictions into pre-contract versus post-contract perspectives. Since *Queen City*, courts

¹⁰³ Domino's Pizza LLC 2006 Uniform Franchise Offering Circular, Item 8.

¹⁰⁴ QFA Royalties LLC 2008 Franchise Disclosure Document, Item 8.

¹⁰⁵ See, e.g., *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430 (3d Cir. 1997); *Little Caesar Enterprises, Inc. v. Smith*, 34 F. Supp. 2d 459 (E.D. Mich. 1998).

¹⁰⁶ See, e.g., *Bores et al. v. Domino's Pizza, LLC*, 530 F.3d 671 (8th Cir. 2008).

¹⁰⁷ *Westerfield et al. v. The Quizno's Franchise Company, LLC et al.*, Case No. 06-C-1210 (E.D. Wisc. Nov. 5, 2007) (unpublished).

¹⁰⁸ See Domino's Pizza LLC and Subsidiaries, Notes to Consolidated Financial Statements, Mar. 3, 2006 ("The Company enters into profit-sharing arrangements with franchise and Company-owned stores that purchase all of their food from Company-owned distribution centers. These profit-sharing arrangements generally provide participating stores with 50% of their regional distribution center's pre-tax profit based upon each store's purchases from the distribution center.").

¹⁰⁹ This agreement arose following a ruling in *Collins v. Int'l Dairy Queen*, 929 F. Supp. 875 (M.D. Ga. 1976), in which the court denied International Dairy Queen's ("IDQ") motion for summary judgment on the franchisees' claim that IDQ illegally tied the sale of food products and supplies to its franchises to its sale of franchise agreements.

generally have concluded that franchisors can avoid antitrust liability by making complete, pre-contract disclosure of supply-related arrangements.¹¹⁰ As a result, plaintiffs after *Queen City* have sought to win cases by challenging the quality of the franchisor's pre-contract disclosures and taking advantage of contract ambiguities or outright omissions. Their aim is to show that the franchisor acted opportunistically based on incomplete information shared during the pre-contract stage and failed to reasonably inform franchisees about plans to impose and profit from the specific sourcing controls that the franchisor later wishes to enforce.

Nothing suggests that franchisors cannot, or should not, address legal risks by drafting pre-sale disclosures and franchise agreement provisions in broadly-worded, conditionally-couched language that informs the franchisee in the most inclusive of terms that the franchisor reserves the right (e.g., may) at any point during the franchise term, in the franchisor's sole discretion (to emphasize its dominion over the subject), impose sourcing restrictions involving every article or service that may at any time make up the franchisee's operations and, in doing so, may derive revenue from the arrangement.¹¹¹ As long as the franchisor further discloses that the magnitude of future sourcing restrictions may affect up to 100% of a franchisee's ongoing purchases, current law appears to foreclose the franchisee from later complaining under any legal theory – antitrust, breach of contract, fraud, consumer protection statutes, or comparable allegations - that it was unfairly locked into purchasing unwanted tied goods even when the sourcing restriction enables the franchisor to extract supra-competitive prices.¹¹²

As long as the franchisor's disclosures and supplier-related contract provisions are clear and complete, they should not be invalid because the language chosen is sweeping and general about future action that might or might not ever be taken. Indeed, generalized disclosures about the franchisor's supplier policies, potential to derive revenue from franchisee-supplier transactions, right to modify suppliers and supplier policies at any time without notice, and related topics seems to be the safest approach for reducing legal risks in this area.¹¹³

¹¹⁰ Janet L. McDavid & Richard M. Steuer, *Symposium: The Law Of Vertical Restraints In Franchise Cases And Summary Adjudication: The Revival Of Franchise Antitrust Claims*, 67 ANTITRUST L.J. 209 (1999).

¹¹¹ By "pre-sale" disclosure, we refer to the information contained in the franchisor's franchise disclosure document which applicable law requires franchisors to give to every prospective franchisee before the franchisee commits to buy a franchise (unless the transaction is exempt from both federal and any applicable state franchise sales laws). Section III(A)(1)(b) of this paper explains the scope of mandatory pre-sale disclosures about sourcing restrictions. As part of the pre-sale disclosure process, the franchisor must provide a copy of all franchise contracts to the prospective franchisee. Once informed about contractual rights and duties vis-à-vis purchasing arrangements, current law is relatively intolerant to complaints by franchisees later on during the lifespan of the franchise relationship about franchisor conduct within the scope of contractually reserved rights.

¹¹² See Warren S. Grimes, *Perspectives on Franchising: When do Franchisors have Market Power? Antitrust Remedies for Franchisor Opportunism*, 65 ANTITRUST L.J. 105, n.82 (1996) ("Franchisees are, of course, not helpless. ... [F]ranchisees are protected to some degree by disclosure regulations and by their ability to negotiate contractual protection. ... Precontract opportunism may give rise to legal remedies, as, for example, when the franchisor is guilty of fraud or misrepresentation or otherwise violates state or federal disclosure protections ... Antitrust remedies for these abuses are unlikely.")

¹¹³ See Hillman, *supra* note 66. The author offers this example of a highly generalized disclosure informing franchisees pre-contract that it may change its supplier policies post-contract: "Franchisor reserves the right in its sole discretion to modify this policy, including without limitation modifying the number and identity of authorized suppliers of the Products. While Franchisor has not determined at present to modify this policy, franchisee should expect that it may do so, and that such a modification may increase franchisee's costs of obtaining one or more Products necessary to the operation of the franchise." *Id.* at 46.

All things considered, pre-sale disclosure and careful contract drafting seem an extraordinarily simple way to snuff out legal contests over sourcing controls. The advice has not been lost on franchisors. Franchise agreements today routinely reserve to franchisors broad reservations of rights to impose, expand, modify, and profit from future sourcing controls even when supplier restrictions do not exist at the relationship's inception or materially change with time during its term.¹¹⁴ What is critical is that the franchisor's disclosures be objectively informative, i.e., be sufficient to impart enough information to make franchisees reasonable aware of the scope and implications of the franchisor's authority.¹¹⁵

It is fair to say that the real bone of contention over sourcing controls today is not so much that franchisors regulate purchasing arrangements or derive revenue from franchisee-supplier transactions, but that franchisors do not guaranty their franchisees competitive pricing of supplies.¹¹⁶ After all, franchisee opposition to sourcing controls typically surfaces only after they learn they are getting a bad deal.¹¹⁷

So what would franchisees have to say about best practices when it comes to addressing sourcing restrictions in the franchisor's franchise agreement? An interesting resource is the Franchisee Bill of Rights published by the watchdog American Association of Franchisees and Dealers (AAFD). The AAFD's Franchisee Bill of Rights reveals that sourcing

¹¹⁴ See, e.g., *SubSolutions, Inc. v. Doctor's Assocs.*, 436 F. Supp. 2d 348 (D. Conn. 2006). After more than 7 years of litigation over the franchisor's designation of an exclusive POS supplier, the federal district court found the franchisor's pre-sale disclosures were adequate to put a reasonably prudent franchisee on notice of the franchisor's right to change its POS specifications and supplier. "Further it is an undisputed fact that in franchise agreements DAI reserved the right to change its product requirements and approved vendors and specified that it could in its discretion require its franchisees to purchase products from particular vendors. Thus, any prospective franchisee knew that DAI might require it to purchase some essential item from an exclusive vendor." *Id.* at 355 (citing *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430 (3d. Cir. 1997)).

¹¹⁵ Jeffrey L. Harrison, *An Instrumental Theory of Market Power and Antitrust Policy*, 59 SMU L. REV. 1673, 1703 (2006) (suggesting that antitrust policy is shaped more by politics than by economic theories). The article cites *Mumford v. GNC Franchising LLC*, 437 F. Supp. 2d 344 (W.D. Penn. 2006) in which the court rejected the franchisees' antitrust and common law claims challenging GNC's refusal to approve third party suppliers thereby forcing franchisees to buy their supplies from GNC. Plaintiffs argued that GNC had not provided complete information pre-contract about these purchasing restrictions, but the court disagreed. It noted that GNC's franchise agreement adequately disclosed that franchisees would have to purchase inventory from the company, its affiliates, or approved suppliers in certain quantities and with other enumerated restrictions, and that GNC reserved the right to modify the inventory plan in the future. GNC's reservation of rights was expressed in generalized terms: "[f]ranchisor reserves the right to modify the General Nutrition Center Inventory Plan, or Plan-O-Grams, by providing reasonable advance notice of such changes to Franchisee." *Id.* At 356-57. The decision seems to reject the premise that adequate pre-contract disclosure requires a franchisor to disclose with specificity the magnitude of future changes or future costs at the pre-contract stage.

¹¹⁶ Anecdotally, at least, some franchisees sign franchise agreements based on an emotional connection to the brand and the lure of independent business ownership without carefully reading the disclosure document or contract or evaluating the experiences of existing franchisees. See Karen B. Satterlee & Kerry L. Bundy, *The New Franchise Rule: "You Made Me Do It": Reliance in Franchise Fraud Cases*, 26 FRANCHISE L.J. 191 (2007) (reviewing cases dismissing franchisee claims of misrepresentations based on proof that the franchisee had not read the disclosure document or franchise agreement before investing in the franchise opportunity.). See also BLAIR & LAFONTAINE, *supra* note 1, at 160. The economist authors note that "some prospects do not even talk to other franchisees before making their own commitment," and recommend that franchisees take a more analytical approach in comparing franchise choices.

¹¹⁷ BLAIR & LAFONTAINE, *supra* note 1, at 164. ("Basically, recent franchisee [tie-in] allegations boil down to the complaint that they are being overcharged for requisite ingredients and supplies. This overcharge must be the underlying source of the franchisees' complaint for otherwise they would suffer no injury.").

controls per se are not the real focus of franchisee concern, the lack of competitive sourcing is. Standard 9.3 of the AAFD's "fair" standards of behavior, which are designed to "level the playing field" between the disparate economic interests of franchisors and franchisees, recognize that franchisors have a legitimate right to designate suppliers and derive revenue from franchisee-supplier transactions.¹¹⁸ In return, to balance competing interests, Standard 9.3 proposes that franchisees receive competitive pricing. The AAFD Standard does not expect franchisors to guarantee competitive pricing or necessarily to address the subject of competitive pricing in the franchise agreement, but it does expect franchisors to consider the franchisee's reasonable objective (no different than the franchisor's own) to achieve a competitive return from the franchise investment and not be exploited by the franchisor's contractual power over the franchise relationship.

The AAFD's proffered solution to sourcing controls focuses on the proper way to allocate future, unknown business risks that are neither predictable nor even certain, but over the long term are inevitable, such as price fluctuations, regulatory changes, competitive changes and even political changes. All businesses, franchise and non-franchise alike, face these same risks and confront the same limitations when it comes to predicting and preparing for the future. Standard 9.3 aspires to balance the economic interests of franchisors and franchisees by seeking a commitment from the franchisor to maintain a franchisee's competitive pricing regardless of whatever adjustments the franchisor may make to purchasing arrangements and sourcing controls as the franchisor leads the franchise system through the uncharted black hole called the future.

Some economists believe that a more efficient approach to protecting franchisees from exploitative sourcing controls is more "vigorous competition" in the sale of franchise licenses.¹¹⁹ "If one franchise contract subjects a franchisee to a higher risk of exploitation than another contract, this should be factored into the franchisee's evaluation of profit potential for the two systems and thus into the final decision as to which franchise contract best suits him."¹²⁰

In recommending best practices for drafting and disclosing contract provisions pertaining to sourcing restrictions, franchisees should give more credit to the multiple benefits of comprehensive sourcing controls recounted in this paper. A nascent franchise system may be too small for it to be economical for the franchisor to regulate supplier relationships beyond approving local sources identified by individual franchisees. However, unless new franchise chains are forward-thinking and reserve the right to regulate supplier relationships as comprehensively as the largest franchise systems with well-integrated supply chain management systems, they may encounter legal challenges if and when they later seek to change supply arrangements post-contract. Consequently, the best practice for franchisors to follow is to address supplier topics as if anything may be possible, but recognize that

¹¹⁸ American Association of Franchisees and Dealers, Franchisee Bill of Rights (July 27, 2009), <http://www.aafd.org/images/logo/Standards.pdf>. Standard 9.3 entitled "Right to Reasonable Profit/Pricing" reads: "Where a franchisor designates the source of supply for any products or services and the franchisor or an affiliate receives and discloses an economic benefit on the sale of such products and services, the franchisor is entitled to a reasonable profit on the sale of such products and the franchisee is entitled to a competitive price which enables the franchisee to achieve a reasonable profit margin."

¹¹⁹ BLAIR & LAFONTAINE, *supra* note 1, at 164-65.

¹²⁰ *Id.* at 167 n.188.

prospective franchisees may view free-wheeling contract clauses with some degree of suspicion, if not hostility, in evaluating competing franchise opportunities.

VII. PROCUREMENT AND VENDOR AGREEMENTS: BEST PRACTICES

A. An Overview of Procurement

“Traditionally, the main activities of a purchasing manager were to beat up potential suppliers on price and then buy products from the lowest cost supplier that could be found.”¹²¹ Today, purchasing is viewed as part of a broader function called procurement. The procurement function is broken down into four categories: consumption management, vendor selection, contract negotiation and contract management.

Effective procurement begins with understanding what kinds of products are needed, from whom and at what prices. The products needed include direct or strategic materials necessary for the products that the franchise sells and indirect or MRO (maintenance, repair and operations) products that the franchisees consume as part of daily operations. Expected levels of consumption for each of these types of products must be set and compared with actual levels of consumption on a regular basis.

“Once there is an understanding of the current purchasing situation and an appreciation of what a company needs to support its business plan and operating model, a search can be made for suppliers who have both the products and service capabilities needed.”¹²² Typically, a franchisor seeks to narrow the number of suppliers with whom it does business in order to leverage its buying power to obtain a better price in return for higher purchasing volume, while maintaining redundant supplier capacity for critical supplies necessary for franchise operations.

Once suppliers are identified, contracts are negotiated with individual suppliers on the franchisor’s preferred vendor list. The simplest negotiations tend to be for MRO products where suppliers are selected on the basis of lowest delivered price. The most complex negotiations are for mission critical supplies that must meet the franchisor’s specifications or for which high levels of service or technical support are needed.

Once contracts are in place, the franchisor must measure vendor performance against the contracts. Specifically, the franchisor must trace the performance of its suppliers and hold them accountable for the service levels they agreed to provide. If the supplier fails to meet its contractual requirements, the franchisor must make the supplier aware of its shortcomings and ensure they are corrected.

¹²¹ HUGOS, *supra* note 10, at 64.

¹²² *Id.* at 68.

B. The Nuts and Bolts of the Vendor Agreement

1. Why is a Vendor Agreement Desirable?¹²³

Some franchise distribution systems, including those of significant size, may employ little or no documentation with suppliers. Purchases may be made based on a telephone call or an exchange of email. Suppliers, interested in doing business with a purchaser for multiple franchise or corporate owned locations, may view a signed agreement as a potential impediment to a lucrative selling relationship. Franchisors may view themselves as providing only one thing to the vendor in return for its supplies, *viz.*, money, and may view informal vendor agreements as providing the franchise system with more flexibility in purchasing. While these viewpoints may be understandable, from the perspective of the franchisor such informal supply arrangements are almost certainly mistaken, particularly if the supplies go to the heart of the products and services provided to the franchisor's retail customers.

The fundamental problem with informal supply arrangements is that the franchisor cannot ensure a certain and constant supply of the products and supplies needed by the franchise system on terms that are known and enforceable. Additionally, from a practical standpoint, a uniform, written vendor agreement with suppliers vastly simplifies administration of what can otherwise be one of the most complicated and time consuming tasks undertaken by a franchise system. Depending on the size and nature of the franchise concept, a franchisor may have hundreds of suppliers for products as diverse as uniforms, linens, cleaning supplies, toiletries, food, paper, equipment, computer hardware and software and signage. Ensuring a constant supply of goods made to the franchisor's specifications, accounting for these arrangements and their terms, and tracing the performance of suppliers to determine whether they are performing as required, can be nearly impossible unless contract terms are clearly spelled out, preferably in a uniform form of vendor agreement.

2. Contractual Structure: Separate Master Agreement and Purchase Orders

While most franchisors would likely agree that a written vendor agreement is necessary,, many might naturally balk at the complexity and cost of creating a rigorous agreement with every vendor, particularly those involving smaller transactions for readily available items. In contrast, the franchisor's attorney may be hesitant to employ a standard purchase order, especially if the product is critical to brand integrity, or, as is often the case, it will be branded with the franchisor's trademark or will be manufactured according to the franchisor's proprietary specifications.

In many cases, a good solution is to employ a standard master vendor agreement negotiated at the outset of the relationship, coupled with a purchase order for each transaction during the course of the relationship. The master vendor agreement sets forth those terms applicable to every purchase, including the level of commitment, the ownership of the product and marks, confidentiality, warranties and representations, and product reporting, recall and indemnification. The purchase agreement incorporates the master agreement by reference and adds those additional terms that may vary by transaction, including price, freight rates, order lead time and distribution centers to be supplied.

¹²³ See generally FOLEY & LARDNER, PRODUCT DISTRIBUTION LAW GUIDE § 2.01 (2009) (providing a good overview of this topic from the perspective of both the buyer and the seller).

Separating the master vendor agreement from the purchase order also allows a franchise system to easily set up multiple supplier relationships for the same product and within the same region, allowing adequacy of supply and competition amongst vendors. Such redundant relationships are particularly important for brand critical supplies which may be especially vulnerable to supply disruption, such as foods subject to contamination or product recall. By engaging multiple vendors with separate purchase orders for each transaction, the franchisor can quickly and seamlessly shift the supply to an alternate vendor, ensuring the franchisor's ability to provide its franchisees with a system critical input.

3. Designation as an "Approved Vendor"

Item 8 of the amended Franchise Rule requires franchisors to disclose "the franchisee's obligations to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items related to establishing or operating the franchised business" from approved vendors.¹²⁴ To the extent the franchisor requires purchases from approved vendors, the vendor agreement should mirror this requirement by designating the supplier as an "approved vendor" authorized to sell only those products specifically requested by the vendor and subject to the franchisor's specifications.¹²⁵

When coupled with a franchise agreement requiring purchases from "approved vendors," including the "approved vendor" language within the vendor agreement allows for better franchise compliance, as the franchisor can easily establish whether a franchisee has purchased a product from an approved vendor and issue appropriate warnings or defaults to franchisees purchasing and selling unapproved product. Second, as stated above, establishing a stable of approved vendors familiar with the franchisor's product specifications and with the capacity to meet the franchisor's requirements for the product in question helps the franchisor to avoid product shortages should another approved vendor prove unable to deliver the product needed, either temporarily or long term. Third, including the approved vendor nomenclature within the vendor agreement allows the franchisor to more easily comply with its Item 8 obligation to identify the goods or services required to be purchased.¹²⁶

4. Ownership of Product and Intellectual Property

Many franchise concepts assert ownership of the products and services they provide, whether the 11 herbs and spices comprising Kentucky Fried Chicken, to the methods employed to pamper guests of Starwood owned luxury hotels.¹²⁷ As part of the vendor agreement, the

¹²⁴ 16 CFR § 436.5(h) ("Item 8: Restrictions on Sources of Products and Services").

¹²⁵ At the same time, the vendor agreement should clearly state, notwithstanding the "approved vendor" designation, that the vendor agreement is not an exclusive dealings contract and that the franchisor may engage other vendors or service providers to provide the same or similar products.

¹²⁶ 16 CFR § 436.5(h)(1).

¹²⁷ See, e.g., *Court Enjoins Hilton, Ross Klein and Amar Lalvini in connection with Litigation filed by Starwood*, N.Y. Times, Apr. 24, 2009. In this case, Judge Stephen C. Robinson, United States District Judge for the Southern District of New York, entered a stipulated preliminary injunction in connection with litigation filed by Starwood against Hilton Hotels Corporation and former Starwood executives Ross Klein and Amar Lalvani. Starwood alleged that Klein and Lalvani, aided and abetted by Hilton, stole massive amounts of proprietary and highly confidential Starwood information which was used to expedite Hilton's entry into the lifestyle hotel market, reposition its luxury brands and substantially reduce its costs and risks of doing so. The preliminary injunction barred the defendants from using, directly or indirectly, any documents or information derived from Starwood).

supplier should acknowledge that many of the products to be provided are proprietary and unique to the franchisor's brand and may not be sold, distributed or supplied to any party other than the franchisor absent written consent in advance. Such a provision is obviously important to safeguard the franchisor's property. Such a prohibition also reduces potential liability to unauthorized third party purchasers, who may use the product incorrectly or after the "use by" date. While one might anticipate supplier resistance to such a limitation on sales, particularly when the supplier has a dominant market position, such prohibitions are relatively common.¹²⁸

Suppliers may also be involved in the creation of new products for the franchise system. In addition to new products rolled out by the franchisor, such products may also include products developed by the supplier as new sources of raw material become available, or resulting from new methods of manufacturer. In either case, the ownership of the new product may be contested if it is not addressed within the vendor agreement.¹²⁹ Therefore, the vendor agreement should specify that new products designed and produced by the vendor at the direction or on behalf of the franchisor belong exclusively to the franchisor. The vendor should also affirmatively agree to cooperate with the franchisor in obtaining intellectual property protection for any intangible or tangible work product produced.

Finally, it is recommended that products manufactured by the vendor employ the franchisor's trademark and trade dress in product packaging and labeling. While exceptions obviously exist for products that are "off the shelf," branding the property has a number of positive effects. For example, the franchisor can more easily determine whether the vendor is supplying product to third parties in violation of the vendor agreement. Branding also increases franchisee compliance with purchasing obligations, as the product is more likely to be deemed unique to the franchisor and of greater value, and because unapproved purchases may be more easily spotted during inspections by the franchisor. Of course, if the franchisor authorizes the vendor to use the franchisor's trademark, the vendor agreement should also include a license limiting the vendor's use of the mark solely in connection with the products it is producing, and the vendor's agreement to immediately notify the franchisor of any infringement or challenge to the mark of which the vendor becomes aware.

5. Confidentiality

The manufacturer of supplies is entrusted with one of the franchise system's most valuable assets: the brand's product specifications. Often, a manufacturer is also directly or indirectly privy to other highly proprietary aspects of the franchisor's business plan. Manufacturers source materials for new product testing and enter into purchase agreements for future marketing events and limited time offers. Depending on the nature of the franchise supply chain, manufacturers (and distributors) may also be aware of product profit margins and sales volumes by product, either regionally or nationally. Should the franchisor employ master vendor agreements and enter into long term relationships with its suppliers, the likelihood that the vendor will become privy to confidential information becomes even greater.¹³⁰ Accordingly, as part of the vendor agreement, the franchisor and the supplier should enter into an agreement in which the supplier agrees to maintain all confidential and proprietary information of the franchisor. Franchisor information typically subject to such an agreement may include lists of

¹²⁸ FOLEY & LARDNER, *supra* note 123, at 2116.

¹²⁹ *Id.* at 2117.

¹³⁰ *Id.* § 2.24A.

vendors, products, recipes, formulas, specifications, food preparation procedures, devices, techniques, plans, financial information, forecasts, advertising and pricing.

6. Level of Commitment: Requirements Contracts

If, as discussed above, the franchisor opts to employ a long-term master vendor agreement with multiple purchase orders, it is generally optimal to structure such agreements as requirements contracts. A requirements contract, within the meaning of the Uniform Commercial Code,¹³¹ is an agreement in which the supplier is required to sell and the franchisor to purchase all of the franchisor's requirements for a particular product.¹³² While vendors will often push franchisors for specific volume commitments (typically in return for promised reductions in unit prices), it is recommended that no guarantee of purchase volume be provided. Instead, it is preferable to provide the vendor with a forecast based on historical sales, making clear that the franchisor is making no representation or warranty regarding the amount of products that will be purchased by the franchisor. Further, the vendor should specifically acknowledge to the franchisor that future volumes can vary substantially depending on market conditions, product eliminations, promotional activities, new product introductions and other factors that cannot be foreseen. A franchisor can further circumscribe its commitment to the supplier by limiting its requirements to those of one or more regional distribution centers assigned to the vendor. The franchisor should also reserve the right to add, delete or reassign the distribution centers assigned to the vendor, and make clear that the franchisor has no obligation to make up any volume to the supplier resulting from such changes.

This is not to say that the franchisor may disregard the forecasted volume it provides to the vendor carte blanche. Under the UCC, such forecasts must be made in good faith, and "no quantity unreasonably disproportionate to any stated estimate or, in the absence of a stated estimate, to any normal or otherwise comparable prior output or requirements, may be tendered or demanded."¹³³ Therefore, the franchisor should attempt to forecast its needs as accurately as possible and advise the vendor if its anticipated requirements are likely to change.¹³⁴

7. Risk of Loss, Pricing and Payment Terms

When a master vendor agreement is employed, the specific price and payment terms for any given purchase are typically specified in each applicable purchase order. The franchisor should seek to obtain a price based on F.O.B. destination, rather than F.O.B. shipping point. By specifying F.O.B. destination, the franchisor shifts the risk of loss to the vendor until the goods reach the destination specified. Conversely, if the price is quoted as F.O.B. shipping point, the risk of loss shifts to the franchisor at the point of the place of shipment, *i.e.*, the vendor's facility. If the franchisor is employing single source distribution, the F.O.B. destination would typically be the regional distribution warehouse.

¹³¹ As franchise supply arrangements typically involve the sale of goods, the Uniform Commercial Code ("UCC") forms the backdrop for vendor agreements. Article 2 of the UCC governs the sale of goods.

¹³² See UCC § 2-306(1).

¹³³ *Id.*

¹³⁴ FOLEY & LARDNER, *supra* note 123, at 2116.

When purchasing critical supplies with limited manufacturers, the franchisor should seek to lock in a fixed price for the term of the purchase order, without any additional charges for taxes or other fees. Consistent with delivery F.O.B. destination, the franchisor should also not be required to make any payment until a fixed period after delivery, rather than upon the date of shipment, and the franchisor should seek a credit limit in an amount sufficient to allow the purchase of all of the products covered by the individual purchase order.

Finally, a franchisor should seek a warranty from the supplier to provide “most favored nation” pricing. As generally understood, a most favored nation contractual provision is a representation or warranty by a vendor that the prices, net of all discounts, for any products provided by the vendor to the franchisor shall not be greater than those prices currently being charged to any other customer of the vendor for similar items purchased in substantially equal amounts. If the vendor reduces its pricing to any other customer for such items during the term of the vendor agreement, the vendor agrees to also reduce the prices for the products supplied to the franchisor. Again, in an era of extreme price volatility, such a most favored nation provision can be extremely helpful in allowing the franchisor to deliver goods and services to its franchisees at the most competitive price possible.

8. Warranties and Representations

Any discussion of warranties within a vendor agreement must be placed firmly within the context of the treatment of warranties within the UCC. The UCC addresses warranties relating to the quality of goods and warranties relating to title and infringement.

With respect to quality, warranties may be either express or implied.¹³⁵ Express warranties arise when the seller describes the goods in words, provides a sample or makes promises regarding the quality of the goods.¹³⁶ Simply by supplying goods to the specification of the franchisor, a vendor will typically be deemed to have made an express warranty that the goods meet such specifications.¹³⁷ Unless specifically excluded, the vendor, as a “merchant,”¹³⁸ also makes an implied warranty that the goods sold are “merchantable,” *i.e.*, that the goods would pass without objection as being the goods described.¹³⁹ Finally, an implied warranty of fitness for a particular purpose arises when the seller knows about the purpose for which the buyer is purchasing the goods, and the buyer is relying upon the seller’s expertise in supplying the goods.¹⁴⁰

¹³⁵ See generally Patrick J. Maslyn & W. Andrew Scott, *Contractual and Business Aspects of Structuring Supplier Agreements*, 30th Annual Forum on Franchising, at 12 (discussing in detail the express and implied warranties applicable to supply contracts).

¹³⁶ UCC § 2.313(1).

¹³⁷ Maslyn & Scott, *supra* note 135.

¹³⁸ UCC 2-104(1) “Merchant” means a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction, or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.”

¹³⁹ UCC § 2-314(1).

¹⁴⁰ UCC § 2-315.

With respect to title and infringement, under the UCC the seller warrants that he has good title to the product and may transfer it free of an lien or encumbrance.¹⁴¹ Merchant sellers also warranty that the goods do not infringe on the property rights of other sellers.¹⁴²

While the UCC provides buyers broad protection, it is recommended that the vendor contract specify the warranties the parties intend to provide and receive.¹⁴³ For example, with respect to quality, the contract should specify that the vendor will deliver goods that conform to the buyer's specifications and are free of defects and fit for their intended use. The contract should also include specific warranties relating the type of goods being purchased. For example, in the case of a food franchise, the buyer will want warranties that the goods are not adulterated or misbranded within the meaning of applicable laws such as the Federal Food, Drug and Cosmetic Act¹⁴⁴ and the Poultry and Poultry Products Inspection Act.¹⁴⁵

The franchisor should also seek warranties regarding the vendor and its operations. For example, the vendor should warrant that it is in good standing in all jurisdictions in which it conducts business, and that it is in compliance with all applicable laws. When the consumer of the goods is not the direct purchaser of the goods, as is nearly always the case within the context of the franchise supply chain, the vendor contract should also state that all warranties survive delivery of the product and run to the ultimate consumer, notwithstanding that the consumer has no contractual privity with the vendor.

Finally, to remove any doubt raised by the specification of warranties with the vendor agreement, the supplier should warrant that it is not disclaiming any express or implied warranty with respect to the goods sold.

9. Reporting, Product Recall and Indemnification

Having required the vendor to warrant the merchantability of the goods and the vendor's compliance with all applicable laws, it is helpful to include a provision within the vendor agreement in which the vendor advises the franchisor should it fail to satisfy its warranties. The vendor should agree to immediately advise the franchisor of any problems related to the goods or the facility in which they are manufactured including labeling issues, product contamination, manufacturing or packaging errors, or any other action or omission that could impact the safety, efficacy or salability of the goods, along with the corrective actions being taken. The vendor should also advise the franchisor of regulatory action or inspections involving its facilities or goods, and the remedial action taken by the vendor in response.

If any of the goods are subject to a product recall or seizure, or if any governmental agency requests or suggests a product recall, the vendor should agree to comply with the franchisor's product recall procedures, which should be attached and incorporated into the vendor agreement by reference. While the nature of the product recall procedures will vary

¹⁴¹ UCC § 2-312(1).

¹⁴² UCC § 2-312(3).

¹⁴³ FOLEY & LARDNER, *supra* note 123, at 3016.

¹⁴⁴ 21 U.S.C. § 301 *et seq.*

¹⁴⁵ 21 U.S.C. § 451 *et seq.*

considerably depending on the nature of the franchise system, all franchisor recall procedures are designed to protect the health and safety of the franchisor's consumers, ensure franchisor compliance with all laws, and minimize exposure to liability. In instances in which a recall has not been mandated by a government agency, such procedures also establish benchmarks for when the franchisor or its vendors should initiate a product recall, including identification of the problem, implementation of product retrieval, and termination of the recall.

In the event of a product recall, the vendor should agree to be solely liable and to indemnify the franchisor for all costs associated with the recall, including (i) notification of distributors, franchisees and consumers, (ii) freight charges associated with product retrieval, and (iii) counsel and advisor fees associated with the recall. The vendor should also agree to replace recalled products free of charge, or, in lieu of replacement, refund the purchase price. In the event the vendor is unable or unwilling to provide replacement products to the franchisor's specifications, the franchisor should be allowed to obtain replacement products from other suppliers, and the vendor should agree to be liable for the additional expense associated with obtaining the replacement products (*i.e.*, cover damages). Further, in a business arena in which even a successful product recall can cause lasting damages to the franchisor's brand, the vendor should agree that neither the vendor nor the franchisor will make statements to the press or the public without first consulting the other.

Finally, whether or not a product recall is initiated, the franchisor should seek broad indemnification from the vendor with respect to any liability resulting from the goods being purchased.¹⁴⁶ For example, the vendor should indemnify the franchisor for any damages or loss resulting from the products being purchased. The vendor should indemnify the franchisor for any breach of warranty or of the contract, as well as any losses resulting from the willful or negligent acts of the vendor or its agents. Lastly, the franchisor should seek indemnification from the vendor for any product liability resulting from the goods sold.

VIII. CONCLUSION

A company that is supported by a systematic and strategically coordinated supply chain has significant competitive advantages over its competitors. This truism applies to both franchise and non-franchise systems alike.

In the franchise context, supply chain performance allows franchisees to depend on the reliable delivery of inventory, supplies and other materials that are both essential for the franchisee's operations and uphold brand standards. In order for a franchisor to optimize a supply chain's efficiency and responsiveness to the needs and requirements of chain participants including the supply chain's ultimate customer, the franchisee, the franchisor must capture and integrate a vast amount of knowledge. This knowledge ranges from its own communication of specifications to chain participants, to managing the raw materials providers, transporters, warehouses, and intermediate handlers who mix or assemble raw materials, and to ensuring efficient order management and the timely distribution of finished, mixed or assembled goods to each individual franchisee. Additionally, the franchisor must have the expertise to measure the performance of the various supply chain drivers and strategically forecast and plan not just with respect to future production needs, but also about whether to enter a new market or exit from an existing market and how best to address competition.

¹⁴⁶ See FOLEY & LARDNER, *supra* note 123, at 3019 (itemizing the losses for which indemnification should be sought).

Even if the franchisor outsources supply chain management, the franchisor must still monitor competitive, financial and other fluctuating variables and adjust supply relationships appropriately to ensure that its franchisees receive maximum value from the outside supply chain manager. To accomplish these ends and guaranty that the consumers' experience with the brand remains consistent with the franchisor's uniform operating methods and quality standards, a franchisor must exert considerable control over the supply chain's constituents. Information technology today allows companies to capture data and combine and process data flowing from disparate chain participants into useful reports, and communicate information inexpensively and rapidly to other companies in the supply chain that depend on the real-time information to perform their own functions. This includes data such as demand forecasts, inventory status, production capacities, transportation and delivery schedules, sales promotions, new product specifications and designs, order processing, customer feedback, competitor intelligence, and market trends.

The sophistication of a franchise system's supply chain management will likely develop as the franchise system matures and grows in size. A nascent franchise system's involvement in supply chain functions may be limited to issuing product specifications and approving third party suppliers that individual franchisees select in their local markets. A mature franchise system's supply chain management may be highly integrated and coordinated and extend not only to designating specifications for all elements of operations, but also to designating all suppliers or serving as the exclusive supplier to the system.

Existing franchisees likely have their own opinions as to the relative value of sourcing controls. When sourcing controls yield no economic upside for franchisees, or, even worse, when franchisees perceive no purpose in sourcing controls other than to guaranty the franchisor another stream of revenue from the franchise relationship, then sourcing controls can be a highly divisive issue within a franchise network. Even if supply chain management improves the efficiency of inventory procurement, it may be difficult for franchisees to see past the profits that their franchisor is able to reap from by being able to force (contractually speaking) a captive audience of franchisees to buy all of their requirements from the franchisor's designated sources, which may be the franchisor or its affiliate. When franchisees perceive that purchasing controls leave them victims of franchisor opportunism, it is especially hard for franchisees to see any of the benefits that flow from sourcing controls, which range from maintaining quality control standards and ensuring on-going product availability, competitive pricing and brand protection, to saving franchisees time otherwise spent on inventory procurement and curtailing opportunistic free-riding by other franchisees in the system.

Differences in perceptions about the virtues of sourcing controls may be attributed to the fact that franchisors and franchisees have divergent economic interests that are nevertheless highly interdependent. Supply chain issues are so complex that prospective franchisees, especially less sophisticated ones, may not know how to value a franchise network with a highly efficient supply chain. As for the legal risks arising from sourcing controls, these appear to be significantly curtailed through diligent pre-sale disclosures that are consistent with the franchisor's past and current practices.

ROCHELLE SPANDORF

Rochelle Spandorf, a Certified Legal Specialist in Franchise and Distribution Law in California, is a partner with the national law firm of Davis Wright Tremaine LLP in its Los Angeles office. She has more than 30 years of experience representing franchisors, manufacturers, licensors, and suppliers in their domestic and international expansion and strategic development. She works with clients in diverse industries, from start-up concepts to mature public companies, in helping them structure domestic and international franchise, licensing, dealer and distribution programs. She helps numerous franchise companies comply with franchise sales laws by preparing disclosure documents, franchise contracts and financial performance representations. She counsels manufacturers, suppliers and franchisors on a broad array of operating issues ranging from contract enforcement to trademark protection, relationship disputes, antitrust and pricing matters, terminations and transfers, and mergers and acquisitions. She also advises product manufacturers, suppliers and licensors on possible alternatives for structuring distribution networks so they are not regulated as franchises. Ms. Spandorf is nationally ranked by Chambers USA as one of the nation's leading franchise attorneys. She also has the distinction of being the first woman to chair the American Bar Association's Forum on Franchising, the nation's leading franchise law association. She has twice served as chair of the California State Bar Franchise Law Committee and currently serves on the California State Bar Board of Legal Specialization Committee for Franchise and Distribution Law. She is a frequent speaker and author on franchise topics for numerous professional organizations. She graduated from the Washington University School of Law and Cornell University with distinction.

CHESLEY K. "BUD" CULP III

Bud Culp is a partner in the Denver, Colorado law firm of Moye White LLP, where he is a member of the firm's Franchise and Distribution Practice Group. Bud has extensive experience in reviewing, structuring and drafting agreements for franchise, licensing and distribution relationships and in regulatory compliance. Bud is also a skilled litigator who has tried, arbitrated and mediated franchise disputes involving system compliance, protection of trademarks and trade secrets, class actions and antitrust issues.

Prior to rejoining Moye White in 2009, Bud was Vice President and Assistant General Counsel for Quiznos Sub, at which Bud managed all of Quiznos North American litigation and served as lead counsel for Quiznos Canada Restaurant Corporation.

Bud has a B.A. from the University of Colorado (Phi Beta Kappa, with distinction), and a J.D. (cum laude) from Harvard Law School.

Phone: 303 292 7958

Fax: 303 292 4510

Email: bud.culp@moyewhite.com