

**International Franchise Association
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COMMISSIONS, REBATE, AND DISCLOSURE: OH MY

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I. Introduction

When the economy is good, and franchisees are profitable, the relationship between franchisors and franchisees is usually amicable. When times are tough, and tensions are running high, the relationship oftentimes becomes strained. Unfortunately, it is during these times that the prospect of litigation is highest and claims by franchisees against franchisors, in all sorts of shapes and sizes, get filed.

Given that there is a need for uniformity throughout a franchise system, it is not surprising that franchisors attempt to ensure uniformity through the selection of sole suppliers. It has become increasingly common, however, for franchisees, either in their individual capacities, or in the form of associations, to file claims against franchisors related to the franchisor's receipt of rebates from suppliers. This is especially true where franchisees are required to make purchases from companies designated as sole suppliers. Although sometimes these sole suppliers offer discounted prices which ultimately benefit franchisees, franchisees still take issue with franchisors deriving income from the franchisees' purchases.

Disputes between franchisees and franchisors over franchisors' requirements that supplies and materials be purchased either from the franchisor itself or a designated "approved" supplier appear to be increasing. Franchisees sometimes perceive that higher quality products could be purchased on the open market, and franchisees often sense that they're obliged to pay more than a fair market price due to constraints on their choice of suppliers and the rebates and commissions their franchisors collect. These concerns are an increasing driver of franchisee litigation and are attracting regulators' attention.

The claims that are asserted by franchisees against franchisors related to the franchisor's receipt of supplier rebates are limited only by the creativity of the attorneys representing the franchisees, but usually come in the form of lawsuits asserting breach of contract, breach of the implied covenant of good faith and fair dealing, fraud, violation of States' unfair trade practices acts, antitrust violations and sometimes even claims of racketeering. If the lawsuits are not quickly resolved through an early dispositive motion, the lawsuits can become very expensive, with significant exposure.

Franchisors must navigate between sometimes conflicting objectives. They want to ensure that franchisees use supplies and materials of an appropriate quality level even if these are expensive, and they often feel they are best qualified to objectively assess potential suppliers. Moreover, franchisors are under pressure to maximize their profitability, particularly if they have been acquired by Private Equity firms, and collecting rebates and commissions can be an important source of profit.

Yet franchisors also need to maintain high franchisee satisfaction with their system and retain franchisees' confidence that they operate with their interests in mind in order to promote the continued growth of their systems. They know that most franchisees want

to feel that they're running their own business and that mandatory constraints on supplier selection are at best disliked and at worst resented. And of course franchisors want to avoid litigation. Even the threat of litigation can detract from enterprise value when potential acquirers see a misalignment of interests between franchisor and franchisees that may trigger a class action lawsuit.

Navigating between these conflicting objectives can be difficult. Presumably, most franchisors think carefully about how far they can increase effective cost prices on required supplies (either by restricting approved sources of supply and/or by collecting rebates and commissions) without triggering significant discontent. But a few franchise brands have gone beyond this basic tradeoff analysis and taken major steps to reduce the potential for conflict.

The key to avoiding or fending off rebate-related claims is a well-drafted and robust Franchise Disclosure Document ("FDD") which clearly and unequivocally states that the franchisor will receive consideration from suppliers based on the purchase of goods and services by its franchisee. This paper focuses on the ways in which FDDs and related documents can be drafted in order to help insulate a franchisor from costly rebate-related lawsuits. The paper will also examine the various types of claims asserted by franchisees and will demonstrate how a well-drafted FDD or franchise agreement helps lead to the dismissal of claims. Moreover, this paper will discuss practical business practices that can help avoid disputes between franchisors and franchisees related to the franchisor's receipt of rebate payments.

II. Federal Regulations, State Regulations, and Proposed/Vetoed Bills

A. FTC Franchise Rule – FDD Item 8

Franchisors are required to provide certain information about their supply arrangements in their Franchise Disclosure Document ("FDD"), which is the document that the franchisor must provide to prospective franchisees prior to the sale of the franchise. The contents and format of the FDD are governed by the Federal Trade Commission's ("FTC") Rule on Franchising (the "Franchise Rule").¹ The FDD contains detailed information about the structure of the franchise system as well as financial information about the franchisor and/or its parents and affiliates. This information is intended to allow the prospective franchisee to make a fully informed decision as to whether to purchase the franchise and, therefore, it is incumbent upon the franchisor to ensure that it discloses all required information and that the information is accurate. The following is an overview of the federal disclosure obligations relating to supply arrangements that include a rebate, commission, or other material consideration to be paid to the franchisor or its affiliates.²

¹ 16 C.F.R. § 436.6(a).

² This paper does not address all disclosure obligations required under Item 8. For a more exhaustive analysis of Item 8 disclosure requirements the authors suggest the following resources: Abhishek Dube, Colin Krull, *Basic Track: Registration and Disclosure*, IFA 54th Annual Legal Symposium (2022).

1. Sourcing Restrictions

A franchisor's supplier arrangements may have to be disclosed in several ways throughout the FDD; however, the most likely location for this information is in Item 8.³ This Item specifically requires franchisors to disclose the franchisee's obligations to purchase or lease goods and services from designated suppliers. Examples of such goods and services include but are not limited to supplies, fixtures, equipment, inventory, computer hardware and software, real estate and other purchases related to establishing or operating the franchised business.⁴ The franchisor is permitted to broadly describe the categories of goods and services that are subject to sourcing restrictions; the Franchise Rule does not mandate disclosure of each product the franchisee is required to purchase or lease, or the product specifications with which the franchisee must comply and franchisors typically view that information as proprietary or trade secret. The franchisor is not required to disclose information about goods or services the franchisee may purchase from any source unless the franchisor or its affiliate is the *sole* source for the item. This situation often arises when the franchisor or its affiliate sells proprietary products to the system.⁵

Many franchisors require franchisees to purchase certain goods and services from suppliers approved by the franchisor.⁶ If the franchisor imposes such a sourcing restriction, then the Franchise Rule requires the franchisor to also disclose: (i) whether it has a process for approving alternative suppliers, and (ii) whether any officer of the franchisor owns an interest in a required supplier.⁷ While some franchisors are open to approving any supplier that meets their standards (which they may or may not share with franchisees), many franchisors want to limit the number of approved suppliers for the system. From the franchisor's point of view, having a limited number of approved suppliers is beneficial because it (i) provides reliable, consistent sources of products and services, (ii) reduces costs by allowing the franchisor to leverage the systems' purchasing power when negotiating with suppliers, (iii) ensures quality, safety, and consistency of supplies distributed across the system, which in turn helps enhance the customer experience, protect the brand, and drive revenue. Franchisees tend to view sourcing

³ If the franchisor discloses information regarding a required purchase or lease in Item 5 or 6, it does not need to repeat this information in Item 8.

⁴ 16 C.F.R. § 436.5(h). See also Fed. Trade. Comm'n, *Franchise Rule Compliance Guide*, (May 2008), www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf (hereinafter, the "Compliance Guide").

⁵ Andrew P. Beilfuss, Jess Dance, Jason C. Williams, *Running on Empty: Dealing with Supply Chain Issues*, ABA 43rd Annual Forum on Franchising (2020), at 5 citing FTC *Statement of Basis and Purpose and Regulatory Analysis*, 72 Fed. Reg. 15,486, (March 30, 2007) (to be codified at 16 C.F.R. pts. 436-37) (hereinafter "Statement of Basis and Purposes"), at 6.

⁶ Loh, *infra* note 10, at 5. "The greater purchasing power and leverage from an approved supplier relationship can also result in a more tailored and reliable source of supply than might be the case for a single franchisees purchasing on its own. An approved supplier should be more knowledgeable about the franchisor's system and might be able to anticipate needs or product developments to benefit the system. A preferred supplier might be able to give the franchise system priority for delivering in times or product shortages." *Id.*

⁷ Compliance Guide, *supra* note 16, at 53 (defining "officer" to include any person with management or policy making authority and "interest" to include any percentage of direct ownership from which the officers derives income or other financial benefit); see also, Gina Romo, R. James Straus, Suzanne Trigg, *Building an Effective Supply Chain and Distribution System*, ABA 35th Annual Forum on Franchising (2012) (addressing issues regarding proprietary items).

restrictions, especially when they apply to a substantial portion of the goods and services the franchisees must purchase, as a serious burden and potential risk. The Item 8 disclosure requirements promulgated by the FTC were intended to address this potential point of conflict by requiring the franchisor to provide a base level of transparency regarding the extent of their sourcing restrictions, so that the prospective franchisee can make an informed decision prior to purchasing the franchise.⁸

2. Revenue And Other Material Benefits

In addition to disclosing the existence of sourcing restrictions, the franchisor must also disclose whether it or its affiliates will derive “revenue or other material benefits” from franchisees’ required purchases or leases. It is common practice, especially in sophisticated franchise systems, for the franchisor to negotiate system-wide supplier agreements and suppliers frequently offer benefits to incentivize the franchisor to enter these relationships. For franchisors, the benefits provided by suppliers offer a welcomed alternative revenue stream, which can be essential in systems where the franchisor must cover the overhead for administering the supply chain on behalf of the system.⁹ Unsurprisingly, franchisees may view the franchisor receiving benefits from a supplier with suspicion. As other commentators have noted, “The pitfalls of a supply arrangement are thus rooted in the negotiations process: suppliers desire the security of participating in a franchising supply arrangement, franchisors desires vendor rebates to sweeten the pot, and, without a seat at the table, franchisee interests—at times—slip into an afterthought.”¹⁰ At its core, franchising is a symbiotic relationship and franchisors are motivated on some level to maximize profits for their franchisees. However, even if the franchisor’s receipt of revenues or supplier benefits is completely above board, the optics of an inherent conflict of interest remain and this frequently leads to conflict between the franchisor and franchisee.

The disclosure requirement regarding “revenue or other material benefit” appears deceptively simple, but can encompass a broad universe of information. The term “material benefits” is not limited to rebates and “may include cash, volume discounts, kickbacks, rebates, or vendor contributions to the marketing fund.”¹¹ This disclosure

⁸ Beilfuss, *supra* note 5, at 5 citing *FTC Statement of Basis and Purpose and Regulatory Analysis*, 72 Fed. Reg. 15,486, (March 30, 2007) (to be codified at 16 C.F.R. pts. 436-37) (hereinafter “Statement of Basis and Purposes”); *see also*, Loh, *infra* note 10, at 6 (noting “While vendor rebates are only a small component of a franchise supply arrangement, they are a major point of contention among franchisees and franchisors. Utilizing rebates in ways franchisees deem inappropriate can lead to major disputes between the parties.”).

⁹ *See* Loh, *infra* note 10, at 2.

¹⁰ Peter L. Loh, Ronald T. Coleman, Timothy Comer, Joseph Goode, and Mikaela R. Mitcham, *Supply Arrangements and Rebates: Franchisor’s Rights vs. Franchisee Revolts*, IFA 54th Annual Legal Symposium (2022); *see also*, Ramsey, *infra* note 11 at 19 (“There are many forms of supplier income, but all supplier income has either the actual or perceived effect of operators paying more for goods and services than they would in the absence of supplier income.”); Romo, *supra* note 7, at 3 (noting that franchisors “may receive various benefits from [their] supply chain, such as annual or other periodic payments from suppliers, up-front payments from suppliers or distributors (*i.e.*, an “exclusivity fee” or “sourcing fee”), contribution to marketing (such a through co-branding) or discounts for purchases made by company outlets.”).

¹¹ Beilfuss, *supra* note 5, at 8; *see also* David B. Ramsey, Curtis S. Gimson, Robert G. Huelin, *Supply and Demand: How to Negotiate Supplier and Distributor Agreements and Work with Franchisees Regarding Their Implementation*,

includes benefits the franchisor or its affiliate receive from a supplier based upon franchisees' required purchases or leases, as well as revenue the franchisor or its affiliates receive from selling goods and services directly to franchisees. Importantly, this disclosure includes both the benefits that the franchisor or its affiliate currently receives as well as benefits they *may receive in the future*. Thus, even if the franchisor does not currently receive benefits subject to disclosure, the best practice is to nonetheless state in Item 8 that the franchisor reserves the right to receive such benefits in the future so that the prospective franchisee is aware of this potential change.¹² An accompanying reservation of rights should also be included in the franchise agreement.

If the franchisor or its affiliates receives direct revenue or supplier benefits subject to disclosure, then the franchisor must disclose the "precise basis" for receiving the revenue or benefits as well as: (i) the franchisor's total revenue, (ii) the franchisor's revenue from all required purchases or leases by franchisees, (iii) the percentage of the franchisor's total revenue that comes from franchisees' required purchases or leases, and (iv) the revenue received by the franchisor's affiliates from franchisees' required purchases or leases.¹³ The franchisor may disclose the benefits received as a percentage or a flat dollar figure on an aggregate basis. Importantly, the franchisor does not need to disclose this information for each supplier specifically and best practice is to avoid providing information at such a granular level in order "to preserve confidentiality of supply deals... as this provides a competitive advantage to the franchisor and may cause issues to the supplier if it has deals with others that are not as generous."¹⁴ Franchisors frequently include language in Item 8 expressly stating that they have the right to receive various categories of supplier benefits and to earn a profit on the sale of goods and services to franchisees. While this may not come as welcome news to a prospect, it does serve to mitigate any risk of confusion down the road.

When the franchisor exerts control over the systems' supply chain, and especially in instances where the franchisor or its affiliates receive revenue, rebates, or other consideration because of required franchisee purchases or leases, an inherent tension can arise between the franchisor and its franchisees. As noted above, the FTC intended for the required disclosure in Item 8 to force the franchisor to be transparent about its practices so that prospective franchisees can make an informed decision about purchasing the franchise; however, the reality is that despite the Item 8 disclosure requirements, franchisors must sometimes make some judgment calls regarding the level of transparency they want to provide in their Item 8 disclosures.¹⁵ As other commentators have noted, "A franchisor's decision [regarding] how much information it will disclose to

IFA 52nd Annual Legal Symposium (2019), at 20 (noting that there are "far more subtle forms of supplier income...and it is not necessarily the franchisor that is always the party benefitting from supplier income.").

¹² Beilfuss, *supra* note 5, at 7.

¹³ Compliance Guide, *supra* note 16, at 54.

¹⁴ Beilfuss, *supra* note 5, at 8.

¹⁵ Beilfuss, *supra* note 5, at 7. Item 8 also requires disclosure of rebates received by area representatives "to the extent the arrangement was set up by the franchisor or the franchisor otherwise knows about it." See, Lulu Gomez and Beata Krakus, *Drafting the FDD for Multiple or Otherwise Complex Offerings*, ABA 39th Annual Forum on Franchising (2018) citing NASAA, *Multi-Unit Commentary* (September 16, 2014), www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf, at A.R. 8.0.

its franchisees about income or benefits that it receives from suppliers often has a significant impact on the franchisee/franchisor relationship, particularly if the franchisees do not see that income or benefits are used for the good of the whole franchise system.”¹⁶ That being said, the penalties for incomplete or insufficient disclosure can be steep. As addressed later in this paper, Item 8 disclosures are a frequent source of franchisee litigation and may subject the franchisor to enforcement actions by federal or state regulators.

B. State Disclosure Laws/Prohibitions Relating to Supply Arrangements

Fourteen states (the “Registration States”) have enacted laws that require franchisors to register its FDD with the state prior to engaging in franchise sales activity within the jurisdiction.¹⁷ Generally, the Registration States impose the same disclosure obligations as are required under the Franchise Rule; however, some states have additional disclosure requirements and/or prohibitions against certain supply chain practices by the franchisor. For example, Maryland explicitly requires additional disclosures in Item 8. Maryland’s regulations require franchisors to also disclose: (i) any affiliation between the franchisor and a supplier, (ii) if the supplier is affiliated with the franchisor, the cost to the seller of the items; (iii) the prevailing market price for the goods, and if none exists, an explanation as to why the market price cannot be determined, and (iv) the manner, if any, in which the franchisor or its affiliate under the terms of the franchise agreement ensures the availability of the goods.¹⁸ Indiana’s law prohibits franchisors from requiring goods, supplies, inventories, or services to be purchased exclusively from the franchisor or sources designated by the franchisor where such goods, supplies, inventories, or services, of comparable quality are available from sources other than those designated by the franchisor. This requirement does not apply to “the principal goods, supplies, inventories, or services manufactured or trademarked by the franchisor, leaving the franchisor free to publish a list of approved suppliers of goods, supplies, inventories, or services and to retain the ‘reasonable’ right to disapprove a supplier.”¹⁹

It is notable that when franchisees do challenge a franchisor’s supply chain practices and achieve favorable results, these court decisions can influence the manner in which state regulators review the FDD during the registration process. For example, in

¹⁶ Romo, *supra* note 7, at 3.

¹⁷ California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, South Dakota, Rhode Island, Virginia, Washington, and Wisconsin.

¹⁸ Md. Code Regs. 02.02.08.16(J); *see also* Ramsey, *supra* note 11, at 27 (citing IND. CODE tit. 23, art. 2, ch. 2.7, § 1(1)); *see also* HAW. REV. STAT. tit. 26 ch. 482E, § 482E-6(2)(B) (permitting franchisors to impose restrictions on suppliers if the restrictions are “justified on business grounds”). In addition to the Registration States, there are other states with statutes governing the relationship between the franchisor and franchisee and some of these states also have statutes limiting the franchisor’s control over the supply chain. *See, e.g.*, IOWA CODE tit. XIII, ch. 523H, § 523H.12(1) (requiring franchisors to allow a franchisee to “obtain equipment, fixtures, supplies, and services used in the establishment and operation of the franchised business from sources of the franchisee’s choosing,” though the franchisor is permitted to impose “standards as to [the] nature and quality” of required goods and services). The Iowa statute “provides an exception for restrictions applicable to reasonable quantities of inventory, goods or services that the franchisor requires the franchisee to obtain from the franchisor or its affiliates, in certain circumstances. Ramsey, *supra* note 11, at 27.

¹⁹ Ramsey, *supra* note 11, at 27 (citing IND. CODE tit. 23, art. 2, ch. 2.7, § 1(1)).

the wake of the decision in *Money Mailer v. Brewer*,²⁰ the authors have received anecdotal examples²¹ of regulators in Washington requesting detailed information about how franchisors determine the prices for items they sell directly to franchisees. This increased scrutiny evidences the ways in which litigation can influence and lead to increased scrutiny during the FDD registration process. It also serves as an important reminder that franchisors and their transactional counsel must stay abreast of these court decisions as they make decisions regarding supplier arrangements and FDD disclosures.

III. Best Practices for Structuring Supply Arrangements

A. Legal vs. Relationship Considerations²²

The following is a high-level overview of the spectrum of supply chain arrangements that may exist in a franchise system²³, including which arrangements are most likely to include rebates and other consideration paid to the franchisor or its affiliates based upon franchisees' required purchases or leases.²⁴

1. Levels of Control

i. Minimum Franchisor Control

Every franchise system must maintain some level of uniformity and consistency and, therefore, even at end of the spectrum where the franchisor exercises minimum control, the franchisor will still require franchisees to source and purchase some goods and services that comply with the franchisor's written specifications. In this arrangement, the franchisor typically does not participate in negotiations with the suppliers. Instead, the franchisees are free to negotiate their own contracts with the supplier of their choice so long as the product they purchase is compliant. Franchisees may favor this arrangement because they feel it provides ultimate autonomy to control costs for their business and

²⁰*Money Mailer v. Brewer*, 449 P.3d 258 (Wash. 2019); *see also* Taylor Bennett and Caitlin Carrier, *Fair and Reasonable Pricing – The Impact of Money Mailer v. Brewer*, Franchise Law Journal, Vol. 39, No. 4 (Spring 2020) (“When a franchisor generates profits from these purchases, a corroding effect on franchisee morale emerges as it is seen as nothing more than a hidden profit center for the franchisor.”); WASH. REV. CODE tit 19, ch. 19.100 § 19.100.180(2)(b) (prohibiting franchisors from requiring a franchisee to purchase or lease goods or services of the franchisor or from approved sources of supply unless the restrictions are reasonably necessary for a lawful purpose justified on business grounds, and do not substantially affect competition).

²¹ Although anecdotal, this is especially true where the franchisor's supply chain structure requires franchisees to purchase generic goods and services directly from the franchisor or its affiliates at a substantial markup over the prices the franchisee could obtain elsewhere.

²² Peter L. Loh, Ronald T. Coleman, Timothy Comer, Joseph Goode, and Mikaela R. Mitcham, *Supply Arrangements and Rebates: Franchisor's Rights vs. Franchisee Revolts*, IFA 54th Annual Legal Symposium (2022).

²³ This is certainly not an exhaustive list of potential supply chain structures, as these can vary substantially from system to system; however, this paper seeks to provide a broad strokes description of the most frequently used supply chain structures for franchise systems.

²⁴ A discussion of the strategy for structuring and negotiating supply chain agreements is beyond the scope of this paper; however, the authors suggest the following resources: Bethany L. Appleby and Gaylen L. Knack, *Structuring and Negotiating Essential Vendor Agreements and Dealing with Financial Terms, Discounts, and Rebates*, ABA 44th Annual Forum on Franchising (2021); *See also*, Ramsey, *supra* note 11, at 4 (providing summary of standard terms for supply chain agreements). Additionally, this paper does not address potential anti-trust issues that can arise in certain supplier arrangements. *See* Ramsey, *supra* note 11, at 26.

because the franchisor and its affiliates usually do not receive any benefits from suppliers. The primary downside to this arrangement is that the system is unable to benefit from economies of scale. Minimal franchisor control also results in less consistency over the goods and services purchased by the franchisees, which can raise concerns about brand protection. The franchisor's only means of ensuring compliance with specifications may be on-site inspections or reacting to customer complaints. Unfortunately, the damage might be done by the time the franchisor discovers the franchisee is using non-compliant goods or services. In today's digitally connected world, an issue with substandard products at one franchisee location can impact the goodwill of the entire system within a matter of hours.²⁵ While many emerging franchisors may opt to exercise minimal control over the supply chain because they lack the resources to play a bigger role, as the franchise system grows it is almost inevitable that the franchisor will want to maintain more control over the system's supply chain and, as a result, revenues from sales to franchisees and/or benefits from suppliers are not far behind.²⁶

ii. Purchasing Cooperative/Outsourcing

Franchisors sometimes form purchasing cooperatives to appease the franchise system after franchisees push back on the franchisor's sourcing restrictions; however, in some instances a growing system may adopt purchasing cooperatives as a solution to the issues identified above.²⁷ Depending on the size and makeup of the franchise system, the franchisor could create a single cooperative or multiple cooperatives by grouping outlets in geographic proximity to one another (e.g., by region). The purchasing cooperatives may include both franchise and corporate-owned outlets. Additionally, in some instances the franchisor may mandate the formation of the purchasing cooperative (assuming it has the contractual right to do so) and in others it may allow franchisees to opt into a purchasing cooperative if they meet certain requirements, such as a threshold number of interested locations within a specified proximity. Typically, each cooperative will be a separate legal entity and will be responsible for bearing the cost of administering its own supply chain. The franchisor usually maintains some presence in the cooperative(s) (e.g., a seat on the board and/or because corporate-owned locations are members) but can no longer make unilateral decisions regarding selection of suppliers or allocation of rebates and other benefits.²⁸

²⁵ Beilfuss, *supra* note 5, at 5; Loh, *supra* note 10, at 3.

²⁶ Ramsey, *supra* note 11, at 2 (“A larger, more mature franchise system should transition to a more efficient and consistent supply chain model that delivers products to more outlets spread over a larger geographic area. In particular, larger systems should consider a supply chain run by the franchisor or a purchasing cooperative that allows the entire system to benefit from economies of scale.”); *see also*, Romo, *supra* note 7, at 7 (providing overview of different levels of control a franchisor may choose to exert over its systems' supply chain); Loh, *supra* note 10, at 4 (noting that “the rationale for most franchisors to exercise control over sources of supply is doing so is essential to maintain quality and brand image for the franchise system.”).

²⁷ Romo, *supra* note 7, at 9 (noting that if a purchasing cooperative is utilized, “the franchisees will typically fund the supply chain through fees charged through equity ownership interest in the supply chain cooperative and through ongoing fees imposed by the cooperative on products distributed to the franchisees”).

²⁸ *Id.* at 8 (noting that although franchisors do not entirely relinquish control over the supply chain when a purchasing cooperative is utilized, the franchisees generally obtain significant control over the management and operation of the supply chain, and the franchisor's influence is considerably reduced.).

Aside from relieving the franchisor from the time and cost associated with managing the system's supply chain, one of the primary advantages of purchasing cooperatives is that they allow the members to leverage their purchasing power to negotiate better prices while also providing reassurance that members will receive goods or services of a consistent quality. Additionally, by implementing purchasing cooperatives, the franchisor can build trust with its franchisees. As other commentators pointed out, "Even if it is objectively true that certain forms of supplier income [paid to the franchisor] do not unfairly benefit the franchisor, many franchisees will simply not believe it, and their perception of unfair advantage cannot be overcome unless the franchisees themselves have some ownership and control over the purchasing function."²⁹ Of course, ceding control to franchisees is easier than pulling it back, so forming such cooperatives should not be done hastily. In order to maintain flexibility in the future, franchisors that form purchasing cooperatives frequently require the cooperatives to use bylaws and/or membership agreements that give the franchisor the ultimate power to modify or end the purchasing cooperative arrangement.

Another intermediate option that provides the franchisor with more control is for the franchisor to outsource management of the supply chain to a third party. In this scenario, the franchisor retains a third party that specializes in supply chain management (e.g., a broadline distributor). The franchisor is able to "take advantage of the expertise, efficiencies, and technologies available through third party supply chain specialists."³⁰ In some instances, the franchisor may receive benefits from suppliers and/or the third party specialist that manages the supply chain on the franchisor's behalf; thus, this option may not provide an adequate solution for a system where trust between the franchisor and franchisees is especially strained. Additionally, in this scenario, while the franchisor can pass along some of the risk to the third party, the franchisor will bear the cost of vetting and retaining the appropriate third party supply chain specialist.

iii. Maximum Franchisor Control

At the other end of the spectrum of options, are arrangements where the franchisor maintains total control over some or all aspects of the supply chain for the system. In this scenario, the franchisor may control the identification of product, negotiating agreements, and logistics of distribution. The franchisor may even manufacture and/or distribute some or all products sold to franchisees. This arrangement provides the franchisor with maximum assurance regarding quality and consistency of products,³¹ it may strain the franchisor-franchisee relationship for all the reasons discussed above.

More control also comes with a corresponding increase in liability and cost for the franchisor. As other commentators have pointed out, "if the franchisor brings the majority of the supply chain function in-house, such as by manufacturing products for the franchisee

²⁹ *Id.* at 21.

³⁰ Beilfuss, *supra* note 5, at 4.

³¹ Loh, *supra* note 10, at 5 ("The greater purchasing power and leverage from an approved supplier relationship can also result in a more tailored and reliable source of supply than might be the case for a single franchisees purchasing on its own").

system, negotiating supply arrangements directly with suppliers, and/or directly managing the distribution side of the supply chain, the franchisor will need to employ a tremendous amount of working capital both to initiate the supply chain process and for the ongoing management of the system supply chain.”³² If the suppliers selected by the franchisor fail to deliver (either literally or figuratively), the franchisor may face everything from franchisee unrest to legal claims. Supply chain management is complex, which is why there is a market for third party companies to manage this aspect of operations, so “franchisors who exercise direct control [over their systems’ supply chain] must be prepared to invest in the level of time and expense that is required to maximize the supply chain’s benefits to the system as a whole. The failure to do so could put the system at a competitive disadvantage.”³³

B. Best Practices to Ease Tension

For supply chain arrangements where the franchisor maintains some level of control and/or receives benefits from suppliers, there are additional options that franchisors may consider lessening any inherent tension that these arrangements will provoke with franchisees. One option is for the franchisor to voluntarily contribute some, or all revenues or other consideration received from suppliers because of franchises purchases or leases, to the system marketing fund or another expense that franchisees may perceive as more beneficial. For examples, franchisors can consider requesting that suppliers “fund system conventions and meetings...through charges for the privilege of having a vendor booth and sponsorship of convention speakers and events.”³⁴ Franchisors should not promise any allocation of supplier benefits unless they are confident that they can comply. As we will discuss later in this paper, misallocation of supplier benefits can easily give rise to claims by franchisees.

Another best practice is for the franchisor to solicit franchisee input regarding the supply chain, especially when the franchisor is considering substantial changes. Even if the franchisees’ input is limited to an “advisory” capacity, having a seat at the table and greater insight into the franchisor’s practices can go a long way in quelling franchisees’ frustrations.

IV. Common Causes of Action Relating to Rebates

A. Breach of Contract and Implied Covenant of Good Faith and Fair Dealing

³² Romo, *supra* note 7, at 9 (addressing resources associated with different levels of franchisor control over supply chain management).

³³ Beilfuss, *supra* note 5, at 4; Loh, *supra* note 10, at 5 (noting that “a franchisor of even modest-sized systems often can leverage economies of scale to achieve more favorable pricing or other supply terms than could a single franchisee purchasing on its own”).

³⁴ Romo, *supra* note 7, at 44. For examples, franchisors can consider requesting that suppliers “fund system conventions and meetings...through charges for the privilege of having a vendor booth and sponsorship of convention speakers and events.” *Id.*; see also, Loh, *supra* note 10, at 6 (noting that utilizing rebates to benefit the system as a whole is an excellent way to quell disgruntled franchisees” and suggesting franchisor may contribute supplier benefits to employee benefit programs or incentive programs).

Perhaps the two most common causes of action asserted by franchisees that are challenging the propriety of a franchisor receiving rebates are breach of contract and breach of the implied covenant of good faith and fair dealing. A franchisee has a greater likelihood of succeeding on its claims where the FDD and franchise agreement are either silent with respect to the franchisor's right to receive rebates, or they are drafted in an ambiguous manner. Likewise, if the franchise agreement does not include a robust merger or integration clause, franchisees may be able to succeed on a claim that extra-contractual promises, policies or statements were made or adopted by the franchisor which either prohibit, or seriously limit, the franchisor's ability to receive rebates. As a result, before accepting rebates, a franchisor must be especially careful in drafting its franchise agreement and FDD. Likewise, even if a franchisor has well-drafted disclosures, it must be careful not to waive its right to accept rebates through its post-contract conduct and representations.

As the cases discussed below demonstrate, a well-drafted FDD and franchise agreement can help a franchisor dispose of a breach of contract or implied covenant claim early in a case and, conversely, a poorly drafted FDD could lead to lengthy and expensive litigation and a frayed relationship with franchisees.

1. Quiznos

In *C.K.H., LLC v. The Quizno's Master, LLC*,³⁵ a group of franchisees brought a variety of claims against their franchisor, including a claim that the franchisor breached the franchise agreement by failing to secure the best possible prices for goods and equipment and by not passing on vendor rebates to the franchisees. The claim was not premised on the provisions of the franchise agreements themselves, but instead on representations made in the UFOC, in which the franchisor stated that it would "negotiate arrangements with suppliers for the benefit of franchisees, which often include volume discounts."

In dismissing the franchisee's breach of contract claim, the court observed that nothing in the franchise agreement suggested that such discounts would be passed on to franchisees. Indeed, the FDD stated that the franchisor had the "right to receive payments from suppliers on account of their dealings with you and other Franchisees and to use the amounts we receive without restriction . . . for any purpose we deem appropriate." Likewise, the franchise agreements themselves contained similar language granting the franchisor the right to use any volume discounts received "without restriction and for any purpose Franchisor deems appropriate." Based on these disclosures, the Court found that the franchisees could not possibly state a breach of contract claim.

2. Marriott

³⁵ No. 04-1164, 2005 U.S. Dist. LEXIS 42347 (D. Colo. Mar. 25, 2005).

While the disclosure in *Quiznos* was deemed sufficient to facilitate the disposal of a breach of contract claim at the motion to dismiss stage, the disclosure in *In Town Ltd. Partnership v. Marriott Intern., Inc.*³⁶ was found to be insufficient to warrant dismissal on the pleadings. In *Marriott*, franchisees sued their franchisor, which also served as their hotel manager, and an affiliate of their franchisor that essentially acted as the franchisor's procurement agent. Under the terms of the management agreement, the franchisor was granted unfettered authority to manage the hotel and, in exchange, the agreement provided that the franchisor's compensation for its services would consist solely of the management fees set forth in the agreement. The franchisees sued their franchisor and the procurement agent, asserting numerous causes of action, including breach of contract, alleging that the procurement agent entered exclusive or preferred contracts with vendors to supply hotel goods and, in return, the franchisor and procurement agent received "sponsorship funds," which were payments and rebates by vendors made in the course of selling, or in exchange for the opportunity to sell, goods to the hotel. According to the franchisees, the franchisor and procurement agent kept the rebates for themselves and did not disclose them to the franchisees.

The franchisor and procurement agent moved to dismiss all the franchisees' claims, including their breach of contract claim. The procurement agent argued that the breach of contract claim should be dismissed because the agreement between the franchisor and franchisees expressly permitted the franchisor to make a reasonable profit on the purchase of goods. The procurement agent based its argument on a provision in the management agreement that stated that the franchisor "shall have discretion and control . . . in all matters relating to the management and operation of the Hotel, including . . . procurement of inventories, supplies and services (purchases from [franchisor] and its affiliates shall be at competitive prices) . . ." The procurement agent argued that the identified provision contemplated that the franchisor and its affiliates may profit from purchasing hotel supplies.

The franchisees responded to the argument by pointing to other sections of the management agreement they contended expressly prohibited the franchisor from retaining profits related to the management of their hotel except as provided in the management fee provision of the agreement. Specifically, one section of the agreement provided that the franchisor "will retain, as a management fee for services performed hereunder, an amount . . . equal to twenty percent (20%) of Operating Profit." Later, the agreement provided that "[n]o charge or fees are to be paid by [franchisees] to [franchisor] except as provided in the Agreement."

In denying the franchisor's motion to dismiss, the court found that it could not "conclusively determine whether the [a]greement expressly permits the payments of the payments alleged to be wrongful in this case." While the court acknowledged that there may be some validity to the argument that the phrase "purchase from [franchisor] and its affiliates shall be at competitive prices" contemplated that the franchisor and procurement agent are permitted to profit from sales, the other language, appeared to restrict the franchisor's compensation to the amounts set forth in the management agreement. The

³⁶ 246 F. Supp. 2d 469 (S.D.W. Va. 2003).

court concluded that some factual development regarding the specific details of the relationship between the franchisor and the procurement agent, the context and nature of the alleged rebates and payments received, the course of dealing of the parties, and the standard practice in the industry, would help it determine whether the franchisor was permitted to accept the rebates. In other words, the court suggested that it would only be after extensive discovery was taken that it could potentially determine whether the rebates were contractually permissible. The parties settled the case in the months that followed.

3. Little Caesars

Sometimes, franchisees do not challenge the franchisor's ability to receive rebates but instead, the franchisees attempt to get a proverbial "piece of the action," claiming that they should receive rebates as well. For example, in *Little Caesar Enters., Inc. v. Smith*,³⁷ a group of franchisees sued their franchisor for, among other things, breach of contract based on their allegation that the franchisor had failed to credit them with rebates, discounts, and bonuses paid by vendors. The franchisees contended that they were entitled to a portion of the fees received by the franchisor under the franchise agreements or pursuant to the implied covenant of good faith and fair dealing.

The franchisor moved for summary judgment, arguing that there was nothing in the franchise agreements which required it to provide the franchisees any portion of the rebates and credits and that the implied covenant of good faith was inapplicable. The franchisees responded to many of the arguments made by the franchisor in its motion for summary judgment, but did not rebut the franchisor's argument that the franchise agreement did not include any provision which would entitle the franchisees to a portion of the rebates. The court granted the franchisor summary judgment on the franchisees' breach of contract and implied covenant claims with little analysis based on the franchisee's failure to rebut the franchisor's argument. It is therefore impossible to know how the court would have ruled had the franchisees at least attempted to rebut the franchisor's argument.

4. Dunkin' Donuts

The opinion in *Dunkin' Donuts v. N.A.S.T., Inc.*,³⁸ teaches us that great expectations can lead to great disappointment. In *Dunkin*, after being sued for breach of contract and trademark infringement, a franchisee filed a breach of contract counterclaim against its franchisor alleging that the franchisor's sister company had received a million-dollar rebate from a marketing agreement with a vendor. To support its claim, the franchisee alleged that the franchisor had a "Marketing Operating Philosophy" document which discussed how vendor rebates would be used. The document stated that if any of the franchisor's sister companies entered into a contract providing for a vendor rebate, that rebate would be split among all of the franchisor's sister brands, including the brand in which the defendant was a franchisee. According to the franchisee, the franchisor

³⁷ 895 F. Supp. 884, 900 (E.D. Mich. 1995).

³⁸ No. 02-1877626, 2003 WL 1877626 (N.D. Ill. Apr. 11, 2003).

breached its agreement by failing to apply the correct share of the rebate with the system in which the franchisee operated.

The franchisor moved for summary judgment, arguing that the franchisee's breach of contract claim failed because the Marketing Operating Philosophy was not a contract and there were no provisions in the franchise agreement itself which could serve as the basis of a breach of contract claim. The court agreed and granted the franchisor summary judgment. Specifically, the court observed that the policy was not an agreement and expressly provided that "[i]t is not intended to supersede or take the place of any terms contained in the franchise agreement . . ." Additionally, the court noted that the franchise agreement did not make any reference to the policy, but instead contained a robust integration clause making clear that what was contained in the franchise agreement was the entirety of the parties' agreement.

B. Racketeering, State Unfair Trade Practice Act and Franchise Act Claims

The cases discussed above demonstrate that a well-drafted FDD and franchise agreement containing express language leaving no doubt that the franchise agreement itself permits a franchisor to receive rebates can help dispose of franchisees' contract-based claims. Faced with a robust disclosure and integration clause, some franchisees attempt to get around contractual language by bringing statutory claims under State consumer protection laws and franchise relationship laws. Upping the ante, some franchisees even bring racketeering claims which, as one court has described them, are "the litigation equivalent of a thermonuclear device."³⁹ Fortunately for franchisors, just as a well-drafted FDD and franchise agreement can help insulate the franchisor from contract-based claims, so too can well-written documents help insulate a franchisor from statutory claims.

1. Great White North Franchisee Association

The decision in *Great White North Franchisee Association-USA, Inc. v. Tim Hortons USA, Inc.*,⁴⁰ is informative. In *Great White*, a purported association of franchisees sued their franchisor alleging that it implemented an allegedly illegal and predatory business scheme to convert its franchise system into a supply chain business resulting in large profits for the franchisor at the expense of the plaintiff's franchisee members. The plaintiff alleged that the franchisor reaped outrageous profits by price-gouging franchisees on all essential goods necessary to operate their restaurants. The plaintiff further claimed that the franchisor's direct affiliates or primary suppliers imported and sold essentials for everyday operations to the franchisor, which in turn either directly or through a distributor resold those items to franchisees at a profit. According to the plaintiff, the amounts the franchisees paid for supplies greatly exceeded the price at which they could purchase the exact same products from another vendor, and certainly from the market rate. Based on its allegations, the plaintiff brought numerous claims, including

³⁹ *Miranda v. Ponce Fed. Bank*, 948 F.2d 41, 44 (1st Cir. 1991).

⁴⁰ No. 20-20878, 2020 WL 8024349 (S.D. Fla. Dec. 21, 2020).

two alleging violations of the Florida Deceptive and Unfair Trade Practices Act (“FDUTPA”) based on violations of the FTC Franchise Rule regarding disclosures or omissions in the franchise documents.

The franchisor moved to dismiss all of the plaintiff’s claims. After finding that the plaintiff, an association, lacked standing to assert its first FDUTPA claim, the court found that the plaintiff failed to state its second FDUTPA claim because the practices alleged to be unfair and deceptive were clearly disclosed in the FDD and the franchise agreements. Applying Florida law, which is largely consistent with the law in other states, the court found that a FDUTPA claim cannot succeed where the acts complained of comply with the terms of a contract. In coming to its conclusion, the Court noted that the franchise agreement specifically stated that the franchisor may require that any and all items, including ingredients and commodities, be purchased solely from the franchisor or an approved third party and, importantly, that the franchisor may make a profit from such sales. Specifically, in pertinent part, the franchise agreement stated that:

[T]he Franchisee specifically agrees that the Franchisor may require that any and all Items, including ingredients and commodities which may form any part of the Items or the whole product of any food or beverage made, sold or consumed on the Premises or from the Franchised Restaurant . . . be purchased solely from the Franchisor, TH or a third party.

It is hereby acknowledged by the Franchisee, that in purchasing such Items, ***the Franchisor*** or TH ***may make a profit or may receive an allowance commission, rebate, advantage or other benefit on the price of Items sold to the Franchisee.***

Another provision that the Court found probative was one which stated that the franchisee may seek approval to purchase supplies from sources other than those already designated by the franchisor. The court observed that there was no allegation that any franchisees attempt to request alternate suppliers (presumably ones that would not be providing a rebate to the franchisor). In dismissing the claim, the Court made clear that “the mere fact that [the franchisor] obtained a larger profit than Plaintiff’s members would like does not in and of itself constitute a deceptive or unfair practice.”⁴¹

The *Great White* decision suggests that the greater the level of transparency in the franchise documents, the less likely it is that a franchisee can successfully assert that a franchisor is unlawfully receiving rebates. In other words, if a franchisor expressly states that it may make a profit, obtain a rebate, receive a discount, or receive any other benefit

⁴¹ The plaintiff took an appeal and the Eleventh Circuit *sua sponte* remanded the case for the district court to consider whether diversity jurisdiction existed due to a pleading deficiency in the plaintiff’s complaint. On an extremely limited record, the district court determined that, based on the allegations of the complaint, the court lacked jurisdiction and vacated its order.

from suppliers based on purchases made by franchisees, it is extremely unlikely that a franchisee will be able to state a claim that survives a motion to dismiss.

2. Tim-Minn

In *Tim-Minn, Inc. v. Tim Hortons USA, Inc.*,⁴² a group of franchisees filed a complaint against their franchisor alleging, among other things, that the franchisor violated the Minnesota Franchise Act (“MFA”) based on the FDD’s statement that the franchisor would charge the franchisees only a “reasonable” markup of goods that franchisees are required to purchase directly from the franchisor or from one of its approved vendors. The franchisees claimed that the franchisor violated Section 80C.13(2) of the MFA, which prohibits any person from “offer[ing] or sell[ing] a franchise . . . by means of any written or oral communication which includes an untrue statement of a material fact” because the markup of goods was unreasonable, and therefore the FDDs contained an untrue statement.

After years of litigation, with extensive written and oral discovery, the franchisor moved for summary judgment on the grounds that there was no competent record evidence that the alleged markups were unreasonable. The franchisees were unable to offer any evidence demonstrating that the specific items identified in their complaint which were allegedly sold at unreasonably marked-up prices, which included bacon, soda and vinyl gloves, were actually marked up at all. In granting the franchisor summary judgment, the Court explained that while the franchisees’ claim was “based on a sense that they were charged more than they should have been,” “a sense falls short of a ‘scintilla of evidence’ required to defeat a motion for summary judgment.

3. Quizno’s

In *Siemer v. Quizno's Franchise Co. LLC*,⁴³ a group of franchisees filed a class action against their franchisor claiming that it was unlawfully deriving a profit off of the franchisees’ purchase of supplies. The franchisees brought numerous claims, including statutory claims under RICO, the Sherman Act, the Illinois Franchise Disclosure Act, as well as common law claims for fraud, breach of contract and breach of the implied covenant of good faith and fair dealing. The franchisees alleged that the terms of their franchise agreements required them to purchase products either from the franchisor or approved vendors. The franchisees further alleged that their franchisor sold goods at extremely marked-up prices and that the franchisor benefited either directly when they, or an affiliated company, sold the goods, or indirectly when an approved vendor sold the goods and the franchisor received a rebate. According to the franchisees, the franchisor also fraudulently withheld information it was required to disclose, including that the franchisor “failed to disclose the substantial markups and kickbacks that add to the prices of food, supplies, services and other materials that must be purchased from [the franchisor] or its approved suppliers.”

⁴² No. 20-23481, Order on Motion for Summary Judgment (S.D. Florida Sept. 9, 2022) (ECF 158).

⁴³ No. 07-2170, 2008 WL 904874, at *7 (N.D. Ill. Mar. 31, 2008).

The franchisor moved to dismiss all of the franchisees' claims, arguing that the franchisees' reliance on alleged misrepresentations regarding pricing and vendor rebates was unreasonable in light of the disclosures made in the UFOC and the explicit terms of the franchise agreement and that the integration clause in the franchise agreement barred the franchisees from arguing that it relied on statements made by the franchisor. Specifically, the franchisor pointed to the language in its FDD which stated that:

We and our affiliates have the right to receive payments from suppliers on account of their dealings with you and other Franchisees and to use the amounts we receive without restriction (unless we or our affiliates agree otherwise with the supplier) for any purpose we or our affiliates deem appropriate. We and our affiliates negotiate purchase arrangements with suppliers for the benefit of Franchisees, which often include volume discounts. Some suppliers pay us and/or our affiliates fees for products purchased through these negotiated agreements, and willingness to pay us and/or our affiliates may be a condition of our approval of a supplier.

The court agreed with the franchisor's argument and dismissed all of the franchisees' claims. In making its decision, the court stated:

Turning to the specific allegations, [the franchisees'] claim is that [the franchisor] requires its franchisees to pay prices it knows to be higher than those the franchisees could get from third-party vendors for goods of equal or better quality, and that the prices the franchisees pay are deliberately inflated by kickbacks to the franchising entity. According to [the franchisees], this directly contradicts representations made in the UFOC that contracts with suppliers would be made for the benefit of franchisees. Importantly, the UFOC does not say that the supplier contracts will be made for the sole benefit of franchisees. Instead, as explained above, the Franchise Agreements explicitly warned [the franchisees] that [the franchisor] might "receive payments from suppliers on account of such suppliers' dealings with Franchisee and other franchisees and may use all amounts so received without restriction and for any purpose Franchisor and its affiliates deem appropriate." The UFOC, similarly, warned [the franchisees] that [the franchisor] had "the right to receive payments from suppliers on account of their dealings with you and other Franchisees and to use the amounts we receive without restriction . . . for any purpose we or our affiliates deem appropriate." . . . In light of the explicit contractual provisions, it would be unreasonable for [the franchisees] to have assumed that [the franchisor] would not negotiate contracts with suppliers that would benefit [the franchisor]. And even if [the franchisor] did owe [the franchisees] a duty to disclose, these contractual provisions would clearly satisfy any such duty.

The *Siemer* decision once again demonstrates the importance of including express language in the franchise agreement making clear that the franchisor may receive a

rebate. It is certainly possible, however, that another court may have latched onto the UFOC's statement that the franchisor "negotiate[d] purchases with supplier for the benefit of Franchisees," and found that such a statement created ambiguity.

C. Fraud/Misrepresentation Claims

Generally included in franchisees' complaints that they are being overcharged for items and that franchisors are receiving kickbacks are fraud or misrepresentation claims. As the cases discussed in this section demonstrate, misrepresentation-based claims can be exceedingly difficult for franchisees to successfully assert, especially where the FDD includes robust disclosures.

1. Tubby's

In *Tubby's #14, Ltd. v. Tubby's Sub Shops, Inc.*,⁴⁴ the franchisor was sued by a group of its franchisees who alleged that the franchisor was involved in a kickback scheme. But the franchisees did not stop there. They also sued the franchisor's affiliates, including the franchisor's advertising fund and the company ("SDS") which purchased all of the products that were later sold to and used by franchisees. SDS entered agreements with food manufacturers and the manufacturers or distributors of other products and then stored and then sold the products to franchisees who were required to purchase the items from SDS. According to the franchisees, the franchisor set up a scheme where SDS negotiated product purchase contracts with manufacturers which included substantial "kickbacks" paid by manufacturers to the franchisor. According to the plaintiffs, the kickback scheme consisted of the franchisor asking manufacturers to increase prices by 30-90%, and then to bill SDS the inflated amounts. In turn, the franchisees alleged that when billing franchisees, SDS would then add its overhead and profit to the amount submitted by the manufacturers. Upon receiving the bill, franchisees would pay the SDS invoices, SDS would then pay the manufacturers the entire invoice amount, and in return, the manufacturers would pay SDS the kickback. The franchisees asserted claims for violation of the Michigan Franchise Investment Law ("MFIL"), fraud, breach of contract, breach of the implied covenant of good faith and fair dealing. The franchisees further alleged that the franchisor did not disclose the profits in their Item 8 disclosure within its FDD.

The franchisor moved for summary judgment on many of the plaintiff's claims, including their MFIL and fraud claims, which were essentially the same. Included among the franchisor's arguments was that it was not obligated to disclose the existence of SDS in its FDD (then a Uniform Franchise Offering Circular, or "UFOC") because SDS was the franchisor's affiliate. According to the franchisor, the MFIL and the FTC law only required disclosure about revenue the franchisor received from third party suppliers and that franchisors are only required to disclose the franchisor's total revenues and the portions that come from required purchases. Finally, the franchisor argued that there was no misleading or incomplete information in its FDD that would constitute fraud under the MFIL or the common law.

⁴⁴ No. 04-70918, 2006 WL 2796181 (E.D. Mich. Sept. 27, 2006).

In denying the franchisor's motion for summary judgment, the court found that there was a genuine issue of material fact as to whether the franchisor was required to report the revenue received by SDS and the amount of the alleged kickbacks the franchisor received from SDS in its item 8 disclosure. The court observed that "[w]hile [the franchisor] claims that such disclosure is not required, the rules stated above suggest otherwise." Furthermore, if the franchisor was required to make the disclosure and failed to do so, a genuine issue of material fact existed as to whether its failure to disclose was fraudulent.

2. Cleaning Authority

In *The Cleaning Authority, Inc. v. Neubert*,⁴⁵ the franchisor brought an action against franchisees after they allegedly unilaterally terminated the franchise agreement. In response, the franchisees filed counterclaims alleging that the franchisor fraudulently induced the franchisee into acquiring a franchise based on the franchisor's alleged failure to disclose rebates it was receiving from an affiliate. The franchisor's affiliate sent advertising brochures to customers in a franchisee's territory. At the same time the franchisees signed their franchise agreements, they signed service agreements with the affiliate. The franchisees claimed that they paid more than \$35,000 as an initial franchise fee to the franchisor, a \$2,000 mailer setup fee to the affiliate, royalties and more than \$500,000 to the affiliate during the time the franchise agreement was in effect. The franchisees' fraud claims alleged that the franchisor's FDD contained numerous and material misrepresentations and that the franchisor did not disclose the rebates, "kickbacks" or other payments it received from the affiliate. Instead, according to the franchisees, the franchisor represented that except for certain sponsorships, it did not receive rebates from any approved suppliers.

The franchisor moved to dismiss the claims on the ground that there could be no fraud where the FDD made clear on the first page that the franchisee would "also pay an affiliate of ours an initial mailer set up fee." Item 1 of the FDD included a disclosure identifying the franchisor's affiliates, including the affiliate allegedly paying a kickback to the franchisor. The Court observed that "[w]hat was required was for [the franchisor] to disclose whether it or its affiliate 'will or may derive revenue' from required purchases" and that the franchisor adequately disclosed that information, rendering the fraud claim factually and legally unsupportable.

3. Lady of America

Another good example of the uphill battle franchisees face when bringing a fraud claim based on the franchisor's receipt of rebates comes from the decision in *Randall v. Lady of Am. Franchise Corp.*⁴⁶ In that case, franchisees sued their franchisor for, among

⁴⁵ No. 09-3447, 2011 WL 666892 (D. Md. Feb 11, 2011).

⁴⁶ 532 F. Supp. 2d 1071 (D. Minn. 2007).

other things, fraud, based on its alleged failure to disclose that it received rebates from certain vendors.

The franchisor moved for summary judgment because, among other things, it contended that it adequately disclosed the rebates in the FDD where it stated that it might get unspecified rebates from unspecified vendors. The court was skeptical that the franchisor could succeed on its argument that it fully disclosed vendor rebates because the FDD's "blanket statement is almost surely insufficient under federal and state franchise laws, which require detailed disclosures by franchisors about vendor rebates." The motion for summary judgment was granted, however, based on the franchisor's argument that the franchisees had offered no admissible evidence that it received rebates, and instead offered only the hearsay statement of a landlord that he paid a \$10,000 kickback to the franchisor.

D. Antitrust Claims

In addition to pursuing the more common breach of contract, implied covenant, fraud and unfair competition law claims, some franchisees have pursued federal antitrust claims against franchisors in connection with the franchisor's receipt of rebates. One reason franchisees may have pursued such a strategy is because of the shock-and-awe value associated with antitrust claims and because, while pleading them is not necessarily expensive, defending such claims is, even where the claims are without a strong basis.

The most common type of antitrust claim brought by franchisees seeking to challenge their franchisor's receipt of rebates are tying claims. A tying arrangement is an agreement by a party to sell one product, but only on the condition that the buyer also purchases a different (i.e., "tied") product, or at least agrees that it will not purchase the product from another supplier. Attempts to bring franchise disputes into federal court under the Sherman Act, based on an illegal tying arrangement, generally fail at the pleading stage because the claims invariably depend on a narrow market defined by a franchise agreement, rather than a proper antitrust product market or geographic market.⁴⁷

⁴⁷ See *Dunkin' Donuts Franchising LLC v. Sai Food Hosp., LLC*, No. 4:11-CV-01484, 2013 WL 1688341, at *6 (E.D. Mo. Apr. 18, 2013) (granting motion to dismiss "claim that [Dunkin' Donuts] unlawfully tied the sale of donut franchises/fast-breakfast food restaurant franchises to the purchase of new equipment for franchised stores"); *Martrano v. Quizno's Franchise Co., L.L.C.*, No. 08-0932, 2009 WL 1704469, at *12 (W.D. Pa. June 15, 2009) (granting motion to dismiss claim that "Quizno's illegally ties the sale of its franchises (the tying product) to the subsequent sale of supplies and services (the tied products)"); *Beuff Enters. Fla., Inc. v. Villa Pizza, LLC*, No. 07-2159, 2008 WL 2565008, at *12 (D.N.J. June 25, 2008) (granting motion to dismiss where pizza franchisee was allegedly "forced to purchase supplies, furniture, equipment, fixtures, and signs from sources designated by" franchisor).

The seminal case for considering tying claims in the context of franchising, particularly for quick-service restaurant chains, is *Queen City Pizza v. Domino's Pizza*,⁴⁸ in which a group of franchisees and their franchisee association sued their franchisor, alleging that the franchisor violated the Sherman Act by prohibiting the franchisees from buying dough from another source and by requiring the franchisees to buy unwanted ingredients from the franchisor as a condition of continuing to be in the franchise system. In affirming the district court's order granting the franchisor's motion to dismiss, the Third Circuit observed:

The essence of a successful nationwide fast-food chain is product uniformity and consistency. Uniformity benefits franchisees because customers can purchase pizza from any Domino's store and be certain the pizza will taste exactly like the Domino's pizza with which they are familiar. This means that individual franchisees need not build up their own good will. Uniformity also benefits the franchisor. It ensures the brand name will continue to attract and hold customers, increasing franchise fees and royalties.

Many courts have followed the reasoning of *Queen City*, but by the point that a franchisor has obtained the dismissal of an antitrust claim, or been awarded summary judgment, it will have likely incurred a substantial amount of attorneys' fees. Thus, antitrust claims will always present problems for franchisors which require purchases to be made from itself or approved vendors.

E. Franchisee Association Claims

For a variety of strategic reasons, franchisees have increasingly opted to attempt to bring claims against franchisors on a collective basis, as a franchisee association, in lieu of bringing their own claims. The general standard for establishing association standing applies to franchisee associations and requires the association to prove that: "(a) its members would otherwise have standing to sue in their own right; (b) the interests it seeks to protect are germane to the organization's purpose; and (c) neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit."⁴⁹ Most challenges to associational standing focus on the second and third requirements.

In order to satisfy the second prong of the test for associational standing, the interests at stake in the lawsuit must be germane to the organization's purpose.⁵⁰ To show a direct conflict between the challenged conduct and the organization's mission, movants must point to a "concrete and demonstrable injury to [their] activities" – "a mere setback to [their] abstract social interests is not sufficient."⁵¹ An association must show that the

⁴⁸ 124 F.3d 430 (3rd Cir. 1997).

⁴⁹ *Hunt v. Washington State Apple Adver. Comm'n*, 432 U.S. 333, 343 (1977).

⁵⁰ *White's Place, Inc. v. Glover*, 222 F.3d 1327, 1330 (11th Cir 2000).

⁵¹ *Safari Club Int'l v. Zinke*, No. 15-01026, 2017 WL 8222114, at *4 (D.D.C. May 2, 2017).

challenged conduct would “perceptibly impair” its daily operations.⁵² Where the claims asserted by an association are not germane to the association’s stated purpose, the association lacks standing.⁵³

1. Great White

In *Great White*, a franchisee association brought an action against a franchisor on behalf of its franchisee members alleging, among other things, that the franchisor required the franchisees to purchase items from mandatory suppliers at a far greater price than what the franchisees could pay for the same items from another supplier. The association alleged that statements made in the franchisor’s FDD regarding the use of franchisees’ advertising fund contributions and the franchisor’s ability to markup prices of goods and receipt of compensation from suppliers was untrue. The association sought declaratory relief that the franchisor violated the Florida Deceptive and Unfair Trade Practices Act (“FDUTPA”) by making misrepresentations in its FDD and an injunction to prevent the franchisor from making misrepresentations in future versions of its FDD.

The franchisor moved to dismiss because, among other things, the franchisee association lacked standing to seek injunctive relief and because the interests sought to be protected were not germane to the Association’s stated purpose “[t]o provide a common interest organization for Tim Hortons franchisees, creating a forum for discussion, education and advocacy for franchise owners.” The Court agreed and dismissed one of the association’s FDUTPA claims. First, with respect to the association’s standing to seek injunctive relief, the court explained that injunctive relief could only be sought to prevent future harm. Agreeing with the franchisor’s argument, the court found that none of the association’s franchisee members could satisfy this requirement because, as existing franchisees, they would not be provided the franchisor’s FDD again in the future and, as a result, there was no chance that they could be harmed in the future by any misrepresentations in the FDD.

The court also adopted the franchisor’s argument that the association did not satisfy *Hunt’s* second requirement, that the interests the association seeks to protect are germane to the association’s purpose. As alleged in the complaint, the association’s purpose was “[t]o provide a common interest organization for [franchisor’s] franchisees, creating a forum for discussion, education and advocacy for franchise owners.” The

⁵² *New England Anti-Vivisection Soc’y v. United States Fish & Wildlife Serv.*, 208 F. Supp. 3d 142, 166 (D.D.C. 2016).

⁵³ See also *California Parents for the Equalization of Educ. Materials v. Noonan*, 600 F. Supp. 2d 1088, 1106-08 (E.D. Cal. 2009) (holding that association lacked standing to bring claims focused on Jewish indoctrination where association’s stated purpose was to promote an accurate portrayal of Hinduism in textbooks); *Ranchers Cattlemen Action Legal Fund United Stockgrowers of Am. v. U.S. Dept. of Ag.*, 415 F.3d 1078, 1103-04 (9th Cir. 2005) (association lacked standing where association failed to demonstrate connection between the purported environmental interest that association attempted to raise and the “trade and marketing” interested it was organized to protect); *McKinney v. United States Department of Treasury*, 799 F.2d 1544, 1553 (Fed. Cir. 1986) (holding that non-profit public interest law firm lacked standing to protect the economic interests of non-member producers and workers where the complaint did not indicate that the purpose of the organization was to protect those people).

franchisor argued that because the association was expressly for the benefit of existing franchisees, as opposed to the general public or prospective franchisees, the interests sought to be protected were not germane to the association's purpose. The court agreed and found that the association lacked standing for this reason as well.

2. Adventure Park

The decision in *Adventure Park Franchisee Ass'n, Inc. v. UATP Mgmt., LLC*,⁵⁴ is also informative. In that case, an association of over 50 franchisees sued the franchisor seeking declaratory relief on behalf of their members, seeking a judicial determination that the franchisor engaged in tortious conduct and breached franchise agreements based on the franchisor's alleged withholding of revenues from a new program until the franchisees agreed to change certain terms of the program. Part of the new program required franchisees to use a specific vendor in a way that would result in the violation of markup prohibitions in the franchise agreement. Some franchisees agreed to the terms of the new program while others did not. The association alleged that the franchisor's conduct breached the implied covenant of good faith and fair dealing, breached the franchise agreements and violated various States' unfair competition laws. Specifically, the franchisee association claimed that the franchisor imposed mandatory vendors for the purchase of various items and that the franchisor received rebates from those purchases.

The franchisor moved to dismiss on the grounds that the franchisee association lacked standing and, more specifically, that *Hunt's* third requirement, that neither the claim asserted nor the relief requested required the participation of individual members in the lawsuit, could not be satisfied. After considering the franchisor's arguments that the association's individual members' experiences varied enough so that their individual participation would be required, the court dismissed the claim, concluding that the association was "simply not in the best position to present the subtleties of the franchisees' individualized contract and tort claims."

V. Practical Solutions to Avoid Franchisor/Franchisee Disputes

A. Limitation on Products Required to be Purchased Through Franchisor: Massage Heights

One way to reduce the potential for conflict between franchisors and their franchisees is for the franchisor to limit the items that must be purchased from approved suppliers to only those items that are proprietary and/or integral to the operation of the franchise. Establishing a limited subset of essential products that franchisees must purchase from approved suppliers and allowing franchisees the freedom to engage suppliers of their choice for all other non-essential products helps to foster the sense of entrepreneurial autonomy that many franchisees seek in the operation of their businesses.

⁵⁴ 537 F. Supp. 3d 897 (N.D. Tex. 2021).

Massage Heights Franchising (“Massage Heights”) has utilized this strategy within its system. Massage Heights, a family-owned 117-unit spa chain, operates a subsidiary company called Summit Franchise Supply (“Summit”) to sell equipment and supplies to its franchisees. Massage Heights mandates that franchisees use Summit to place their pre-opening setup orders, as this helps ensure that new “retreats” open on schedule. Summit can ensure high in-stock positions on essential items, and they can ship everything required just-in-time, rather than new franchisees having to track shipments from multiple suppliers and worry about one or two critical items coming late. The benefits to the franchisees are clear, as they will have invested heavily in pre-opening staffing, training, and marketing, and postponing the retreat’s opening date would be very damaging. Franchisees are likely to accept this as a win-win for franchisor and franchisees, even if they might have been able to find lower prices on some of the supplied items.

After opening, Massage Heights franchisees are only required to purchase items that have a direct effect on the guest experience from Summit, like Massage Heights-branded products and its specially-formulated proprietary massage lotions and essential oils. Franchisees are free to buy uniforms, marketing materials, office and laundry supplies and much more from the supplier of their choice, even though Summit also sells these items. Over time, Summit may lose a portion of the resupply business to low-cost vendors but supplying the retreat’s opening order allows Summit to build a trusted relationship which most franchisees are happy to maintain for the long term without feeling some of the content that sometimes arises when a franchisee feels like their ability to make their own decision has been taken away. Moreover, franchisees see that Summit spends a significant portion of its gross profit as a sponsor of the annual Massage Heights convention, which franchisees can see direct benefit from.

B. “Rebate to Royalty” Swap: Planet Fitness

Another way that franchisors can reduce the potential for conflict is to replace the rebates and commissions with alternate sources of profit. Planet Fitness, a fast-growing gym chain with over 2,400 units and 17,000,000 members, adopted this strategy to defuse franchisee concerns about rebates and commissions. For many years, Planet Fitness collected rebates on a wide range of materials and supplies, and as of 2017 it calculated that these collectively amounted to approximately 1.59% of the revenue of the average Planet Fitness “club.” In 2017, Planet Fitness offered each of its franchisees a choice: maintain the traditional arrangement, or accept a “rebate to royalty swap.” Accepting the swap meant that the franchisees’ royalty would increase by 1.59 percentage points (from 5.00% to 6.59% in most cases) – but in return, Planet Fitness would permanently forego collecting rebates on most materials and supplies sold to franchisees who accepted this offer.

The offer was seen by a wide majority of Planet Fitness franchisees as a positive proactive step from Planet Fitness. Planet Fitness offered additional incentives to further sweeten the deal, including dropping a requirement that franchisees supply a costly welcome gift to new members, limiting its ability to “cross-default” franchisees with

multiple Franchise Agreements, replacing personal guarantees with affiliate guarantees in certain circumstances, and allowing those franchisees who sold their clubs to transfer their then-current royalty rate to the purchaser, rather than using the occasion of a sale as an opportunity to increase royalty rates.

A sizable majority of Planet Fitness franchisees accepted the deal, but Planet Fitness also benefitted because it was able to maintain the profitability it formerly received from the rebates and commissions in a new recurring and seemingly more stable form, while at the same time strengthening its relationship with its franchisees. As investors assess the value of a franchise brand, they value the “automatic” recurring revenue of the royalty stream more highly than the up-and-down transitory revenue from commissions and rebates. The “rebate to royalty swap” is believed to have helped further increase the market value of Planet Fitness, whose share price and market capitalization grew significantly in the years following the deal.

VI. Conclusion

When rebates and commissions are properly structured and disclosed, they can add value to not only the franchisor, but to the entire franchise system. However, it’s important that franchisors look beyond the enticing alternative revenue stream and factor in the potential risks associated with franchisee dissatisfaction and increased attention and scrutiny from the regulators if the franchisor’s approach is deemed to be self-serving or inadequately disclosed. There’s a delicate balance that franchisors must attempt to strike when weighing the economic benefits of rebates and commissions against the potential push back from franchisees and regulators.

Rebates and commissions can be an important and sizable source of profit, but that’s not very helpful to a franchisor if that profit is wiped out in order to defend against franchisee litigation. Working to ensure that rebates and commissions bring value not only to the franchisor, but to the system and indirectly the franchisees, and taking creative approaches to give the franchisees a sense of autonomy over the operation of their businesses, can go a long way in helping a franchisor align its goals and objectives with those of its franchisees.