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Supply Arrangements and Rebates: Franchisor's Rights vs. Franchisee Revolts

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I. Executive Summary

This paper address supply arrangements and supplier rebates in a franchising system through case study and informed advice from the franchising legal community. Supply arrangements and rebate systems can be a major point of contention in the franchisee-franchisor relationship; however supply arrangements are integral to the success of a franchise system. This paper will detail franchise distribution and rebate arrangements, how they work, and how to avoid common pitfalls when selecting required suppliers. Supply arrangements, mandated vendors, and supplier rebates are the cornerstone of a well-functioning franchise but can easily result in litigation when executed improperly. The purpose of this paper is to educate the reader about scenarios where supply arrangements have gone awry and how to maintain a prosperous relationship with franchisees by avoiding such scenarios.

II. Introduction to Supply Arrangements and Rebate Systems

Consistency is the ultimate currency for franchise systems. Consumers frequent franchise locations with the expectation that the products are of the same quality and consistency from one day to the next. Similarly, a franchisee typically does not enter into a franchising agreement with aspirations of changing the status quo. The uniformity of a franchising system enables a franchisee to tap into an already existing, loyal customer base, thus avoiding the perils of creating its own following. Product uniformity in a franchising system eliminates risk for both the consumer, franchisee, and franchisor alike. Delivering a consistent product across a vast franchising system is only possible through the implementation of a supply arrangement and distribution system.

Franchisors develop supply arrangements in varying ways in franchise systems. In its simplest form, a supply arrangement is a network of exclusive vendors a franchisor provides to franchisees. Franchisors hand-select the vendors. A franchisee may only purchase goods from the selected vendors at a price the franchisors and vendors previously set during their negotiation process. The price of goods in a supply arrangement is the first point of contention between franchisees and franchisors. Franchisors hope to maintain an amicable relationship with suppliers and therefore may fail to negotiate the lowest possible price on behalf of the franchisees. The result is a supply arrangement that locks franchisees into fixed expenses that an alternative vendor could possibly offer at a reduced price.

If supply arrangements did not strain the franchisee and franchisor relationship enough, enter supplier rebates. Suppliers often offer rebates to franchisors in order to incentivize business between the parties. After all, from a vendor perspective, a supply arrangement eliminates the risks of competing in an open market. From a franchisor's perspective, vendor rebates offer a stable, alternative revenue stream. Accordingly, it is common for vendors and franchisees to negotiate higher rebates in lieu of a lower price for goods. The pitfalls of a supply arrangement are thus rooted in the negotiation process: suppliers desire the security of participating in a franchising supply arrangement, franchisors desire vendor rebates to sweeten the pot, and, without a seat at the table, franchisee interests—at times—slip into an afterthought.

This is not to say franchisors do not have the best interests of franchisees in mind when negotiating supply arrangements. Many franchisors invite franchisee input when implementing changes to the "supply chain." Furthermore, franchisors' profitability directly correlates with franchisees' satisfaction and overall success. Franchisors still have an incentive to negotiate low prices on behalf of franchisees. Vendor rebates are an integral component to franchisor revenue and often necessary to maintain corporate operations. However, when franchisors are pocketing hefty rebates at a franchisee's expense, the optics are less than favorable. At their best, supply arrangements provide benefits to the entire system. As mentioned, supply arrangements maintain product uniformity and quality control that keep customers coming back. At their worst, supply arrangements become a source of dissent and litigation.

III. Overview of Supply Arrangements

Franchisor control over sources of supply can manifest itself in several different forms and rebates is but a small cog in the franchising supply chain machine. Analysis of the business considerations and best practices for choosing among those options and for dealing with supply chain issues is beyond the scope of this paper, but there are excellent resources available.[1]

On one end of the spectrum, franchisors will allow outsourcing to an array of manufacturers and distributors. On the opposite side, franchisors are involved at every point of the supply chain. In the later scenario, manufacturers and distributors are typically affiliates of the franchisor, which is highly common in advanced franchising systems. The form of supply arrangement a franchisor selects all boils down to the franchisor's desired level of control over the supply chain.

a. Minimal Control: Franchisee Choice

The least restrictive means for controlling supply is where the franchisor requires its franchisees to purchase products or select suppliers that meet specifications a franchisor has established. Franchisees may choose among suppliers that meet required specifications, and they are typically free to negotiate their own purchasing terms. This arrangement typically does not involve rebates or compensation to the franchisor from the suppliers.

The corollary, however, is that it offers the franchisor the least leverage for efficiencies and the least control over product quality. Franchisors may eliminate the time and expense of managing the day-to-day intricacies of complicated distribution channels. However, elimination of such expenses comes at a cost. With minimal control over manufacturers, it is difficult for franchisors to offer the same level of product uniformity when compared to more stringent distribution systems. This level of control is optimal for newer franchises that wish to eliminate extra expenses or perhaps lack the expertise of managing a comprehensive supply chain.

b. Intermediate Control: Manufacturing Oversight

As a franchise becomes more advanced, it begins to develop proprietary products that require special attention in the supply chain, specifically with the manufacturer. Accordingly, franchisors move away from the hands off approach detailed above, and seek more involvement in its supply chain. In such a scenario, a franchisor can mandate purchases of certain products or

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[1] *See generally* Collateral Issues in Franchising, Ch. 8 "Supply Chain Issues in Franchise Systems (ABA 2014); Andrew P. Beilfuss et al., Running on Empty: Dealing with Supply Chain Issues, ABA 43rd Annual Forum on Franchising (2020); Bethany 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).

services only from approved suppliers. This structure allows the franchisor to evaluate and approve the quality of specific products and services as well as the capabilities of the suppliers.

Intermediate control over distribution systems also provides the opportunity for the franchisor to negotiate price discounts and other favorable supply terms, which can be of great benefit to franchisees. Many systems that mandate use of approved suppliers also allow a franchisee to request approval of different suppliers or that the franchise be allowed to purchase from a supplier not on the approved list. In such cases, the franchisor should have processes in place to vet the requested supplier and, in particular, to make sure the new supplier meets the franchisor's product specifications and quality requirements. The franchisor might also legitimately consider the economic impact on other franchisees resulting from one or more franchisees being allowed to purchase outside the approved supplier program. In all events, the franchisor normally will retain sole discretion for approving new suppliers, which can lead to disagreements between the franchisee and franchisor.

c. Maximum Control: Vertical Integration

In cases of maximum control, the franchisor itself, or its affiliate, is the sole source of supply for the products offered through the franchise outlets. This is often the case for proprietary products or products sold under the franchisor's trademarks. This degree of control over a supply chain is often referred to as vertical integration. This distribution system requires the highest level of time and expense on the part of the franchisor. However, it also provides the highest level of quality control and product consistency. There are many business issues and risks to consider in connection with the franchisor as the sole supplier,[2] and potential tensions with franchisees relating to cost of supply and other financial terms can be very high in this context.

Controlling every aspect of a supply chain is a costly endeavor. To accommodate such costs, supplier-franchisors might charge a higher price for goods when compared to other competitors that outsource certain supply chain duties. Franchisees may, in turn, feel the franchisor is price gouging in order to turn an extra profit. The exorbitant costs of operating a vertically integrated supply chain can sometimes be lost on franchisees, resulting in tension between corporate and franchisee owner-operators.

d. Why Control Over Sources of Supply Is Important

One common and important characteristic of a franchise system is the franchisor's control over the sources of supply of products and services franchisees use. Many franchise systems view this requirement as essential to maintain brand standards for the benefit of the entire franchise system. Franchisors exercise control over the supply of products and services in different ways. There are many reasons why, from the franchisor's perspective, required or approved supplier relationships are important. A discussion about how comprehensive disclosures may quell franchisee tensions follows below.

The primary rationale for most franchisors to exercise control over sources of supply is that doing so is essential to maintain quality and brand image for a franchise system. Quality delivery of products and services across the entire system is crucial to maintaining consumer goodwill and

[2] *See, e.g.*, Collateral Issues in Franchising at 253-255.

customer satisfaction for the entire brand. A supplier that provides a poor quality product for franchisee use can lead to disastrous consequences for the franchise system.

Inferior food quality at a restaurant or poor Wi-Fi internet service at a hotel will mean a negative customer experience, can result in a bad online review, and risks loss of future revenues and goodwill for the entire system. In a worst case scenario, deficient or defective products can cause injury to consumers resulting in disastrous financial or reputational consequences for the brand. Inability to obtain essential products can result in shortages that diminish the quality or desirability of the franchisee's products or services. Requiring franchisees to use certain products or services or to buy from approved suppliers can mitigate these risks and help ensure the quality of the franchise offering.

Uniformity of the franchise offering is also critical for a franchise system, and approved supplier relationships help to ensure such uniformity. Customers expect a McDonald's Big Mac or a Dunkin' Donuts coffee to taste the same in Washington, D.C. or Washington State. Hotel guests expect a consistent stay experience at a Marriott or a Holiday Inn regardless of location. Use of required or approved products and suppliers can be essential to providing that experience.

In addition to ensuring quality and consistency, approved supplier relationships can create significant economic efficiencies and benefits for franchisors and franchisees. A franchisor with even a modest-sized system often can leverage economies of scale to achieve more favorable pricing or other supply terms than could a single franchisee purchasing on its own. Franchisors can obtain better pricing from key suppliers in return for getting access to a captive or at least concentrated market of franchisee purchasers. Additionally, a franchisor likely has greater supply chain expertise and greater resources to deal with supply chain issues than the average franchisee. Having the franchisor scope out the best products and identify qualified suppliers saves the franchisee time and money and keeps the franchisee from having to duplicate such expertise and resources on its own.

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 franchisee 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 of product shortages.

Supply arrangements present a slippery slope for franchisee-franchisor relationships. In most cases, a rigid and structured supply chain only produces a boisterous minority of disapproving franchisees. Most franchisees appreciate structure and are cognizant of the benefits exclusive vendors provide to the franchise system. As long as the product is keeping customers in the door, and price of goods remains reasonable, franchisees remain generally content with the arrangement for the sake of consistency. In a franchising system, one cannot put a price on uniformity. However, franchisees are not as forgiving when misappropriation of vendor rebates rears its ugly head.

IV. Rebates and Supplier Payments

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. However, rebates remain a useful tool in benefitting a franchise as a whole. The manner in which franchisors use this tool is imperative to maintaining an amicable relationship with its franchisees. For example, many franchisors divert vendor rebates into programs like advertising funds, employee benefit programs, and incentive programs. Utilizing rebates to benefit the system as a whole is an excellent way to quell disgruntled franchisees. Even so, franchisors must still walk a fine line in disclosing rebate allocation to franchisees. Below are a handful of examples where disputes arose in response to franchisor's attempt to reallocate vendor rebates.

a. Allocating Rebates: Advertising Funds

One of the most popular means of using vendor rebates is diverting rebates into national advertising funds. The benefits of this practice are intuitive: franchisees draw a direct financial benefit from a bolstered advertising fund. While this approach might seem like a slam-dunk in maintaining franchisor-franchisee relations, the end is all about the means.

For example, in or around 2009, Burger King Holdings Inc. attempted to divert millions of Coca-Cola and Dr. Pepper rebate dollars into its national advertising fund.[3] However, Burger King franchisees vehemently opposed the move arguing that Burger King was attempting to divert rebate funds originally going to the franchisees' bottom line. According to the eventual lawsuit, Burger King planned to divert $40 million dollars a year from franchisee rebate disbursements into its national advertising fund.[4] While it likely seemed reasonable at the time, franchisees felt the move unfairly reallocated funds owed to franchisees. The lawsuit was eventually dropped after Burger King agreed to leave the rebates as-is and bolster its advertising budget through alternative avenues.

b. Allocating Rebates: Employee Benefit Programs

Franchisors commonly contribute vendor rebates into employee benefit programs. This practice can include covering the costs of employee training programs or contributions to employee healthcare programs. Contributing to employee benefit programs can be helpful, however, franchisees might be displeased with these programs where they fail to increase franchisee revenues.

For example, McDonald's recently announced it planned to reallocate a $300 monthly franchisee payout meant to subsidize Happy Meal toys.[5] Vendor rebates funded the subsidy. Based on the example illustrated above, it is unsurprising that franchisees were *unhappy* to hear McDonald's planned to revoke funding originally going to franchisees. Nor did franchisees care that McDonald's planned to reinvest the money in employee benefit programs. In the eyes of the franchisees, McDonald's was reallocating money that it had originally intended to be franchisee revenues. How the money was to be spent was irrelevant. In response to McDonald's

[3] Richard Gibson, *Have it Whose Way?* Wall Street Journal, (May 17, 2020), *available at: https://www.wsj.com/articles/SB10001424052748704869304575109240807702512.*

[4] Paul Ziobro, *Burger King Ad Plan Is Fought*, Wall Street Journal (May 13, 2009), *available at: https://www.wsj.com/articles/SB124218358517513881.*

[5] Heather Haddon, *Some McDonald's Franchisees Plan Higher Happy Meal Prices*, Wall Street Journal, (Dec. 8, 2020), *available at: https://www.wsj.com/articles/some-mcdonalds-franchisees-plan-higher-happy-meal-prices-11607456510.*

announcement, franchisee owners collectively threatened to raise the price of Happy Meals in the absence of the subsidy.

c. Allocating Rebates: Incentive Programs

This method leaves open the question: why were we not getting the cash in the first place? In yet another example, Subway began advertising an alternative to the $5-footlong campaign by offering a two for-$10-footlong program. In order to encourage franchisee participation, Subway offered a $700 monthly payment to locations that opted into the campaign. Subway intended to fund the program through rebates from Coca-Cola. Timing was not on Subway's side. The corporation kicked off its two for-$10 deal in the midst of the novel Coronavirus pandemic, leaving struggling franchisees wondering why funds were not readily available to relieve the pandemic era economic stresses.

This method of rebate allocation illustrates the important concept that, at the end of the day, every party understandably wants the money. Franchisors are able to utilize rebates as a form of corporate revenue to supplement franchising fees and royalties. Franchisees also benefit from rebates by padding their bottom line. Franchisors that successfully navigate franchisee relationship are always cognizant of this fact. A franchisor may pocket vendor rebates as long as supplier prices stay low, and the product keeps customers coming through franchisee doors. Conversely, franchisors can use a portion of vendor rebates to subsidize higher pricing. At the end of the day, it is all about the money… and transparency.

V. Disclosures and Transparency in the Franchising System

Complete transparency is the best practice for franchisors in navigating supply arrangements. This includes disclosing where rebates are going and how they are benefiting the franchisee. Not only is transparency best practice, it is also mandated by law. The Franchise Disclosure Document (FDD) is a document franchisors provide prospective franchisees interested in opening a franchise location. The FDD contains important financial information regarding the franchise. The purpose of the FDD is to reasonably inform the potential franchisee about the significant investment of opening a franchise location. The FDD serves as a roadmap enabling franchisees to gain a better understanding of how the franchisor-franchisee relationship will function.

An FDD requires disclosures covering 23 categories, or items, as defined by the Federal Trade Commission. Among these items, a franchisor must disclose certain financial information, including the financial performance of the franchise, the business structure of the franchise, including any affiliates, and restrictions on sources of products and services, which includes a list of the required vendors pursuant to a supply arrangement. The FDD should fully disclose affiliated vendors in a supply arrangement. For example, a franchisor utilizing vertical integration will have to disclose it is the owner and operator of the manufacturers and distributors for the franchise supply chain.

Furthermore, with the in depth financial disclosures the FDD requires, franchisees can discern where franchisors are allocating rebate funds, how much vendors are charging for goods, and what vendors franchisees will be required to conduct business with. Franchisees take these disclosures very seriously. Curtailing disclosure requirements exposes a franchisor to a catalogue of legal liability. Cold Stone creamery found itself in the midst of a legal battle with franchisees in 2012 when a group of franchisees filed suit to compel Cold Stone to disclose its allocation of vendor rebates.[6] The franchisees felt Cold Stone was misrepresenting the allocation of funds and wanted to ensure Cold Stone was setting aside the rebates for the brand's national advertising fund. The court ultimately stayed the case pending arbitration, and the parties settled outside of court.

Supply arrangements and vendor rebates are a useful tool in franchises; however they can function as either a hammer or a dagger. Supply arrangements have built the most impressive of franchises, but even so, have the potential to bring the whole system crashing down. Both parties are dependent on each other for success but nevertheless may sometimes be at odds when it comes to supply arrangements and rebate systems.

VI. The Franchisee Perspective: What Can Go Wrong?

Most franchisees recognize the importance of product uniformity, brand image, and, at times, the franchisor's superior purchasing power. For example, franchisees would rightly complain and ask the franchisor to intervene if other franchisees purchased substandard or unapproved products. Doing so may improve the bottom line of the particular franchisee, but it could also cause system-wide damage by disappointing or confusing consumers. Customers might not know what to expect in terms of quality and product offerings across the system and, therefore, might instead choose a more predictable and reliable competitor.[7] Franchise systems may avoid this problem through the strategic use of mandated supply arrangements.

However, the interests of the franchisor and franchisee may diverge when franchisors disallow supplier choice with respect to non-proprietary products or products for which the franchise system has lower purchasing volumes. For example, whole-sale retailers as well as retailers with a business model based on big lots, overstocks, and discount purchases such as Costco and Sam's Club may offer similar products at a lower price, every day, than the comparable product delivered by the franchisor.[8] Allowing some degree of supplier choice with respect to products that are not critical to the franchise system, or at least the ability to seek approval of alternative suppliers, can address franchisee frustration where franchisees are forced to purchase goods and services at prices exceeding what the franchisee could obtain in the open market.[9]

Franchisees are especially sensitive to pricing points in the wake of the COVID-19 pandemic, which has wreaked havoc on all aspects of the business of franchising, including substantial disruptions to the supply chain.[10] Consistent, open communication between franchisors, franchisees, and suppliers is critical to maintaining the franchise relationship, and franchisees are likely to benefit from increased flexibility and accelerated approval of alternative

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[6] Sarah E. Needleman, *Tough Times for Franchising,* Wall Street Journal, (February 9, 2012), *available at: https://www.wsj.com/articles/SB10001424052970204136404577211391192172770.*
[7] Chelsey K. "Bud" Culp III & Rochelle B. Spandorf, *Sourcing Products and Services for the System: Efficiencies and Traps in Supply Chain Management*, A.B.A. 32nd Annual Forum of Franchising 26 (2009).
[8] *Id.* at 27.
[9] Bethany L. Appleby & Gaylen L. Knack, *Structuring and Negotiating Essential Vendor Agreements and Dealing with Financial Terms, Discounts, and Rebates*, A.B.A. 44th Annual Forum on Franchising 6 (2021).
[10] Andrew P. Beilfuss et al., *Running on Empty: Dealing with Supply Chain Issues*, A.B.A. 43rd Annual Forum on Franchising 45 (2020).

suppliers and products when franchisors are unable to source products in time to meet customer demands.[11]

Another possible solution is to allow for more franchisee buy-in through purchasing cooperatives or franchisee councils.[12] These organizations can not only provide tangible, bottom-line benefits to its members but also allow meaningful participation by franchisees in large and small markets to have a say in system-wide topics, including product purchasing decisions and supply chain management.[13]

As mentioned above, another frequent problem that franchisees face relates to how franchisors utilize supplier rebates, and specifically, whether franchisors are using the rebates for the benefit of the system or simply as another revenue stream for themselves. In order to secure a franchise system's business, suppliers and vendors will often agree to provide rebates, volume discounts, tier pricing, purchase commitment discounts, allowances, direct payments, and/or other benefits to the franchisor.[14]

These rebates can be a significant source of revenue and profit for the franchisor, and as such, franchisees may feel that the franchisor is taking advantage of the franchisees' contractual obligation to purchase from designated suppliers in order to extract additional revenue and profit for itself while subjecting the franchisees to less competitive pricing.[15] As mentioned, in June of 2020, Subway attempted to convince its franchisees to participate in a media-supported, two for-$10 Footlong limited-time-offer.[16] Subway offered participating franchisees $700 per month through August of 2020 for a total of $2,100, but franchisees vehemently opposed the offer, at least in part, because Coca-Cola was paying the cash incentive.[17] In a letter to its members in May of 2020, the North American Association of Subway Franchisees said that vendor funds "should be available to all stores without strings attached since vendor funds are never 'given' but negotiated as a trade-off for higher food costs and longer contracts."[18]

The Quizno's franchise system also benefited greatly from supplier rebates in a plan that a class of franchisees ultimately challenged in court. In the Quizno's case,[19] franchisees alleged that Quizno's was profiting from undisclosed relationships with Quizno's-owned supplier middlemen that were unlawfully marking up products the franchisor required the franchisees to purchase, netting over $37 million in food product and equipment kick-backs from *actual* product suppliers in a single year. Given how lucrative supplier rebates can be to a franchisor's bottom line,

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[11] *Id.* at 48.

[12] Gina Romo et al., *Building an Effective Supply Chain and Distribution System*, A.B.A. 35th Annual Forum on Franchising 55-56 (2012).

[13] *Id.*

[14] Beilfuss, *supra* note 10 at 30.

[15] Lee N. Abrams & Robert T. Joseph, *Vendor Rebates: Considerations in Drafting and Litigating*, A.B.A. 34th Annual Forum on Franchising 1 (2011).

[16] Beilfuss, *supra* note 10 at 30.

[17] Jonathan Maze, *Recent Disputes Highlight Franchisors' Use of Vendor Rebates*, Restaurant Business, June 12, 2020.

[18] *Id.*

[19] *Bonanno v. The Quizno's Franchise Co. LLC*, No. 06-02358, 2008 WL 638367 (D. Colo. March 5, 2008). One of the authors of this paper, Joseph S. Goode, represented the plaintiff franchisees in this case.

franchisee skepticism and scrutiny is to be expected. It should not be a surprise that these supplier relationships are a basis for various claims franchisees use against their franchisors.

VII. Franchisor Perspective: Dismantling Murphy's Law

Rebates and supplier payments are common aspects of required or approved supplier relationships, but, as illustrated here, they can be hot-button topics that cause friction in a franchise relationship. Franchisees sometimes believe that a franchisor should be obligated to negotiate the lowest possible product and supply costs, and franchisors should pass on or apply all rebates or payments received from suppliers for the benefit of franchisees. In other words, franchisees sometimes object to a franchisor using exclusive supply arrangements as a profit center. Rebates and supplier payments are a common subject of franchisor-franchisee litigation, as discussed in detail below.

From the franchisor's perspective, there are several legitimate considerations and reasons why it is appropriate to receive rebates and supplier payments. Accordingly, franchisees should look at the whole picture of benefits and costs before taking issue with the franchisor's supply arrangements. Many franchisors use supplier payments to fund the often significant costs incurred in maintaining a purchasing and supply chain operation. Responsible franchisors incur costs to identify and qualify products and suppliers, to tests those products, and to manage the supply chain for the franchise system. A franchisor should be able to cover some or all of those costs through supplier rebates and payments.

Beyond covering its supply chain management costs, some franchisors use rebates and supplier payments to support other expenditures that benefit the entire franchise system. Supplier rebates and payments may be used to support the system's marketing fund or brand development fund, which plainly benefits the franchisees and the brand as a whole. Even where a franchisor takes such rebates and payments into its general revenue, these funds can also benefit the entire system by contributing to the overall financial strength of the franchisor.

Generally, a franchisor has no duty to obtain the lowest possible price for products and services delivered to or used by the franchisees. If the overall costs for the collective products and services from required vendors is reasonable, and if the franchisor is delivering cost and supply chain efficiencies for its franchisees, then supplier rebates can result in a win-win situation for the system.

Another important perspective of a responsible franchisor regarding supplier rebates and payments is that such arrangements are disclosed in the FDD. In Item 8 of the FDD, franchisors must disclose:

> The franchisee's obligations to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items related to establishing or operating the franchised business either from the franchisor, its designee, or suppliers approved by the franchisor, or under the

franchisor's specifications. Include obligations to purchase imposed by the franchisor's written agreement or by the franchisor's practice.[20]

The reference to obligations imposed "*by the franchisor's practice*" includes requirements set forth in the operations manual or other communications of required practices the system must follow. Item 8 goes on to identify 11 specific issues the franchisor must address and explain for each applicable purchase obligation, including:

1) Whether the franchisor or an officer owns an interest in the supplier;

2) Whether the franchisor permits franchisees to use alternative suppliers to meet the franchisor's criteria;

3) Whether the franchisor or its affiliates may derive revenue for other material consideration from required purchases by franchisees;

4) If a designated supplier will make payments to the franchisor from franchisee purchases; and

5) Whether the franchisor negotiates purchase arrangements with suppliers for the benefit of franchisees.[21]

Thus, franchisees should have a great deal of information available to them regarding required supply relationships and supplier rebates for payments before they decide to purchase the franchise. A franchisee can then decide for itself whether to proceed in light of the disclosed arrangements.

Proper disclosure is vital for a franchisor to mitigate risk and protect itself against disgruntled franchisees' claims. Franchisees' supply-related claims can take different forms depending on the underlying facts. Franchisees sometimes use federal and state antitrust laws to challenge franchisor supplier arrangements. Franchise agreement terms also may provide a basis for a breach of contract claim, and franchisees often try to use the implied covenant of good faith and fair dealing to challenge supplier requirements and arrangements they believe are unfair. In some cases, franchisees assert claims for fraud based on alleged misrepresentations about supplier terms. And in a few states, statutes may apply to franchise relationships, either those specifically addressing supplier issues or more generally prohibiting unreasonable acts or practices. In all these situations, full and timely disclosure can provide a sturdy defense to franchisee challenges. Claims and defenses under these theories are discussed in more detail below.

VIII. Potential Franchisee Claims

Generally speaking, franchisors have wide latitude with respect to mandating franchisees participate in certain programs and source products from particular suppliers. However, there are limits. When franchisors go too far, they may expose themselves to liability to franchisees based on a variety of legal theories, including: (1) antitrust violations, (2) fraud and misrepresentation

[20] 16 C.F.R. § 436.5(h).
[21] *Id*.

claims, (3) breach of contract and breach of the implied duty of good faith and fair dealing, and (4) violations of state relationship laws.

a. Antitrust

Supplier rebates can implicate both state and federal antitrust laws in a variety of ways. One of the most commonly asserted antitrust theories is referred to as a "tying" claim. In essence, tying claims assert that the franchisor has "tied" the purchase of a product in a market in which it has market power with the purchase of another product a preferred supplier sells.[22] Put another way, a tying arrangement involves the sale of "one product but only on the condition that the buyer also purchases a different (or tied) product."[23] These arrangements violate antitrust law when the seller, by virtue of its market power, exploits its control of the "tying" product "to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms."[24] The underlying problem is "the wielding of monopolistic leverage; a seller exploits his dominant position in one market to expand his empire into the next."[25]

A plaintiff alleging a tying claim must generally show the following:

1) The seller's possession of "market power" over the tying product is sufficient to enable it to "force" the buyer to purchase the tied product;

2) The tying product and the tied product are separate and distinct items for which separate demands exist;

3) The defendant conditioned the sale or lease of the tying product on the purchase of the tied product; and

4) The arrangement has an effect on a "not insubstantial" amount of interstate commerce.[26]

Under certain circumstances, tying arrangements are *per se* illegal under federal antitrust laws, but courts have found that a tying arrangement may be lawful if a defendant implements it for a legitimate business reason where no less restrictive alternative is available.[27]

Arguably, the most important (and often, difficult) factor for an antitrust tying claim is the identification of the relevant market and the sellers' power within that market. As commentators have noted, "[t]he plaintiff's entire claim often will rise or fall on the basis of the market definition."[28]

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[22] Abrams & Joseph, *supra* note 15 at 4.
[23] *N. Pac. Ry. v. United States*, 356 U.S. 1, 5 (1958).
[24] *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 21 (1984).
[25] *Times-Picayune Publ'g Co. v. United States*, 345 U.S. 594, 611 (1953).
[26] *Hyde*, 466 U.S. at 12-13.
[27] Abrams & Joseph, *supra* note 15 at 5.
[28] *Id.* at 14.

Dairy Queen offers an illustrative example of franchisees successfully identifying the relevant market to sustain a tying claim.[29] In that case, the franchisees argued that Dairy Queen had tied the right to buy a franchise to the purchase of food products and supplies from approved suppliers who sold the products to authorized warehouses for distribution. The warehouses paid Dairy Queen a fee for every sale it made to a franchisee. Although Dairy Queen argued that it lacked the requisite power in the relevant market to sustain a tying claim, the franchisees argued that the relevant market was soft-serve ice cream franchises in which Dairy Queen is an undisputed market leader.

According to the franchisees, the primary product line identifying and differentiating Dairy Queen as a brand was its soft-serve ice cream. In support of this position, they presented evidence demonstrating that most Dairy Queen locations sold more ice cream items than other food items and realized a higher profit margin on ice cream than on other food options. Dairy Queen argued that the franchisees' proposed market (i.e., soft-serve ice cream franchises) was too narrow and all fast food franchisors competed for the same franchisees. The franchisees argued even if Dairy Queen's assertion was true, there was a probable "submarket" limited to soft-serve ice cream franchises that practical indicia defined such as industry or public recognition, peculiar product characteristics, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors. The court ultimately held that a genuine issue of material fact existed with respect to whether the relevant market consisted of *all* fast-food franchises or a "submarket" for soft-serve ice cream franchises.[30]

Other plaintiffs have also pursued antitrust violations based on the theory that supplier rebates constituted "commercial bribery" under § 2(c) of the Robinson-Patman Act. Section 2(c) prohibits any person from paying or granting anything of value as a commission, brokerage, or other compensation except for the services rendered in connection with the sale or purchase of goods, wares, or merchandise.[31] The statute arose out of a concern that large retailers would use their economic dominance to force sellers to pay a fee for doing business with them, and some franchisee plaintiffs have argued that supplier rebates effectively represent a franchisor's commercial bribery of the exclusive or approved vendor.[32]

However, establishing standing to sue under § 2(c) can be a hurdle for franchisee plaintiffs. In *2660 Woodley Road Joint Venture v. ITT Sheraton Corp.*,[33] for example, the owner of a Sheraton-managed hotel challenged the "Sheraton Purchasing Resource" (SPR) program in which Sheraton negotiated large-volume discounts with suppliers, then required the suppliers to add a surcharge to the price billed to the individual hotels for each purchase. The vendor did not itemize the surcharge, or even disclose it to, the hotel owners in any bills or invoices. Instead, Sheraton received the "rebate" directly from the vendor. The plaintiff sued Sheraton arguing that the SPR program constituted commercial bribery and that it had suffered an antitrust injury because it could

[29] *Collins v. Int'l Dairy Queen, Inc.*, 939 F. Supp. 875 (M.D. Ga. 1996).
[30] For an excellent summary and collection of cases involving tying arrangements in the franchise context, see Abrams & Joseph, *supra* note 15 at 4-21.
[31] 15 U.S.C. § 13(c).
[32] Abrams & Joseph, *supra* note 15 at 22.
[33] 369 F.3d 732 (3d Cir. 2004).

only purchase goods from suppliers participating in the program. The linchpin of the claim, of course, was that the vendor inflated the prices of the goods because of the alleged bribe.

The Third Circuit held that paying inflated prices to suppliers, without more, was not "an injury of the type the antitrust laws were intended to prevent." Instead, the court concluded that the hotel owner's injury was caused by a breach of contract and the corruption of the principal-agent relationship, and although these circumstances could amount to an antitrust injury in an appropriate case, it did not believe that the hotel owner established such an injury. In so concluding, the Third Circuit established a multi-factor test for a plaintiff to demonstrate "antitrust standing" under § 2(c):

1) The causal connection between the antitrust violation and the harm to the plaintiff and the defendant's intent to cause that harm, with neither factor alone conferring standing;

2) Whether the plaintiff's alleged injury is of the type for which the antitrust laws were intended to provide redress;

3) The directness of the injury;

4) The existence of more direct victims of the alleged antitrust violations; and

5) The potential for duplicative recovery or complex apportionment of damages.

b. Fraud and Misrepresentation

Fraud and misrepresentation causes of action aim to redress injuries caused by intentional deceit or omissions of material facts. In the supplier rebate context, franchisee plaintiffs frequently base their fraud claims on the theory that failing to make required disclosures under Item 8 of the FTC Rule constitute common law fraud.[34]

The Tubby's Sub Shop case provides a good example of this type of non-disclosure/fraud claim in action.[35] Franchisees of Tubby's sued their franchisor alleging that the franchisor failed to disclose its profits from a mandatory distribution program. The franchisees claimed that Tubby's selected mandatory suppliers based on their willingness to pay Tubby's a rebate. More concerning, Tubby's set up a subsidiary, SDS, to purchase products from the selected suppliers and resell them to franchisees at a significant mark-up, thereby creating an additional revenue stream from franchisee's mandatory supply purchases. Franchisees argued that although Tubby's FDD identified SDS's warehousing and distribution services, Item 8 failed to disclose the revenues that both Tubby's and SDS derived from the franchisee purchases of supplies. The federal district court

[34] 16 C.F.R. § 436.5. Franchisee plaintiffs utilize this theory at least in part because the FTC Act itself does not provide a private cause of action for violations thereof.

[35] *Tubby's #14, Ltd. v. Tubby's Sub Shops, Inc.*, No. 04-70918, 2006 WL 2796181 (E.D. Mich. Sept. 27, 2006).

denied Tubby's motion for summary judgment, concluding that the allegations and evidence allowed for a claim as common law fraud.[36]

Franchisee plaintiffs also frequently argue that the franchisor's failure to disclose revenue and profits derived from supplier rebates constitute fraudulent inducement to enter into a franchise agreement in the first place. In the Quizno's case,[37] a class of franchisees sued Quiznos alleging, among other things, that Quiznos failed to disclose a supplier rebate scheme whereby a Quizno's-owned intermediary would purchase products from designated suppliers and sell those products to franchisees at a significant and unjustifiable mark-up. Indeed, the suit alleged that American Food Distributors LLC, a Quizno's-owned company that purchased food products from Quizno's-approved suppliers received over $33 million in rebates in a single year. Plaintiff franchisees argued that they would not have entered into their franchise agreements with Quizno's had it disclosed the supplier rebate scheme. Quizno's moved to dismiss this claim, but the court concluded that the allegations of non-disclosure, in addition to other allegations of fraud, stated a claim of fraudulent inducement with adequate particularity to justify discovery.

c. Breach of Contract/Good Faith & Fair Dealing

While a slew of federal and state regulations govern the franchisor-franchisee relationship, it is fundamentally a contractual relationship. Depending on the language of the franchise agreement, franchisee plaintiffs can claim that particular supplier rebate programs constitute a breach of the franchise agreement.

For example, *In Town Hotels Ltd. Partnership v. Marriot International, Inc.*[38] involved franchisees suing an affiliate of Marriott that operated as the hotel chain's procurement agent, Avendra, on the basis that Avendra had unlawfully profited from rebates on franchisee purchases of hotel supplies. Avendra moved to dismiss the breach of contract claim, arguing that the franchise agreements between the franchisees and Marriott specifically provided that Marriott "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 [Marriott] and its affiliates shall be at competitive prices) . . . ." In response, however, the franchisee plaintiffs emphasized that a section of the franchise agreement provided that Marriott would "retain, as a management fee for services performed hereunder, an amount . . . equal to twenty percent (20%) of Operating Profit[,]" and Marriot further agreed that "[n]o charges or fees are to be paid by [the franchisees] to [Marriott] except as provided in the Agreement. . . ."

The conflict between Marriott's reservation of the right to control procurement of supplies with its agreement that it would only receive compensation in the form of a management fee prevented Marriott from succeeding on a motion to dismiss the breach of contract claims. The franchise agreement did not unambiguously authorize the challenged rebates, nor did the language of the franchise agreement unambiguously prohibit the same. Ultimately, in response to Marriott's motion to dismiss, the court held that factual development was necessary to further flesh out,

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[36] Interestingly, commentators have noted that other submarine sandwich franchises, in particular, have faced similar litigation issues related to the quality of the Item 8 disclosures. *See* Abrams & Joseph, *supra* note 15 at 14 n. 33 (collecting cases).
[37] *Bonanno v. The Quizno's Franchise Co. LLC*, No. 06-02358, 2008 WL 638367 (D. Colo. March 5, 2008).
[38] 246 F. Supp. 2d 469 (S.D. W.Va. 2003).

among other things, the specific details of the relationship between Marriott and its franchisees, the context and nature of the supplier rebates, the course of dealing between the relevant parties, and the standard practices within the industry.

Additionally, in the class action litigation *Bird Hotel Corp. v. Super 8 Motels, Inc.*,[39] a federal district court concluded that Super 8 breached its franchise agreements by mandating participation in its TripRewards Program, which required an additional fee payment based on gross room rates. The court held that "[e]ven if Super 8 has retained the right in [the Franchise] Agreement to change its system standards and rules of operation and its customer loyalty program detailed therein, it may not unilaterally impose a fee for the operation of that program greater than what is provided for in the language of the [Franchisee] Agreement."

Similarly, in *National Franchisee Association v. Burger King Corp*.,[40] the court held that the plaintiff franchisee organization stated a claim for breach of the covenant of good faith and fair dealing based on the franchisor's mandating that double cheeseburgers be on the $1 Value Menu, a program that was tied to certain supplier rebates. According to the franchisee organization, participating in this program would have required the franchisees to sell these products at a loss.

While franchisees have had some degree of success in breach of contract claims, the claims rise or fall based on specific contract language. Language that unambiguously favors the franchisor can often provide a basis for dismissal of such claims. For example, franchisees in the Little Caesars system alleged that either their franchise agreements or the covenant of good faith and fair dealing required Little Caesars to credit its franchisees for the rebates it received from the franchise system's exclusive product suppliers.[41] The applicable franchise agreements made no mention of crediting franchisees with supplier rebates or discounts, and Little Caesars argued that the implied covenant of good faith and fair dealing, as Michigan courts have interpreted, did not apply because there was nothing in the franchise agreements that provided Little Caesars with discretion to pass along the supplier rebates to franchisees.

Little Caesars was able to persuade the court to grant summary judgment in its favor on the franchisees' claims for breach of contract and breach of the covenant of good faith and fair dealing. Based on how the courts in these cases interpreted the applicable franchise, both franchisees and franchisors would do well to be specific with respect to supplier rebates.

d. <u>State Relationship Laws</u>

A majority of states have laws generally governing the relationship between franchisors and franchisees, but relatively few states have provisions that specifically govern supplier rebates. In particular, Washington, Indiana, Iowa, New Jersey, and Hawaii all have particular statutes that restrict the circumstances under which franchisor-supplier rebates are lawful. They share important similarities—specifically with respect to requiring mandatory supply purchasing schemes to be "reasonably necessary" to a legitimate business purpose of the franchise.

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[39] No. 06-4073, 2010 WL 572741 (D.S.D. Feb. 16, 2010).
[40] 715 F. Supp. 2d 1232 (S.D. Fla. 2010).
[41] *Little Caesars Enterprises, Inc. v. Smith*, 34 F. Supp. 2d 459 (E.D. Mich. 1998).

The Washington Franchise Investment Practices Act (WFIPA) prohibits offering to sell, selling, or renting "to a franchisee any product or service for more than a fair and reasonable price."[42] The WFIPA also requires the franchisor and franchisee to "deal with each other in good faith" and forbids franchisors from requiring "a franchisee to purchase or lease goods or services of the franchisor or from approved sources of supply unless . . . restrictive purchasing agreements are reasonably necessary for a lawful purpose justified on business grounds, and do no substantially affect competition."[43] Moreover, with respect to disclosures to franchisees, the WFIP prohibits franchisors from obtaining "money, goods, services, anything of value or any other benefit from any other person with whom the franchisee does business unless such benefit is disclosed to the franchisee."[44]

The Hawaii Franchise Investment Law contains similar provisions. It prohibits franchisors from imposing standards that are unreasonable and arbitrary or requiring franchisees to purchase or lease goods or services of the franchisor or from designated sources unless the requirement is reasonably necessary for a lawful business purpose.[45] Like the Washington statute, the Hawaii law also prohibits a franchisor from obtaining "money, goods, services, anything of value, or any other benefit from any other person with whom the franchisee does business on account of such business unless the franchisor advises the franchisee in advance of the franchisor's intention to receive such benefit."[46] Commentators have observed that adequately detailed Item 8 disclosures are likely to satisfy these provisions of Washington and Hawaii law.[47]

The New Jersey Franchise Practices Act (NJFPA) likewise forbids franchisors from requiring participation in mandated supplier relationships that are not "reasonable and necessary[.]"[48] Indiana law prohibits franchisors from, among other things, requiring franchisees to accept goods or supplies that are not necessary to the operation of the franchise, required by the franchise agreement, required by law, nor voluntarily ordered and requires advance notice to franchisees of any price increases.[49] Iowa is unique in that its franchise laws specifically allow franchisees, with some exceptions, to purchase supplies and services from sources of the franchisees' choosing as long as they meet the franchisor's standards.[50] As other commentators have observed, these state relationship laws can provide fertile ground for franchisees to assert claims that the franchisor has overreached in mandating certain supplier relationships. [51]

IX. Franchisor Defenses

a. Antitrust

Franchisee tying claims have been common throughout franchising's history, going back to the seminal decision in *Siegel v. Chicken Delight, Inc*. Over the past 25 years, however,

[42] Wash. Rev. Code § 19.100.180(2)(d) (2021).
[43] Wash. Rev. Code § 19.100.180(1) & 19.100.180(2)(b).
[44] Wash. Rev. Code § 19.100.180(2)(e).
[45] Haw. Rev. Stat. §§ 482E-6(2)(B) and (2)(G) (2021).
[46] Haw. Rev. Stat. § 482E-6(2)(D).
[47] Beilfuss, *supra* note 10 at 31-32. The Indiana Deceptive Franchise Practices Act contains an almost identical provision, Ind. Code § 23-2-2.7-1(4), but this particular provision has not yet been judicially interpreted.
[48] N.J. Stat. § 56:10-7(e) (2021).
[49] Ind. Code § 23-2-2.7-2(1)(i) and (7).
[50] Iowa Code § 523H.12 (1992) & § 537A.10.9 (2021).
[51] Appleby & Knack, *supra* note 9 at 7-9.

franchisees generally have fared poorly in attempting to assert tying claims under Section 1 of the Sherman Act. Franchisors have had substantial success in defeating the essential requirement that the defendant must have "market power" in a properly defined product market. Franchisors have also had success defeating franchisee arguments that the allegedly tying and tied items constitute two separate products. The unique nature of the franchise relationship and franchisor disclosure scheme provides a strong basis for these arguments.

The U.S. Supreme Court has explained that "the essential characteristic of an invalid tying arrangement lies in the seller's exploitation of its control over the tying product to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms."[52] A franchisee asserting an unlawful tying arrangement under either a *per se* rule or reason analysis has the burden of properly defining the relevant tying product market within which the franchisor's market power can be measured and the allegedly anticompetitive effects can be assessed. The relevant product market focuses on products or services that compete with each other, *i.e.* products that are reasonably interchangeable and as to which there is cross-elasticity of demand. Plausibly alleging that a franchisor has market power in a properly defined product market is very challenging. The U.S. Supreme Court has held that even a market share of 30% is insufficient as a matter of law to establish market power.[53]

Franchisees often allege that the "tying" product is the franchise itself. But very few, if any, franchisors will have a sufficient share of the relevant market to allow for a plausible claim of market power under such a theory. Franchisees have argued that the relevant market should be defined as a single franchise offering or system, relying on the "lock-in" theory recognized by the U.S. Supreme Court in a non-franchise case, *Eastman Kodak Co. v. Image Technical Services*.[54] This argument, however, rarely survives a motion to dismiss.

The leading case rejecting the "lock-in" theory in the franchise context is the Third Circuit's decision in *Queen City Pizza*.[55] In that case, Domino's franchisees alleged that the franchisor unlawfully required them to purchase ingredients and supplies to make pizzas from either Domino's or its approved supplier as a condition of obtaining Domino's fresh dough or, alternatively, for the "continued enjoyment" of rights under the franchise agreements. The plaintiff franchisees alleged that the relevant market for purposes of their tying claim should be limited to the market for ingredients and supplies among Domino's franchisees.

The Third Circuit affirmed the dismissal of the tying claims because they failed to plead an appropriate relevant market in which Domino's exercised market power. The court held that because the supplies such as pizza dough required to operate a Domino' franchise were reasonably interchangeable with other brands, the Domino's-required supplies did not constitute a relevant market of their own merely because the franchise agreement required the franchisees to purchase them from Domino's. Referring to the franchisees' argument that they were "locked-in" and required to buy the supplies from Domino's' approved vendors, the Court distinguished this case from *Kodak* and explained that the "particular contractual restraints assumed by plaintiff are not sufficient by themselves to render interchangeable commodities non-interchangeable for purposes

[52] *Jefferson Parish v. Hyde*, 466 U.S. 2, 12 (1984).
[53] *Id*. at 26.
[54] 504 U.S. 451 (1992).
[55] 124 F.3d 430 (3d Cir. 1997).

of relevant market definition. . . . [W]here the defendants 'power' to 'force' plaintiffs to purchase the allegedly tying product stems not from the market but from plaintiff's contractual agreement to purchase the tying product, no claim will lie."[56]

The *Queen City Pizza* court further distinguished the *Kodak* decision based on the particular characteristics of the franchise sale process and the franchise relationship. The franchisor had disclosed the approved purchase requirements before the franchisee purchased the franchise, so the prospective franchisee could assess the costs and risks before deciding to agree to that arrangement. The court reasoned that if the franchisee decided that it did not like that arrangement, it was free to reject the Domino's franchise opportunity and seek out another opportunity with different terms. One court summarized the holding of *Queen City Pizza* as resting "on the principle that a product market cannot be defined by contractual restraints on the plaintiff franchisee."

Subsequent decisions have relied on the rationale of *Queen City Pizza* to reject virtually all franchisee-tying claims. In *Rick-Mik Enters., Inc. v. Equilon Enters, LLC*, the court rejected the claims by Shell and Texaco gasoline dealers that the franchisor illegally tied credit card processing services to the sale of the franchise.[57] The franchisees had not alleged that the franchisor had market power in the properly defined tying product market, which the court held was gasoline franchises generally. Relying on *Queen City Pizza*, the court held that "a tying claim generally requires that the defendant's economic power be derived from the market, not from a contractual relationship that the plaintiff has entered into voluntarily."[58]

Courts also have rejected franchisee attempts to define the relevant market as a particular type of franchise offering. In *Arnold v. Petland*, the court found that the proposed relevant market for "retail pet franchises" failed as a matter of law because it did not recognize the purpose of the franchise opportunity and the choices available to the franchisee.[59] The court noted that the fundamental nature of the franchise opportunity "is to make money for the franchisee. It is, in the final analysis, an investment opportunity. Any other of a number of other products created for the same purpose would be reasonably interchangeable."[60]

Similarly, in *Westerfield v. Quizno's Franchise Co.*, the court rejected the franchisee's attempt to define the relevant product market for the market for quick service toasted sandwich restaurant franchises.[61] Instead, the court held that "[i]n the area of franchises such as Quizno's, the relevant product market would include equivalent investment opportunities" which in many cases could include the market for franchises of all types or the employment of capital.[62] Franchisees rarely could plausibly allege, much less prove, that a franchisor held sufficient market power in a market defined to include all reasonably interchangeable investment opportunities available to the franchisee before purchasing the franchise in question.

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[56] *Id*. at 443.
[57] 532 F.3d 963 (9th Cir. 2008).
[58] *Id*. at 12.
[59] No. 2:07-CV-01307, 2009 WL 816327 (S.D. Ohio Mar. 26, 2009).
[60] *Id*. at *7.
[61] 527 F. Supp. 2d 840 (E.D. Wis. 2007).
[62] *Id*. at 24-25.

Finally, franchisors often defeat tying claims on the ground that the allegedly tying and tied items do not constitute separate products. For example, in *Rick-Mik* (discussed above), the court found that the required credit card processing system which was the allegedly tied item was not a distinct product from the franchise. The Ninth Circuit noted that "[f]ranchises, almost by definition, necessarily consist of 'bundled' and related products or services – not separate products."[63] The court held that "[w]here the challenged aggregation is an essential ingredient of the franchised system's formula for success, there is but a single product and no tie exists as a matter of law."[64]

b. <u>Fraud/Misrepresentation</u>

Franchisees may also attempt to challenge vendor rebates and exclusive supplier arrangements based on common-law claims of a franchisor's fraud and misrepresentation. The first line of defense to such claims usually will be the Item 8 disclosures in the franchisor's FDD, as a broad and unambiguous disclosure can defeat such claims. In addition, franchisors should analyze the universe of other potentially applicable fraud defenses that are not specific to the vendor rebate context, such as:

- Failure to plead the alleged fraud with sufficient particularity;
- No reasonable reliance;
- Merger/disclaimer clauses;
- No liability for promises as to future events;
- No materiality; and
- No damage caused by the alleged misrepresentation.

Because these state law defenses vary by jurisdiction, franchisors should analyze the law of the applicable jurisdiction to identify all potentially applicable defenses.

For example, in *The Cleaning Authority v. Neubert*, the franchisees counterclaimed for fraud in the inducement alleging that the franchisor failed to disclose a setup fee payable to an affiliate and also failed to disclose rebates, kickbacks, and other payments the franchisor received.[65] The court granted the franchisor's motion to dismiss on a number of grounds, including that the franchisor's disclosure document accurately disclosed the requirement that the franchisees purchase services from the franchisor's affiliate. The court further held that the counterclaim failed to plead sufficient facts to establish the materiality of the franchisor's statement that it did not "currently" receive rebates from any of the approved suppliers. The court also based its decision on the fact that the franchisor had satisfied the disclosure requirements of Item 8 of the FTC ruling.

Peterson v. Sprock illustrates the importance of traditional fraud defenses in defeating a franchisee claim based on, among other things, an alleged failure to disclose alleged supplier

[63] 532 F.3d 963, 974 (9th Cir. 2008).
[64] *Id*.
[65] 739 F. Supp. 2d 807 (D. Md. 2010).

"kickbacks."[66] Following a bench trial, the judge found that the plaintiff franchisees failed to establish a claim for fraud because the alleged representations "were either not false, lacked justifiable reliance, or did not result in any demonstrated damage to Plaintiffs."[67]

c. Breach of Contract/Good Faith and Fair Dealing

One of the things that franchisor and franchisee lawyers can agree on is that most claims for breach of contract or breach of the implied covenant of good faith and fair dealing stand or fall based on the particular language of the franchise agreement at issue. In the supplier context, franchise agreement language usually grants broad discretion to the franchisor so the franchise agreement language will usually provide a strong defense to breach of contract or breach of implied covenant claims.

It is axiomatic that plaintiff cannot state a claim for breach of contract when the agreement permits the very conduct that is being challenged. Similarly, where the contract does not require a franchisor's specific conduct, courts normally will not impose new obligations at the request of a party. In *Little Caesar Enters., Inc. v. Smith*, the court granted summary judgment against the plaintiff franchisees on their claim that Little Caesar breached the franchise agreement by failing to credit them for rebates, discounts, and bonuses vendors paid to the franchisor's affiliate.[68] Because the franchise agreement made no provision for crediting the franchisees with vendor rebates or discounts, neither the breach of contract nor implied covenant claim could survive.

Similarly, a franchisee cannot state a claim for breach of the implied covenant of good faith and fair dealing where the franchise agreement authorizes the challenged conduct. The implied covenant cannot contradict the express terms of the franchise agreement. Courts routinely dismiss good faith and fair dealing claims that challenge the franchisor's exercise of its contractually authorized discretion.

Thus, if the franchise agreement makes clear that the franchisor has the right to designate approved suppliers (including its affiliates) or to receive rebates from vendors, franchisees likely will have an uphill battle to challenge such conduct under a breach of contract or implied covenant of good faith and fair dealing theory. In addition, franchisors would be wise to develop support for the reasonableness of their approved supplier requirements and decisions. For example, developing and uniformly applying criteria focused on important business considerations like product quality, ability to supply timely and appropriate quantities, and favorable pricing are legitimate business justifications to support the franchisor's policies, and therefore can provide a strong defense to a good faith and fair dealing claim. Evidence that a franchisor has, under appropriate circumstances, granted approval for one or more permanent suppliers also can be helpful to refute a franchisee's claim that the franchisor breached the contract by refusing to approve the franchisees preferred supplier. Finally, the franchisor should be prepared to show the overall benefits to the system from its approved supplier and rebate program. Tangible benefits to the system as a whole, including favorable pricing and insuring quality, will further bolster the reasonableness of the franchisor's requirements.

[66] 106-cv-3087-RWS, 2009 WL 631219 (N.D. Ga. Mar. 10, 2009).
[67] *Id*. at *4.
[68] 895 F. Supp. 884 (E.D. Mich. 1995).

d. State Relationship Laws

As noted above, several states have franchise relationship laws that potentially impact approved supplier relationships and supplier rebates. There is very little case law, however, applying these provisions. What can be said is that these laws focus primarily on the "reasonableness" or "fairness" of franchisor's requirements. Of course "reasonableness" and "fairness" often are in the eye of the beholder, and open-ended concepts like these are more susceptible to artful pleading and creation of fact disputes which may allow a franchisee claim to survive past the motion to dismiss or even summary judgment stage.

To defend against these claims, the franchisor should marshal its evidence of how the challenged supplier arrangement benefits the system and franchisees as a group, despite the complaints of a particular franchisee. Such arguments could focus on the need for the restrictions to promote (1) the quality and consistency of the product or service offering, (2) favorable pricing for the system, (3) a stable source of supply, or (4) financial resources to support the system generally or the franchisor's supplier programs specifically. The evidence would be similar to that needed to a reasonable business justification in defense to a claim for breach of the covenant of good faith and fair dealing. In other words, a defendant would have to show it employed a reasonable business objective, followed a reasoned decision-making process in developing the challenged program, that the challenged program is consistent with other franchise systems in the industry, and did not benefit the franchisor at the expense of the franchisee.

X. Practical Guidance in Navigating Supply Arrangements and Vendor Rebates

"All happy families are alike, but every unhappy family is unhappy in its own way"

- Leo Tolstoy, Anna Karenina (1878)

Hopefully, by now, it is clear that supply arrangements are integral to successful franchises. While supply arrangements are entirely necessary, the pitfalls are numerous, and the ways to fall into them plentiful. The proceeding section provides practical guidance in avoiding such pitfalls that will inevitably result in litigation. While transparency is key, both the franchisee and franchisor can take extra steps in managing their relationship and ensuring the system operates smoothly.

a. Franchisee Best Practices

Record keeping. Franchisees should be vigilant in maintaining records of sales and rebates. While record maintenance is necessary for a profitable business, in the franchise context, records may protect the franchisee from any misallocation of funds it would otherwise deserve. Franchisors are required to disclose a considerable amount of information; however, franchisors are not typically inclined to volunteer information beyond their contractual and statutory obligations. Indeed, franchisors are not likely to explain to the franchisee how a rebate program works. Thorough record keeping enables the franchisee to have a finger on the pulse of cash flows; changes in patterns may alert a franchisee to foul play and protects the franchisee from being accused of the same. In such situations, franchisors (for the most part) will not give the franchisee any "benefit of the doubt." Right or wrong, it often falls to the franchisee to ensure there is accounting of rebates.

Additionally, a franchisee should not assume that franchisors have a better grasp on what rebates are owed to the franchisee. Most cases of rebate misallocation are the result of crossed wires rather than a product of deceptive practice. Nevertheless, the point remains that proper record keeping deters unnecessary squabbles over missing funds. It is not uncommon for franchisee and franchisor records to conflict. Accurate and stringent record keeping standards are the only line of defense franchisees have when such conflicts arise.

Knowledge of agreements. A franchisee should always be familiar with any agreements or disclosures between the franchisee and the franchisor. Notably, the franchisee should be meaningfully informed of the terms of the franchise distribution agreements. The benefits of this practice are twofold: first, it is important for the franchisee to understand its own obligations; second, the franchisee must know the process for enforcing the distribution agreement.

As mentioned above, Item 8 of the FDD requires disclosure of the supplier arrangements with franchisor affiliates. Accordingly, a franchisee may review all distribution agreements by virtue of Item 8 disclosures. The franchisee should review distribution agreements from the outset. Much like securities laws, the disclosure statements serve to educate the purchaser on the nature of the business and the obligations of the investment. Here, a potential franchisee has the rare opportunity to look behind the curtain and understand vital information about the franchisor, as well as any agreements to which the franchisee will be required to become a party.

Stay informed. A franchisee may better protect itself against unfair practices by remaining informed on general business climate as well as the inner workings of the franchisor. In a perfect world, the franchisor would practice the utmost transparency with its franchisees. Unfortunately, franchisors vary in their practice of transparency. Franchisees may protect themselves by finding information through other avenues.

Trade publications like *Global Franchise* and *Franchise Times* are excellent resources for keeping franchisees up to date on events within the industry. Trade publications typically report on franchisor disruptions and may be the first to signal potential trouble for a franchisor and, in turn, a franchisee. These periodicals may also report on disputes between franchisors and mandated vendors. It is important franchisees stay informed on these issues: any disputes with vendors made lead to a disruption in the franchise supply chain. Franchisors are unlikely to be forthcoming with this information so it is imperative that franchisee take initiative to remain informed on such issues.

b. Franchisor best practices

Disclose to avoid woes. Thorough and complete disclosures may be burdensome at the outset but remain necessary in avoiding litigation with franchisees. As discussed above, franchisors must disclose affiliated suppliers in Item 8 of the franchise disclosure document. It is all too easy—and, perhaps, all too tempting—to meet the minimum disclosure requirements without taking any further affirmative steps to ensure the franchisee is fully informed. It is even easier to avoid disclosing corporate-retained rebates where there is a reasonable fear that a more comprehensive disclosure would give rise to animosity from franchisees. However, as this paper hopefully illustrates, incomplete disclosures are easy ammunition for litigation. It goes without saying that disclosures should be complete, truthful, and compliant with state and federal requirements. Franchisors can preemptively go beyond the minimum requirements in order to avoid disputes.

First, a franchisor should ensure disclosures are complete, comprehensive, and truthful. If a disclosure appears even slightly misleading, it is highly likely that litigation is soon to follow. Second, franchisors should make an effort to explain rebate disbursements to franchisees, ensuring the franchisee fully understands the nature of the franchise's supply arrangement and rebate disbursements. While this may be bothersome, it is far less bothersome than fending off allegations of incomplete disclosures or foul play. Franchisees are also likely to operate more efficiently when they are familiar with the intricacies of a distribution system. Indeed, a little extra effort in the outset can lead to greener pastures for all parties involved.

For example, *Tubby's #14, Ltd.* may operate as a cautionary tale to franchisors contemplating a more laissez-faire approach to required disclosures.[69] Tubby's franchisees brought a class action alleging, *inter alia*, that Tubby's corporate failed to properly disclose on its Item 8, "kickbacks" paid to a Tubby's subsidiary by Tubby's manufacturers. The franchisees further alleged the kickbacks were in exchange for a substantial markup on supplies from the mandated manufacturers. In other words, franchisees alleged the Tubby's franchisor was retaining rebates paid by manufacturers, failed to disclose fully the rebates to Tubby's franchisees, and Tubby's franchisees were footing the bill.

The franchisees presented compelling evidence in support of their position, notably, deposition testimony from Dan Kauble, the individual hired to organize and manage the Tubby's subsidiary. Kauble testified that the franchisor had instructed him not to make a complete disclosure on Item 8 regarding the rebate program because the franchisor was "making too much money" and feared a more forthcoming disclosure would lead to disgruntled franchisees.[70] Kauble further testified the defendant was concerned the disclosure would deter future franchisees from buying into the system. "If you send this out to a new candidate, and say, I want you to get involved into a franchising system that not only makes three and-a-half percent advertising, six percent royalties, but I am going to make a million dollars on distribution, they are not going to buy the program."[71]

In denying the franchisor's motion for summary judgment, the court found that the relevant disclosure requirements under the Federal Trade Commission Act and the Uniform Franchise Offering Circular Guidelines required Tubbys to disclose the rebates at issue. The court further found that there was a triable issue of fact as to whether the failed disclosures were fraudulent in nature. While the *Tubby's* facts may seem extreme, they are not unique. *Tubby's* is one of many examples illustrating the pressures franchisors face in drafting disclosures and how quickly poor decision making will inevitably lead to unfavorable outcomes. Accordingly, if franchisors wish to maintain their relationship with franchisees—at minimum—comprehensive disclosures are necessary.

Keep impeccable records. Disputes may still arise even after full, comprehensive, and truthful disclosures. Franchisors should always prepare to address fully the arguments of franchisees. After all, a franchisor's first line of defense against disputes is the production of accurate records. The importance of record maintenance is yet another reason for maintaining

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[69] No. 04-70918, 2006 WL 2796181, at *3 (E.D. Mich. Sept. 27, 2006).
[70] *Id*. at *20 n. 6.
[71] *Id*.

accurate disclosures. Obviously, if records conflict with required disclosures, it is likely that franchisors will do more harm than good in sharing further information with the franchisee.

Accurate disclosures, coupled with thorough record keeping leaves little room for litigation. Furthermore, because records may conflict with the franchisee's own internal records, franchisors are encouraged to document their record keeping procedures, or take other steps to show accuracy and consistency. Liabilities first arise upon the appearance of incomplete disclosures. Litigation is inevitable, however, when a franchisor continues to evade franchisee's request for more information.

Knowledge of the FDD, franchise and distribution agreements. Disclosures are important. It is even more important, however, to understand the information the disclosures contain. In order to provide comprehensive and truthful disclosures, it follows that franchisors must be aware of what they are disclosing. Surprisingly, franchisors sometimes inadvertently overlook these agreements. However, a thorough understanding of the various agreements and obligations thereunder leads to a higher likelihood of compliant disclosures.

Furthermore, it is helpful when a franchise's sales team has a competent understanding of the various agreements when courting potential franchisees; doing so helps manage expectations at the beginning of the relationship. Opening a franchise location is no small endeavor. Accordingly, sales teams should make the effort to educate a potential franchisee of the investment and obligations that will bind them moving forward. As mentioned, a little extra effort in the disclosure process goes a long way. A franchise's sales team may perform this heavy lifting when approaching potential franchisees.

Finally, just as franchisees should understand their obligations under the various franchise agreements, franchisors must also understand the franchise agreements so they may enforce them. Whether the product of confusion or defiance, franchisees may, at times, breach franchise agreements. Breaches of franchise agreements can be particularly troublesome for franchisees and franchisors alike. A franchisor, however, is in a unique position to resolve potential disputes in the outset. A franchisor is not able to do so if it is not aware of the various franchise agreements and how to enforce them.

Stay informed. There is benefit to open lines of communication. Franchisors should take the time to gain a better understanding about what the franchisees think about the franchise agreements. First, this practice helps to notify the franchisor of any misunderstandings a franchisee may have regarding distribution agreements. More importantly, the franchisor can take corrective steps to ensure the franchisee is fully performing and fully informed on the franchise agreements. Second, while the franchisor will likely have to sift through some unruly and boisterous complaints, it is likely the franchisor can find some insightful solutions to problems of which the franchisor might not have even been aware.

XI. Conclusion

There are many ways for rebate and distribution agreements to go wrong, and only a few ways to make them go right. The aim of this paper was not to preach but instead lend some practical tips on how to maintain relationships and ensure operations run as smoothly as possible. Of course, disputes arise and mistakes happen. However, managing conflicts from the outset is key in avoiding litigation. The franchisee and franchisor relationship is unique in that it is both symbiotic and adversarial; both parties benefit from each other's success but can arrive at competing interests. Understanding the nature of the relationship and how to avoid the pitfalls that come with managing the relationship is essential for a thriving franchising system.