



# Supply Chain Management in Franchise Systems Legal Risks and Strategies for Compliance

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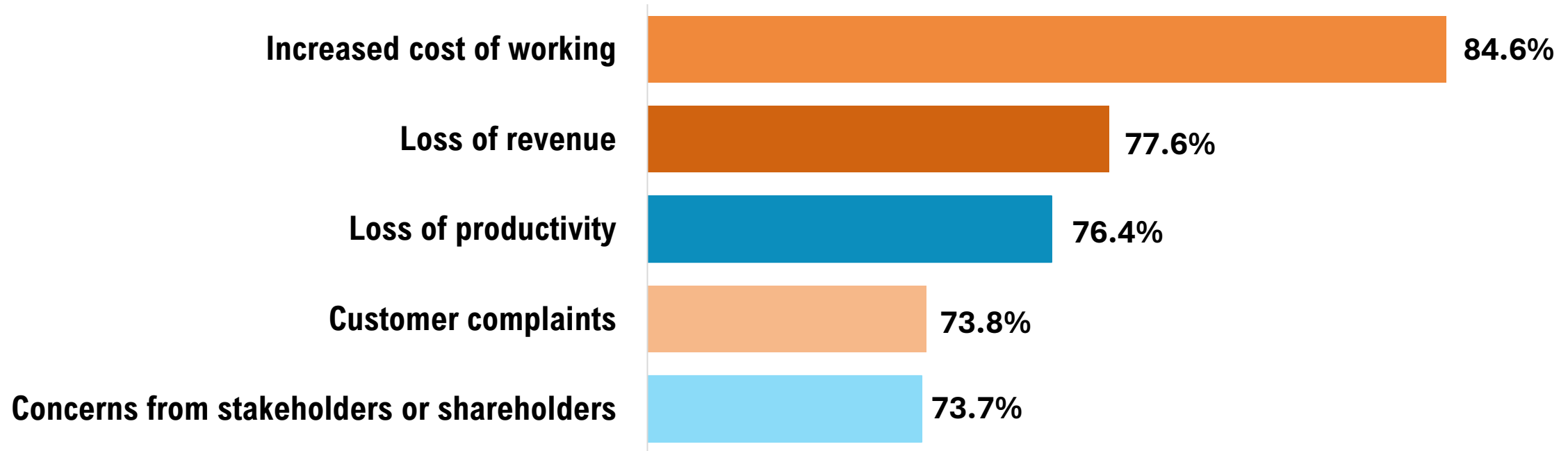
# AGENDA

- Franchise Supply Chain Models
- Legal Challenges in Managing Supply Chains in a Franchise System
- Business Challenges in Managing Supply Chains in a Franchise System
- Role of Distributors in a Franchise Supply Chain
- Best Practices
- Tariffs and Tariffs and Tariffs....Oh My!!

# WHAT IS THE SUPPLY CHAIN????

The network of organizations, people, activities, information and resources involved in the sourcing, procurement, production, transportation, and distribution of goods and services from suppliers to end customers.

# HOW ORGANIZATIONS SUFFER WHEN IT COMES TO DISRUPTIONS IN THEIR SUPPLY CHAIN



Source: <https://www.thebci.org/resource/bci-supply-chain-resilience-report-2023.html>





# Franchise Supply Chain Models

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# FRANCHISE SUPPLY CHAIN MODELS

- **Franchisor-Managed Supply Chains**

- Franchisor is the central coordinator of supply chain decisions and directly oversees sourcing, vendor relationships, quality standards, and distribution strategies on behalf of the system, either directly via captive supply, or through third-party suppliers and distributors

- **Franchisee Purchasing Cooperative-Managed Supply Chains**

- Franchisees collectively manage procurement through a separate legal entity owned and controlled by the franchisees

# FRANCHISOR-MANAGED SUPPLY CHAINS

## BENEFITS

- Allows the system to achieve economies of scale and decrease costs
- Centralized management and control, with the ability to streamline logistics across the system
- Autonomy and swift decision-making capabilities

## CHALLENGES

- Disputes and pushback over supplier income
- Potential for increased tension between franchisor and franchisees
- Difficulty to accommodate local market needs

# FRANCHISEE PURCHASING COOPERATIVE- MANAGED SUPPLY CHAINS

## BENEFITS

- Allows the system to achieve economies of scale and decrease costs
- Time savings for the franchisor and franchisees
- Potential for increased franchisee confidence in pricing and sourcing decisions

## CHALLENGES

- Requires support of franchisees and the franchisor
- Complex organizational and operational governance
- Potential delays in decision making



# SUPPLY CHAIN MODEL SELECTION CONSIDERATIONS

- Size and complexity of the franchise network
- Relationship between the franchisor and franchisees
- Size and sophistication of the franchisor
- Size and sophistication of the franchisees
- Desired level of oversight and control



# Legal Challenges in Managing Supply Chains in a Franchise System

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# LEGAL CHALLENGES – TRANSPARENCY ISSUES

## FDD Item 8 Disclosure – Restrictions on Sources of Products and Services

Requires franchisors to disclose:

- any obligations placed on franchisees regarding the sourcing of goods and services related to establishing or operating the business, and whether the franchisor or its affiliates are approved suppliers or the only approved suppliers of such goods or services
- whether the franchisor issues specifications and standards to franchisees or approved suppliers
- whether the franchisor receives revenue or other material consideration (e.g., rebates, commissions, or other payments) from suppliers based on required purchases or leases by franchisees, and the franchisor's revenues from all required purchases and leases of products
- the existence of purchasing or distribution cooperatives

# LEGAL CHALLENGES – REGULATORY COMPLIANCE

- Environmental, Social and Governance (ESG) considerations
  - California Transparency in Supply Chains Act
  - European Union Corporate Sustainability Due Diligence Directive
  - SEC's climate disclosure rules
- Fair Labor Standards Act
- Occupational Safety and Health Administration
- Trade and Transportation Laws
- Industry-Specific Regulatory Compliance
  - Food and Drug Administration (FDA), United States Department of Agriculture (USDA) Global Food Safety Initiative (GFSI), etc.



# LEGAL CHALLENGES – CONTRACT DRAFTING AND NEGOTIATION

A well-drafted supply chain agreement must not only secure favorable pricing, it must also ensure an adequate amount of protection for the franchise system.

- Regulatory Compliance
- Quality Control
- Indemnification and Insurance
- Limitation of Liability
- Dispute Resolution



# Business Challenges in Managing Supply Chains in a Franchise System

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# BUSINESS CHALLENGES – BALANCING FRANCHISOR CONTROL AND FRANCHISEE AUTONOMY

- Tug-of-war between franchisor mandates and franchisee flexibility
  - Customer expectations demand uniformity
  - Supply chain realities and franchise location may elicit pushback against strict requirements
- Consider some ways to promote buy-in:
  - Volume discounts and rebates
  - Communicating the why??
  - Franchisee advisory councils
  - Identifying areas for flexibility in non-essential items

# BUSINESS CHALLENGES – CONTINUITY OF SUPPLY AND RISK MITIGATION

- Supply chain disruptions are unavoidable, so contingency planning is critical
  - Requiring inventory buffer or bank builds
  - Diversification versus sole-source supply
  - Force majeure protections and “Plan B”





# Role of Distributors in a Franchise Supply Chain

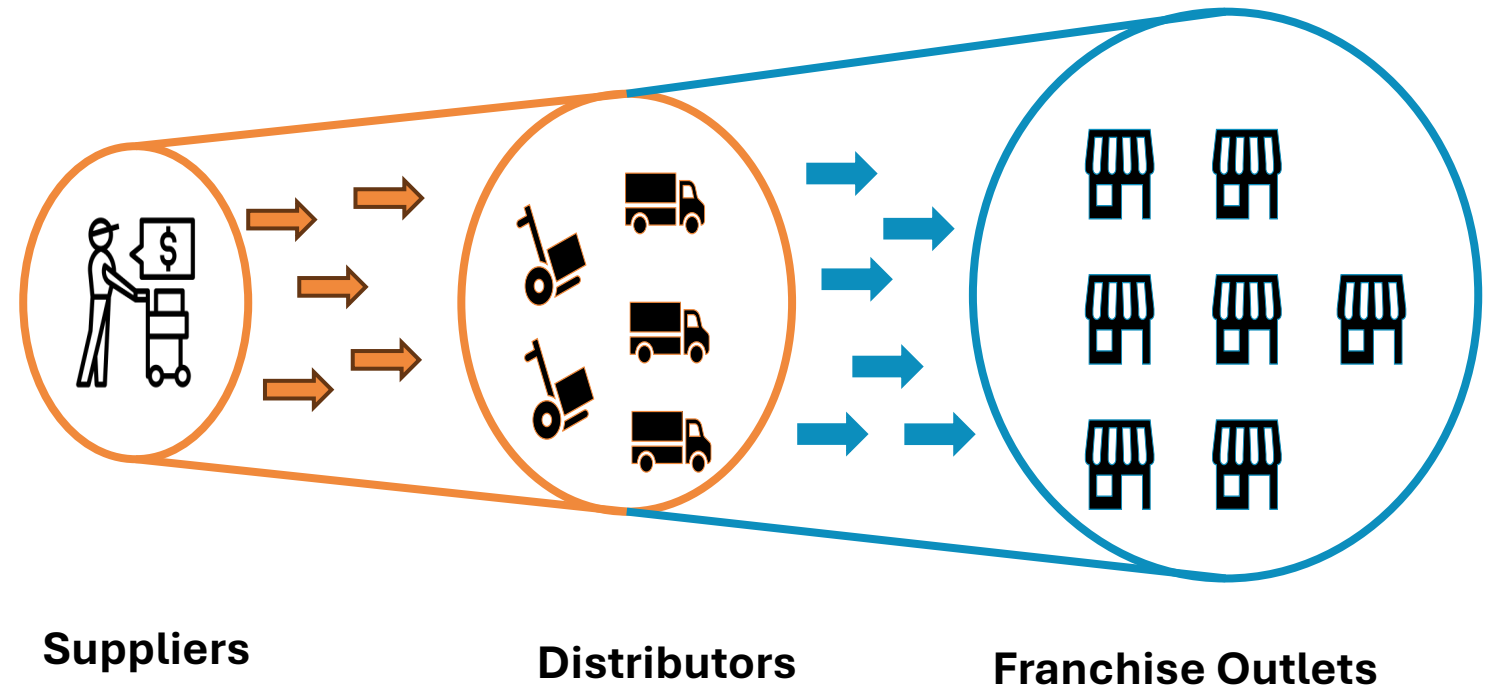
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# ROLE OF THE DISTRIBUTOR IN THE FRANCHISE SUPPLY CHAIN

- Manages the flow of products from approved suppliers to the franchise outlets
- Sizes vary from local or regional distributors that have more limited operational capacity, to broadline distributors that can service an entire franchise system



# MANAGING THE RELATIONSHIPS BETWEEN DISTRIBUTORS, SUPPLY CHAIN MANAGERS, AND FRANCHISEES

**Supply Chain Managers** – typically oversee distributor selection, performance and compliance with system standards, and contract directly with distributors through agreements that govern the sourcing and distribution of products to the system

**Distributors** - source approved products from authorized suppliers and manage inventory to meet franchise outlet needs

**Franchisees** – submit orders to distributors and rely on them for timely and accurate product deliveries



# DISTRIBUTOR CHALLENGES IN FRANCHISE SUPPLY CHAINS

The complexity of franchise networks can present a unique set of challenges on distributors that can strain distributor performance and leave distributors caught in the middle between requirements of the supply chain manager and the individual demands of the franchisees, including:

- maintaining an infrastructure capable of serving a customer base of varying sizes, operational capabilities and locations
- lack of a direct contractual relationship with franchisees
- balancing the desires and expectations of the supply chain manager with those of the individual franchisees
- complying with uniform service level requirements that may not reflect the realities of serving diverse franchise locations





# Best Practices

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# BUILD CLEAR AND BALANCED DISTRIBUTION AGREEMENTS

- Clearly define the obligations of all parties
- Incorporate terms that reflect real-world operational challenges that are specific to the franchise system
- Set realistic data-driven service level requirements that reflect the system's variability and any operational constraints of the distributor

# FOSTER FRANCHISEE INPUT AND TRANSPARENCY IN DISTRIBUTION DECISIONS

- Prioritize transparency and communication in managing distributor relationships
  - Volume rebates
  - Service commitments
  - Pricing
- Seek to create structured opportunities for franchisees to provide input on distributor selection and performance
- Establish clear communication channels
- Foster collaborative problem-solving

# DESIGN COLLABORATIVE PERFORMANCE MONITORING SYSTEMS

- Implement data-driven systems to monitor distributor performance against service level requirements that is accessible to all involved parties
- Routinely monitor and measure performance
- Create clear escalation processes and dispute resolution mechanisms to address performance failures



# PROVIDE FLEXIBILITY FOR LOCAL AND ALTERNATIVE SOURCING IN DEFINED CIRCUMSTANCES

Consider allowing for some level of controlled flexibility to address the need for local sourcing options, while still protecting brand standards - particularly in rural areas, or in response to performance failures

# CONTRACTING BEST PRACTICES

- Key elements of a strong supplier agreement:
  - Well-defined scope of supply, including quality and delivery standards
  - Delivery targets and related penalties
  - Performance metrics and consequences
  - Dispute resolution mechanisms – consider escalation, mandatory non-binding mediation and arbitration
- Transparency in pricing and rebates
- Flexibility in the event of supply chain disruptions

# FOSTER COLLABORATION BETWEEN LEGAL AND BUSINESS TEAMS

- Legal has a role in ensuring compliance and mitigating risk without saying “no”
- The supply chain should be driven by the business team’s goals, but within the legal framework agreed to by the parties
- Many companies develop playbooks for common supply chain and contracting challenges so that the business team can act quickly without seeking legal approval each time

# FOSTER A POSITIVE RELATIONSHIP BETWEEN THE FRANCHISOR AND FRANCHISEES

- Well-defined rights for franchisees to use their own suppliers or distributors is critical
- Certain approval mechanisms can be developed to allow greater flexibility within the overall framework, but the franchisor will want to retain broad flexibility to manage the supply chain
- Supplier income restrictions should be clearly defined as well





# Tariffs and Tariffs and Tariffs...Oh My!!

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# Force Majeure and Commercial Impracticability as Defenses to Performance

- These are not a square fit even though you may see these notice flying across the supply chain
  - Force majeure is a creature of contract so it needs to be in the parties' contract
  - Commercial impracticability arises under UCC 2-615
- Both defenses are where performance is prevented; not just where it is more expensive
- These doctrines do not provide a mechanism for obtaining price increases

# Limited Case Law Precedent

- Courts have consistently rejected arguments that tariff-related price increases excuse performance under force majeure or commercial impracticability
- Only one court accepted a price increase of 572% constituted commercial impracticability *Aluminum Co. of America v. Essex Group, Inc.* (W.D. Pa 1980) – but this also involved a customer windfall that was not being passed onto the sub-supplier
- Courts rarely excuse performance based on government actions unless they fundamentally alter contractual obligations
- Even bankruptcy or insolvency do not excuse performance unless contract becomes objectively impossible to perform under current financial conditions

# Protections for Future Contracts Against Tariffs

- Some broader provisions:
  - “Change in Law” Clause (more common in construction)
  - Economic Hardship Clause
  - Promise to engage in good-faith contract negotiations
- Contracts are unlikely to explicitly allocate tariff costs – why? Companies want to land the business.
- Will see more companies reserving the right to discuss pricing adjustments that were not in place at the time of the quotation





# QUESTIONS

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