



# 2023 LEGAL SYMPOSIUM

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Commissions, Rebates, and Disclosure: Oh My

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

Item 8 requires disclosure of all restrictions on the freedom of the franchisee to obtain goods, real estate, services, etc. from sources of the franchisee's choosing, and of all means by which a franchisor may derive revenue as a result of franchisee purchases or leases of goods and services. All revenues a franchisor (or its affiliates) derives from purchases and leases of products and services to franchisees must be disclosed.

\*Source: (NASAA Franchise and Business opportunities Project Group, Commentary On 2008 Franchise Registration and Disclosure Guidelines (Apr. 27, 2009), available at [http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary\\_final.pdf](http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf))



# Sourcing Restrictions



Item 8 only covers required purchases that the franchisee must make from a specific supplier or limited group of suppliers



Obligation to purchase the items may be imposed via contract per the terms of the franchise agreement, or through operational practices



Item 8 does not mandate disclosure of each individual product that is subject to sourcing restrictions, or the product specifications of the applicable products



If franchisees have total discretion to purchase from any source, but elect to purchase solely from franchisor or its authorized suppliers, such purchases don't require disclosure under Item 8



# Approval of Alternative Suppliers

- For each mandated purchase, Item 8 requires the following disclosure related to franchisees' rights to use alternative suppliers:
  - Whether the franchisor's criteria for approving suppliers are available to franchisees
  - Whether the franchisor permits franchisees to contract with alternative suppliers who meet the franchisor's criteria
  - Any fees and procedures necessary to secure approval to purchase from alternative suppliers
  - How long it will take franchisor to notify a franchisee of the approval or disapproval of an alternative supplier
  - How approvals are revoked; and
  - Whether the franchisor issues specifications for good or services and, if so, how the franchisor may modify the specifications



# Revenue and Other Material Benefits

- Franchisors must disclose whether they will or may receive revenue or other material benefits from required purchases or leases, which can include:
  - Rebates
  - Volume discounts
  - Cash
  - Kick-backs
  - Contributions to marketing funds
- Ordinary sales or volume discounts offered to all buyers, including franchisees, need not be disclosed



# Disclosure of Revenue or Benefits

- Franchisor must disclose the “precise basis” for receiving the revenue or benefits as well as:
  - Franchisor’s total revenue
  - Franchisor’s revenue from all required purchases or leases by franchisees
  - Percentage of the franchisor’s total revenue that comes from required purchases or leases by franchisees
  - Revenue received by the franchisor’s affiliates from franchisees’ required purchases or leases
- Revenue or benefits received may be disclosed as a percentage or a flat dollar figure on an aggregate basis
- Franchisors should avoid disclosing information on each individual supplier in order to preserve confidentiality of supply agreement terms



# Benefits and Burdens of Sourcing Restrictions and Rebates

Franchisors must strike a delicate balance between maintaining control over the source of products introduced into their systems and preserving the autonomy of the franchisees.

Sourcing restrictions and associated rebates can be beneficial to franchisors by:

- Providing reliable, consistent sources of products
- Reducing costs by allowing the franchisor to leverage the system's purchasing power
- Ensuring quality, safety, and consistency of supplies distributed across the system
- Providing an alternate revenue stream that can be used to offset the costs of operating the procurement function, or be reinvested into the system

Alternatively, sourcing restrictions (particularly those that are tied to a rebate or other economic benefit to the franchisor) can create the optics of an inherent conflict of interest, which can put a strain on franchisee relationships and lead to conflict between the franchisor and franchisee



# COMMON CAUSES OF ACTION

- Breach of Contract
- Breach of the Implied Covenant of Good Faith and Fair Dealing
- RICO
- State Unfair Trade Practices Acts
- Fraud/Misrepresentation
- Antitrust





# Breach of Contract?

- “Hotel operations shall be under the exclusive supervision and control of [Franchisor] which, except as otherwise specifically provided in the Agreement, shall be responsible for the proper and efficient operation of the Hotel. [Franchisor] shall have discretion and control, free from interference . . . 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).”



# Breach of Contract?

- “[Franchisor] will retain, as a management fee for services performed hereunder, an amount . . . equal to twenty percent (20%) of Operating Profit.”
- “No charges or fees are to be paid by Owner to [Franchisor] except as provided in the Agreement . . .”



# Breach of Contract? Maybe.

Considering only the face of the Agreement, the court cannot conclusively determine whether the Agreement expressly permits the payments alleged to be wrongful in this case. There is some force to Avendra's argument that the phrase “purchases from [Marriott] and its affiliates shall be at competitive prices” contemplates that Marriott and its affiliates are permitted to profit from sales of supplies to the Hotel. The language of section 5.01.D of the Agreement, however, appears to restrict Marriott's compensation to the management fee set out in the Agreement. This suggests that Marriott's and Avendra's receipt of these payments and rebates may not be permitted. Without some factual development in the case regarding specific details of the relationship between Marriott and In Town Hotels, the context and nature of the alleged rebates and payments received by Marriott and Avendra, the course of dealing of the parties, and the standard practice in the industry, the court cannot resolve the tension between these two parts of the Agreement. The contract does not unambiguously authorize the allegedly wrongful rebates and payments to Marriott and Avendra. At this stage of the proceedings, Avendra is not entitled to dismissal of the counts against it based on the language of the contract. <sup>12</sup>

*In Town Hotels, Ltd. Partnership v. Marriott Intern., Inc.,*  
246 F. Supp. 2d 469 (S.D. Wv. 2003)



# Breach of Contract?

- FDD: Franchisor “negotiate[s] arrangements with suppliers for the benefit of Franchisees, which often include volume discounts.”
- FDD: Franchisor “ha[s] the right to receive payments from suppliers on account of their dealings with you and Franchisees and to use the amounts we receive without restriction . . . for any purpose we deem appropriate.”
- Franchise Agreement: Franchisor may receive volume discounts “without restriction and for any purpose Franchisor deems appropriate.”



# Breach of Contract? No.

- “Plaintiff’s breach of contract claims cannot survive in the face of such unambiguous language.”

*C.K.H., L.L.C. v. Quizno’s Master, L.L.C.*,  
2005 U.S. Dist. LEXIS 42347 (D. Colo. Mar. 25, 2005)



# Unfair Trade Practice?

- "[T]he Franchisee specifically agrees that the Franchisor may require that any and all Items . . . be purchased solely from the Franchisor . . . or a third party."

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



# Unfair Trade Practice? No.

- "The mere fact that Defendants obtained a larger profit than Plaintiff's members would like does not in and of itself constitute a deceptive or unfair practice."

*Great White North Franchisee Association-USA, Inc. v. Tim Hortons USA, Inc.*, No. 20-20878, 2020 WL 8024349 (S.D. Fla. Dec. 21, 2020)



# Fraudulent Inducement?

- '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 . . . 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.'





# Fraudulent Inducement? No.

- “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 . . . and that the prices the franchisees pay are deliberately inflated by kickbacks to the franchising entity . . . 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].”

*Siemer v. Quizno’s Franchise Co., LLC*, No. 07-2170, 2008 WL 904874 (N.D. Ill. Mar. 31, 2008)



# An Operator's Perspective

Many franchisors are caught in a painful squeeze

- Their PE owners or public shareholders demand steadily increasing profits, but royalties are difficult to raise
- It's easier to push suppliers for commissions or increase margins on the price of supplies to their franchisees – but franchisees are also under pressure and increasingly push back

Franchisors often feel that only they can properly assess the quality of the supplies and ingredients their franchisees use

- But franchisees are closer to their local markets and to customers' feedback, and quickly object when they could buy cheaper locally

Unrest or litigation within the franchisee community hurts franchisors both directly and indirectly, so franchisors have to tread carefully



# Some Franchisors Have Found Middle Ground

- Limiting the range of supplies/equipment franchisees are required to purchase from the franchisor or its mandated suppliers – Massage Heights
- Shifting some rebate income to royalty income – Planet Fitness
- Working aggressively to manage costs of supplies and materials, while still taking a margin – Handel's Ice Cream



# Limiting Mandatory Purchases/Suppliers

- Massage Heights limits both the timing and scope of required purchases through its company-owned supply subsidiary
  - Franchisees opening a new location must purchase most start-up supplies and equipment through the company
    - But even if this is more costly than buying from the cheapest local supplier, the franchisee sees a clear benefit from this: assurance that the location will open on time, with everything they need, with little headache or learning curve, and with the quality their consumers want and their professional staff expects
  - After locations open, franchisees are only required to buy those items which directly affect the customer experience from the franchisor's supply subsidiary
    - Many franchisees do shift some less important purchases to low-cost local suppliers, but because they built a trusted relationship with the company's supply subsidiary to get their new unit open, many continue to buy there
    - Massage Heights does make money through its supply subsidiary, but it spends a portion of those profits to support Heights' annual franchisee conference as a goodwill gesture



# Shifting Some Rebate Revenue to Royalty

- Like many franchisors, Planet Fitness historically collected rebates and commissions on a wide range of required products through its mandatory suppliers
  - By 2017, BCG calculated the value of these rebates at 1.59% of average unit revenue
  - In 2017, Planet Fitness offered each of its franchisees the option of maintaining the original arrangement or increasing their royalties by 1.59% in return for a commitment that they would no longer be upcharged for the affected supplies
  - The great majority of franchisees accepted this “rebate to royalty” swap



# The “Swap” Generated Significant Goodwill

- The franchisor offered additional incentives for franchisees to accept the rebate-to-royalty swap
  - Stopped requiring a costly new member welcome gift
  - Replaced personal guarantees with affiliate guarantees in certain circumstances
  - Limited its right to “cross-default” multi-unit franchisees
  - Allowed franchisees who sold their units to transfer their then-current royalty rate to the purchaser
- The swap benefitted the franchisor as well as its franchisees
  - Markets value recurring royalty revenue more highly than less predictable rebates/commissions. The swap is perceived to have increased the market value of Planet Fitness, whose share price and market capitalization grew significantly after the deal.



# Most Strong Franchisors Now Work to Hold Supply Costs Down – and Tell Their Franchisees

- At its recent franchise convention, Handel's Ice Cream made a major presentation highlighting its work to manage its supply chain and reduce input costs – then held a breakout on things franchisees could do to cut costs themselves
- Handel's communicates regularly to its franchisees about trends in the supply chain and what it's doing to control franchisees' costs
- Planet Fitness is now open to case-by-case review of its requirements for periodic gym remodels, though making exceptions to its normal standards may also prove contentious
- When franchisees' costs increase, they raise prices, which lowers sales, which means lower royalties to franchisors. Both sides benefit from effective cost containment.

