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Supply and Demand: How to Negotiate Supplier and Distributor Agreements and Work with Franchisees Regarding Their Implementation

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I. INTRODUCTION

This paper provides an overview of how a franchisor can negotiate supplier and distributor agreements and work with franchisees regarding their implementation. After discussing what comprises a franchise system supply chain, we discuss how franchisors establish supply chains, key elements of supply chain agreements, and common issues in negotiating supply and distributor agreements. We then focus on purchasing cooperatives, how they function and the role they play in supply and distribution arrangements for franchise systems. Finally, we turn to franchise legal compliance concerns with supplier and distributor agreements, pre-sale disclosure requirements in this regard, and competition law issues.

II. ELEMENTS OF THE SUPPLY CHAIN

The first step in creating or improving a supply chain is understanding its component parts. Every supply chain will have the basic elements described below, although they will not always be singular or independent of each other, and they should always be designed to suit the needs of the franchise system and the consumer.

Producers

The first step in any supply chain is the extraction of a resource that is used in a finished product. This includes all raw materials necessary to create the finished goods. These materials can be tangible (sugar, metal, meat, rubber), or intangible (music, software, designs). In a service-based franchise, the producer is the source of knowledge or professional licensing. A producer can also be a third-party service provider to the franchisee, such as a landscaper or office cleaner or real estate broker, especially if the franchisor arranges for the provision of these services to the system.

Manufacturers

The creator of finished goods and services is a manufacturer. Often, the manufacturer will be the same as the producer, as where a finished product (milk, for example) is purchased from a dairy that both raises the cows and processes/packages the milk. Or for intangible goods, where a software developer codes, programs and markets the software. In other cases the franchisor or franchisee is the manufacturer, utilizing goods provided by the producers. In still other cases, the franchisor may establish approved producers for use by a third-party manufacturer that is outside the franchise system.

Distributors

The manufactured goods are typically shipped to a distributor as the next step in the supply chain. Distributors operate warehouses or distribution centers which make regular deliveries of necessary goods or services to franchisees or to the consumer, and may also play an inventory management role, helping to buffer fluctuations in

supply and demand by stocking inventory temporarily until it is needed. As franchise systems grow in size and scope, franchisors often turn to logistics providers for professional supply chain management services in order to maximize responsiveness and efficiency in distribution. There are three basic types of distributor:

i. **Manufacturer/Franchisor as Distributor.** Often, a manufacturer or franchisor (especially if the franchisor is the manufacturer) will handle distribution (including storage until shipping, selection of common carrier and delivery) of the finished goods.

ii. **Warehouse Distributor.** This is typically a storage facility that takes in goods, stores inventory, tracks inventory levels and arranges shipping. Sometimes the Distributor will take ownership of the goods and act as a wholesaler, other times it will simply broker or transport the goods according to the direction of the franchisor.

iii. **Third-Party Logistics Provider ("3PL").** This is a hybrid of the first two types, usually a warehouse-style distribution facility that handles some or all aspects of supply chain and inventory management at the direction of the franchisor. Often, the franchisor will remain the contractual reseller/ owner of the goods with responsibility for choosing producers and manufacturers, but ordering, insurance, storage and transportation are handled by the 3PL.

Retailers (Franchisees and Company-Owned Outlets)

Retailers, whether franchisees or company-owned operators, are the final step in the supply chain. A retailer can also be a 3PL or distributor, if the franchise is offering just-in-time direct delivery to customers. Retailers, of whatever type, must communicate clearly and regularly to the appropriate source of product to ensure that they do not have inventory shortages or excess redundancies and to provide a consistent experience to customers.

Consumers

Consumers are the final stop in the supply chain. Although the needs of each element of the supply chain must be considered, the ultimate driver of supply chain elements must always be the end-use customer.

III. ESTABLISHING THE SUPPLY CHAIN

Although each element of the supply chain will be present in some form, the exact structure of the supply chain will inevitably vary based on the needs of the franchise system. A smaller or startup franchise system may start with a supply chain that is run by the franchisees, or otherwise managed outlet-by-outlet. A larger, more mature franchise system should transition to a more efficient and consistent supply

chain model that delivers products to more outlets spread over a larger geographic area. In particular, larger systems should consider a supply chain run by the franchisor or a purchasing cooperative that allows the entire system to benefit from economies of scale.

As franchisors move from the early, outlet-based supply model to a more systematized approach, the franchisor's lawyers can play a crucial role by crafting excellent supplier and distribution agreements. Appropriate contracts are vital to a healthy supply chain. Such contracts must not only memorialize the terms for the transfer of goods, but also memorialize the relationship of each element in the supply chain to the franchisor, the franchisees and the other elements in the chain. The supply chain contract is also crucial to allocating risk and setting rules for quality control. Many smaller or newer franchise systems make the mistake of thinking that all they need is a 1 or 2 page memorialization of price, quantity, and specifications for the goods or services being supplied—but as we discuss, the legal "base" of protections in well-drafted, robust supply chain contracts forms the core around which the stability and sustainability of the entire supply chain can be built. Previously, we identified the elements of the supply chain, including producers, manufacturers, distributors, retailers and customers. The franchisor has to ensure that each element achieves the necessary service consistency and product quality control. The strength of the franchise brand can depend on that consistency and the quality of products and services delivered to the customer. Selecting the right vendors is therefore critical. Below we identify some of the key considerations in building the supply chain.

RFP

A standard first step when selecting a vendor (supplier or distributor) is the request for proposal ("RFP"), setting forth the specifications and parameters of the system's needs and expectations for the product. The franchisor, or the purchasing cooperative, then reviews the bids received and selects the best vendor or vendors. Several factors should bear on the choice of vendor, including price, quality, service, and capacity to meet the system's needs. The franchisor can also rely on recommendations from franchisees, either in lieu of an RFP or to find candidates for the RFP. This is especially useful if the franchisor is scaling up or expanding a supply chain that has been operated locally by the franchisees.

Geography

A key question for suppliers[1] is the capacity to provide goods nationwide (or internationally). A large, nationwide franchisor might need a national or international

[1] Note that any one vendor can fill more than one element in the supply chain. A producer can also be a manufacturer, a manufacturer can be a distributor, etc. It is less common for a dedicated supplier (a producer or manufacturer that is focused on providing either inputs or finished goods) to also act as a warehouse distributor or 3PL, with a focus on distributing finished goods (whether inputs or final products) and the related issues of inventory management. When we discuss "suppliers" throughout the

supplier capable of meeting the needs of a large franchise system. Examples would include suppliers of beef, chicken, french fries, and soft drinks. A smaller or more local franchise, or a franchise brand built around local sourcing or dependent on locally licensed suppliers may require a regional or even hyper-local supplier, or a stable of such suppliers. Generally, a system will have fewer choices with distributors. In the food service business, for example, in many geographic areas, there are only a few food service distributors large enough to handle a major franchise system.

Reliability

The reliability of a vendor is always important, particularly if a franchisor is establishing a new supply chain in a local area or limited geographic region, or if the franchisor is branching out into new products or otherwise shopping for new vendors. A supplier or distributor that fails to deliver on time can cripple a franchise system and damage the brand. Also, franchisees may be reluctant to embrace a supplier (especially a supplier of any items essential to the franchised business) that they do not know or have grounds to trust. In such circumstances, the franchisor may engage a supplier to furnish goods and services for a limited time in a particular market on a "pilot" or test basis. If the test is successful, then the system may decide to engage the supplier on a systemwide basis for a longer period of time. One other test when selecting a new supplier is the willingness to offer product warranties. A supplier trying to win business that is unwilling to provide basic warranties may be concerned about its ability to deliver or to meet product specifications; conversely, if the supplier offers a warranty, especially one that is transferable from manufacturer to franchisor to franchisee, the franchisor may find that it can offer a material competitive advantage.

IV. SUPPLY CHAIN AGREEMENTS

Once the appropriate supplier (with sufficient capacity, quality control and reliability) has been selected, and a competent distributor (warehouse or 3PL with the storage space, tracking systems, delivery equipment and product mix) has been identified, it is time to negotiate the specific terms and conditions of your agreement. Although there are certain specialized terms that must be considered depending on both the identity of the counterparty (producer, manufacturer, distributor, retailer or customer) and the nature of the goods/services being provided (regulated commercial, foodstuffs, intangibles, licensed, etc), there are far more common terms with minimal variation that you can prepare to contest. First, we review some common forms of agreement, then we discuss common terms in the context of supplier agreements, and then we discuss additional distributor specific terms you might need.

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agreement, we are referring to producers and manufacturers, while "distributors" are warehouses, wholesale distributors or 3PL vendors.

A. General Structure

Fixed Term/Quantity Contract for Goods. Most of the time, the supply chain agreement in the franchise system will be between two parties (producer/manufacturer; producer/franchisor; manufacturer/franchisor; franchisor/distributor, etc.) for the specific benefit of those two parties. The buyer will be using or reselling the goods purchased and the seller will have no commitment beyond delivering the goods to the buyer. On occasion, this form of agreement will have an express third-party beneficiary, as where the goods are purchased from a producer by the franchisor but delivered to a manufacturer for use, or where the goods are purchased by a distributor from a manufacturer at the direction and for the benefit of the franchise system. These contracts typically include a single or regularly recurring purchase of one or more discrete products, with fixed terms for price and delivery. Once the term for delivery is complete, the contract is complete. This is the most common form of agreement.

Master Supply Agreement. Often, a franchisor, rather than entering into systemwide supply agreements on behalf of the whole system, will entire into a master agreement with express provisions allowing franchisees or the franchisor's affiliates to enter into their own agreements with the same supplier on the same terms – whether by means of a form of rider, purchase order, addendum, or other document. This way, in the event of disputes arising from events involving the supplier and a particular franchisee / operator other than the franchisor, the franchisee / operator will have privity of contract with the supplier (and thus, the ability to sue), without the franchisor needing to get involved in the legal dispute. A typical MSA will have a longer length term and will include more flexible parameters for price and delivery, although quality and specifications for the goods should be uniform for the benefit of the brand.

Ideally, the franchisor will negotiate the mandatory form the supplier must use with its franchisees, in order to promote consistency and predictability across the system. The specific language or provisions that should be included in such a form will depend on the situation. However, some common provisions to consider include: (i) a disclaimer by the franchisor of any liabilities associated with the franchisee's account; (ii) an acknowledgement that the supplier may provide the franchisor with financial and other information regarding the franchisee's account; and, (iii) a provision specifying that the franchisor has the power to require the supplier to terminate its agreement(s) with a particular franchisee if the franchisee's franchise agreement is terminated.

Requirements Contracts. A franchisor with a large system that has variable (but not too variable) requirements for a consistent group of products (ingredients for a food product; a discrete and related set of retail goods) may consider a requirements contract. Under this form of agreement, a supplier (or suppliers if the volume required is sufficiently large) agrees to make and sell all of the franchise system's requirements for a particular product or service. Conversely, a seller may demand that the franchisor purchase all of the seller's output of product, especially if the product is highly specialized and the seller has to invest in its production at the expense of producing something else. In either case, this form of agreement works best if the franchisor can

predict a long-term need for the products and has a properly scaled distributor or 3PL to handle the inventory management. It also requires a high degree of comfort and trust between the parties—the supplier will likely be foregoing other business as it dedicates resources to one buyer's needs, and the franchisor may have to agree to some level of exclusivity. A requirements contract should include preferential pricing and volume forecasting terms, as described below. It also must have a thoughtful force majeure clause, and provisions for the replacement of goods if requirements are not met.

B. Supplier Agreement Terms

Once the form of agreement is chosen, the franchisor and its vendor must negotiate specific terms. Most franchisors develop standard form agreements that they seek to have all vendors sign. Vendors will have their own version of the standard form. How this "battle of the forms" resolves will depend in part on the size of the franchise system versus the size of the vendor and the availability of competition for the business. The market for suppliers is usually more competitive than the market for distributors. Typically, the franchise system will send all of its suppliers the system's standard form of agreement, and then suppliers will attempt to negotiate the terms of that agreement. If the system has a purchasing cooperative, the coop will handle such negotiations. If not, usually the franchisor's purchasing department will negotiate on behalf of the system. Set forth below are some of the key terms of supplier agreements and some of the factors a franchise system should consider in negotiating these terms with suppliers.

i. Price

Typically, a purchaser wants to obtain the lowest delivered prices possible. For most products, pricing is on a per unit or per case basis, while services are usually priced in terms of a fee per unit of time or per location. Systems should be careful about the time period during which the negotiated pricing is available; pricing increases at the discretion of the supplier should be avoided, even in contracts where the system would have a prompt right to terminate if the new pricing were not to its liking. If there are price escalation clauses, a purchaser should make sure that they are fair and relevant to the product or service being supplied. Pricing terms should take into account the scarcity of seasonal or limited source materials, perishability of the goods and the potential need to lengthen or shorten the supply chain based on seasonal impacts. With these tips in mind, we wanted to explore some specific pricing models and issues.

Fixed Pricing. A fixed pricing model is excellent if purchases are fixed in time and amount, or if the product has a stable supply with limited variability and a low risk of disruption. A fixed price for a product that has limited and predictable seasonal variability (fresh fruit, oil, etc.) can also be a reasonable way to allocate the risk of windfall (producers may benefit from a slightly higher price when there is abundant product, purchasers get a discount when scarcity raises prices for spot buyers). A fixed price arrangement is probably not advisable if the agreement is going to last for a long time (e.g., where a price might remain the same for three years, and suddenly increase

12% to account for changed market conditions at the time of renewal) or where the price is based on current market conditions and ignores foreseeable variability.

Cost-Plus Pricing. Under this model, the supplier will charge for its cost and then an agreed-upon profit margin. The "plus" may be less than what the supplier gets from a spot or market buyer, but ought to be offset by a commitment to purchase a larger volume of goods over time. This may be a good choice for a specialized product where the supplier must commit resources and choose between customers. This may also be a good choice for franchisors who manufacture their own product. A key factor is negotiating the basis for calculating the cost, especially if the cost may change over time based on the variability associated with ingredients or other inputs.

Formula Matrix Pricing. This model typically will establish certain conditions for purchase (timing, amount, type, etc.) and then set the price based on the mix of conditions. Often there is a fixed minimum price (or maximum price) which can be adjusted to reflect the actual conditions of purchase (volume discounts, increases or drops in the cost of goods or production, expedited or delayed delivery, etc.). The formula matrix model works well with supply agreements that extend over a large geographic area (where local costs and conditions will vary) or over a long period of time. Another opportunity for formula pricing is through a distributor where the products are delivered based on varying purchase prices – such that the franchisees are purchasing inventory with different cost of goods basis, and the franchisor has an interest in smoothing out the differences. In this case, using a formula to determine the price for goods, perhaps based on averages of the market price or actual price for the goods from the original source, will allow the franchisor to deliver cost certainty, potential savings and some insulation from market variability to the franchisees.

Market Pricing. This model is exactly what the name implies: the periodic purchase of goods at the fair market price prevailing at the time of purchase. This is often the best way to get the lowest price for goods, especially if the goods are widely available, the volume of purchases varies over time and the buyer is prepared to shop for good deals. In this model, the buyer and supplier may enter into a master supply agreement with terms and conditions for services and "legal" boilerplate (storage, quality control, insurance, indemnification, etc.) but price, quantity and delivery usually will be determined at the time of purchase and memorialized in a purchase order, statement, work order or other point-of-sale document. This is not an advisable approach if there are predictable or expected seasonal or event-based changes to market prices for the goods that leave the franchisor open to undesired spikes in the cost of goods.

'Most Favored Nation' Pricing. In this model, the purchaser will seek to ensure that the price remains competitive with other participants in the supply chain, or with the larger market, even when the relationship between purchaser and supplier is fixed or exclusive over a long period of time. The 'MFN' clause commonly will require the supplier not to charge more than the price offered to some other defined customer or group of customers – a competitor of the franchisor, or a comparable buyer in size or

scope or market power. Suppliers may resist this type of pricing, unless the purchaser is a very important customer. One option to encourage the supplier to offer MFN pricing is to create a floor, whereby the MFN pricing only applies if the supplier grants better pricing to a smaller customer; for example, a system with 1,000 outlets could require that the supplier not grant lower prices to any system with fewer than 1,000 outlets.

ii. Other Terms

In addition to the basic terms discussed above, supply agreements can involve a number of other significant business terms that will depend on the nature of the supply. We discuss some of the common ones here.

Volume. Ensuring adequate product supply, especially in a large franchise system where there are limited supplier choices for core products, is a critical aspect of the supply agreement. A volume commitment may include a purchase commitment, to ensure that the supplier has a sufficient market, or a production commitment, to ensure sufficient supply, or both. Each party should also address its obligation to forecast its purchase or production (or both), and the method, timing and content of such forecasts should be identified in the contract. It is also important to determine when the forecast is binding (meaning it creates a production floor or ceiling) and when and how it can be adjusted due to changes in market conditions. If the volume commitment is tied to exclusivity, it may also be necessary to determine when the parties can suspend or adjust the exclusivity, or otherwise to establish cover rights if either party cannot meet its volume commitments. A franchisor should be cautious about establishing volume commitments, especially if the supply agreement is for a preferred supplier and there are multiple options for the franchisor or the franchisees. A volume commitment that is not coupled with favorable pricing might result in a franchisor missing out on preferable market conditions. However, if the franchisor is seeking to secure favorable supply commitments as against other purchasers, or most-favored customer pricing, or if the franchisor is seeking to ensure minimum levels of product availability despite potential market disruptions, then a volume commitment may be not only desirable but necessary. A volume commitment may be especially valuable when the franchisor is working with a smaller supplier or a very specialized product, where the supplier would have to dedicate a substantial portion of its resources in order to satisfy the system's need.

Obsolescence. Goods that are likely to be replaced by a newer model or updated version should be subject to price adjustments and special rights of return that reflect that the planned obsolescence creates a forced depreciation that can harm the franchisees (as well as the franchisors and suppliers).

Exclusivity. Exclusivity is a critical consideration in the supply chain, but it is a two-edged sword and must be carefully negotiated. The decision to pursue exclusivity is often tied closely to price because of the great benefits to a producer or manufacturer to corner the market within a franchise system (for example, a franchised restaurant system will either serve Coca-Cola products or Pepsi products, but not both). A supplier

will often make significant price concessions in return for exclusivity, and such a supplier may be motivated to provide outstanding quality and service in the hope of maintaining and renewing the exclusivity arrangement. This is a significant potential benefit, but there are a few risks that must be addressed: (i) an exclusive supplier not facing a competitor can charge higher prices; (ii) the damage to the system if the exclusive supplier goes bankrupt or undergoes other significant business adversity can be substantial; and (iii) the system cannot get the benefit of innovation or technology developed by competitors of the exclusive supplier during the exclusivity period. It is also important to ensure that the supplier does not impose proprietary systems or restrictive conditions on the use of the products, such that the barriers to entry are too great for its competitors and the costs of change are too high for the franchise system. A supplier that offers initial price concessions and then creates a supply system that is too costly to change will then have the leverage to revoke or reduce those concessions later on.

The exclusivity provision should clearly state the scope of exclusivity (system wide or limited in scope of time or geography), performance standards to maintain exclusivity, and specifications for the quality or quantity of goods. The term should also state whether the exclusivity is tied to price reductions, discounts or rebates and if the exclusive supplier can offer independent deals to franchisees outside the terms of agreement with the franchisor or purchasing cooperative. If the risks of exclusivity are too great, we recommend that the franchisor consider a preferred vendor approach, where the supplier offers price concessions in exchange for promotion within the system, preferred access to the franchisees, or better integration with franchise systems (e.g., on its website, intranet and/or in other system messaging).

Ownership of Intellectual Property. Franchisors and suppliers will each want to safeguard their respective intellectual property ("IP"). However, if the supplier develops a product specifically designed for the franchisor's system, who should own the associated IP? In such circumstances, the franchisor should insist on owning the IP and that the supplier cooperate with other potential suppliers of the product in question; otherwise, the system will be beholden to the supplier that developed the product and may be stuck with that supplier as the exclusive source for that product. Certainly, the system can compensate the developing supplier for the efforts and risks it undertakes to develop a special product, but the franchisor of the system should own the associated IP.

Compliance with System Standards. Systems must protect their brands. Accordingly, provisions requiring suppliers to comply with system standards on quality and use of trademarks or other intellectual property and to comply with safety measures imposed by the system are typical. Systems should also require that suppliers only sell approved products and services to operators. An agreed schedule that specifies the products and services to be sold by the supplier can eliminate any confusion in this area.

Indemnification and Insurance. It is standard in all supplier agreements to require the supplier to provide indemnification and adequate insurance. The system needs to make sure that the supplier will provide indemnification against all third party claims attributable to the supplier's negligence or breach of warranty and against all claims that the use of the supplier's products or services infringe a third party's intellectual property rights. The indemnification should protect all parties on the purchasing side of the relationship: franchisor, franchisees, the purchasing cooperative, if any, distributors who purchase the product, and their respective officers, directors, employees, successors and assigns. It is typical to allow an exception to the indemnification obligation for an indemnified party who is guilty of gross negligence or willful misconduct, although sometimes suppliers will try to negotiate this exception to apply to ordinary, rather than gross, negligence of an indemnified party. The indemnified parties should have a right to participate, at their expense, in the defense of any claim, and to sign off on any settlement of a claim.

As for insurance, the supplier should be required to obtain comprehensive general liability insurance. Ideally, the system should be able to increase the amount of required coverage over time, but this is likely to run into resistance from suppliers. The system should be able to handle this by requiring a minimum amount of coverage for the term of the agreement and as long as the term is not too long, that minimum should suffice. The system also needs to be satisfied with the size and solvency of the insurer. If the supplier has employees that will perform work at locations or outlets of system operators, then it is important to require the supplier to have workers compensation coverage and to have that coverage be primary. It is typical to require the supplier to (i) furnish certificates of insurance, specifically naming as additional insureds the franchisor, purchasing cooperative, franchisees, etc., and (ii) provide notice of any material changes in insurance coverage.

Warranties. Ideally, the supplier will provide a warranty on its products to all subsequent users. The basic (implied and express) warranties on the sale of goods apply to all supply agreements unless specifically excluded. Those warranties include: warranty of merchantability[2], warranty of fitness for a particular purpose, warranty of materials and workmanship, and warranty of title. Taken together, these warranties serve to ensure that the goods are of sound and consistent quality, fit for the user, safe for use, not subject to reclamation by a creditor and not in violation of any entity's IP rights – all important features for everyone downstream in the supply chain.

Most suppliers have standard warranties that they offer their customers and virtually all suppliers expressly disclaim any implied warranties[3], as they desire certainty

[2] Merchantability means goods that: (i) would pass without objection in the trade under the contract, (ii) are of fair, average quality, (iii) are fit for the ordinary purpose for which such goods are used, (iv) are of even kind, quality and quantity within each lot or unit, (v) are adequately packaged and labeled, and (vi) conform to promises or affirmations made on the label or container.

[3] Under the UCC, a disclaimer must be conspicuous and express in order to be enforceable. Typically the disclaimer of warranty will be all in bold and in all-caps will read: "ALL OTHER WARRANTIES EXPRESS

regarding what responsibilities and risks they are assuming. Note, if the franchisee is also a supplier it may want to limit or disclaim warranties, even those it fights to get from its own suppliers. It is important, and may be of great benefit to the franchise system, to ensure that manufacturer's warranties are transferable (such as from franchisor to franchisee) and that all suppliers will cooperate with the franchisor or purchasing cooperative in processing warranty claims against the manufacturer.

Most suppliers are reluctant to stray from their standard warranties, but often it is possible to negotiate variances on matters such as how long a purchaser will have to assert a warranty claim and who will pay for parts, shipping and labor associated with a warranty claim. A franchisor that is purchasing goods for system use, especially comestibles or products with a safety aspect (chemicals, medical devices) should push hard to ensure that some or all of the standard warranties are provided, or at least that the franchisor's preferred terms are in place.

Term/Termination. The importance of the duration of the agreement is often underestimated. For several reasons, the franchisor may wish to keep the term relatively short; in most cases, not more than two or three years unless the franchisor can terminate without cause upon 30-90 days notice. The franchisor may want to keep a term short for several reasons: (i) it may want to replace a supplier whose performance is inadequate, but not bad enough to warrant termination for cause; (ii) pricing that may have been attractive to the system at the beginning of the term may become unattractive over time and a short term can lessen the effects of that; (iii) if there are any exclusivity arrangements in favor of the supplier (ideally, there would be none unless there are substantial price advantages given in exchange for the exclusivity), a short term lessens their effect; and (iv) a product or service that was desirable at the beginning of the term may become obsolete or unnecessary because of technological changes or strategic changes by the system. For these and other reasons, the system should be wary of automatic renewal provisions, particularly provisions that call for a lengthy renewal term unless there is substantial advance notice of nonrenewal (e.g. 180 days). Often, systems may desire to end a relationship with a supplier only to find out that they are locked into an additional term because of a failure to deliver a nonrenewal notice in a timely fashion.

In addition to limiting automatic renewal and ensuring that the agreement has a fixed term of appropriate length, the termination provision should be more detailed than may be common in a typical commercial agreement. Ending a producer or manufacturer relationship can be expensive and disruptive as franchisees adapt to new products, new prices, new delivery systems or delays resulting from the selection or operation of a new supplier. Termination rights and procedures should be explicit and must include: (i) performance standards that trigger termination, (ii) rules for transferring a franchisor's proprietary product, (iii) conditions for working with the new supplier to transfer system-specific operating information, (iv) the allocation of rights to continue the use of any

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OR IMPLIED, INCLUDING THE WARRANTIES OF FITNESS FOR A PARTICULAR PURPOSE AND MERCHANTABILITY ARE HEREBY DISCLAIMED."

jointly held or jointly developed intellectual property or trade secrets and/or the transfer of such IP to new suppliers and destruction of the same if no rights to continue use exist, and (v) the disposition of unsold or mid-production products, the wind-down period during which products will continue to be sold and the timing of final payment or reconciliation of outstanding amounts.

Inspection and Audit Rights. It is standard to require a supplier to permit inspection of its manufacturing and storage facilities and of its books and records. The facility inspection rights are important if the supplier furnishes food products, but less so if the products are equipment or non-perishable items. Typically, such an agreement calls for the supplier to pay for such inspections but that is negotiable. Suppliers often raise trade secret concerns, but these should be alleviated by standard confidentiality provisions. Systems must be able to audit books and records relating to the business between the supplier and the system to ensure that the supplier is adhering to the agreed pricing for the system and to safeguard against any unauthorized supplier income.

Dispute Resolution. Most disputes between systems and suppliers are resolved without resort to formal proceedings. Incorporating a provision that requires senior executives of each side to meet in an attempt to resolve a dispute and, failing that, formal mediation, may help avoid expensive legal proceedings. As for arbitration vs. litigation, there are advantages and disadvantages to both. Litigation tends to be lengthier and more expensive, but arbitration, especially if there are three arbitrators rather than one, can be just as expensive. Additionally, there is usually no appeal from an arbitrator's decision and often no written opinion setting forth the reasoning for the arbitrator's decision. It is common for most systems to require that any proceedings, whether arbitration or litigation is selected, be brought in the jurisdiction where the system's headquarters is located. Suppliers, not surprisingly, prefer that any proceedings be in their home jurisdiction. Who wins out on these issues is a matter of negotiation. A possible compromise is to require the complaining party to bring proceedings in the other party's home jurisdiction.

C. Distributor Agreements

Distributor agreements entail all of the issues described above with respect to supplier agreements. Additionally, there are other concerns with distributor agreements. We discuss some of the most common ones here.

Performance Criteria. Systems will want to ensure that distributors make deliveries accurately and on time. It is typical to require that each distribution center achieve a negotiated percentage (e.g. 90%) of "clean" -- i.e. accurate, error-free -- deliveries and on-time deliveries. For example, a distribution agreement could provide that failure of a distribution center to meet such a requirement over an extended period (e.g. three months) would give the system the right to terminate the agreement with respect to that distribution center.

Inventory Management. There are a number of critical issues that should be addressed in distributor agreements in regard to inventory management (including the franchise agreements or program document, if the franchisor elects to use one). The topic of inventory management should be examined carefully in light of the needs of each franchise system. We discuss some of the critical inventory management issues in the following paragraphs, though this is not an exhaustive list.

Inventory Limits. Franchisors who control their own distribution may stock large amounts of inventory, but third-party distributors may not be interested in carrying the risk of loss or obsolescence or may be limited in the available space for holding inventory. Using a 3PL may resolve this issue (where the 3PL is a third-party warehouse stand-in for the franchisor's direct distribution facility) as the 3PL can be selected based on having sufficient warehouse space for the franchisor's desired level of inventory, but the 3PL will expect the franchisor to bear all responsibility for determining the level of stock and bear all costs for disposing of obsolete inventory. One issue is how obsolete inventory is defined, and obviously the definition will be more important for perishable products. Systems can use several strategies to minimize obsolete inventory, including requiring periodic reports from distributors on slow moving items and requiring suppliers of perishable products to deliver products with sufficient remaining shelf life to distributors.

Inventory Tracking. Franchisors who manage their own distribution, either directly or through a 3PL, must ensure that they have developed an appropriate method for tracking the inventory. A 3PL should be required by contract to demonstrate inventory tracking systems, to provide periodic reports regarding the status of inventory in stock, scheduled for delivery, and pending shipment, to ensure that the franchisor is able to properly account for the value of product held at the 3PL. More than one franchisor has lost money on audits and write-downs due to poor inventory tracking by a 3PL without adequate systems. This should be an important consideration in the 3PL selection process.

Inventory Distribution. In the world of on-time delivery and customized ordering, the price for goods (whether food stock, phone accessories, dry goods, fixtures or something else) is not necessarily determined by the original price of payment but can be adjusted to reflect then-current market pricing without much difficulty. This can allow franchisors to offer discounts or to pass through savings to franchisees, but it requires careful tracking of inventory movement and price to avoid losses from inventory depreciation. Franchisors should contract with their distributor or 3PL to ensure that there is agreement on the method of tracking (is it shipped by lot, or by FIFO ("first in, first out"), or by COGS (cost of goods sold), by pallet or delivery date, etc.), that there is appropriate reporting and auditing, and that the risk of loss is properly apportioned.

Shipping. On-time delivery is a key component of modern inventory management. This means that any ordering portal must tie closely to the method of shipping and return, including means for tracking product, cut-off rules for same-day

and next-day shipping and working with the 3PL or distributor to ensure that the common carrier or special shipping service provider can meet the delivery needs of the franchise system. It may not be sufficient to allow a distributor to handle selecting a common carrier and insuring the product during delivery—cost savings may come from leveraging volume or from pursuing an exclusive relationship with a carrier through the 3PL or directly with the franchisor. Franchisees must be clearly informed of the rules for ordering and shipping and the franchisor must establish the process and policy for handling lost and delayed shipments. The 3PL may be required to pay fines or to reduce its monthly or annual fee for service if shipping times and delivery metrics are not satisfied.

Insurance/Title. A good supply chain contract includes terms related to the transfer of title and the obligation of the 3PL or distributor to have adequate property insurance and loss prevention policies. If a franchisor is using a 3PL, where the franchisor remains the "owner" of the property and the 3PL handles storage, stocking and shipping as a third-party resource rather than as an independent seller, then the franchisor must ensure that its contract covers the 3PL's responsibility for securing and protecting the product, for insuring against it (and the franchisor may then be bound to respect limits on the value of the property in inventory), and indemnification for lost or damaged products.

Returns/Inspections. Depending on the nature of the goods and the flow of distribution, the manufacturer, franchisor, distributor, 3PL or the franchisees may bear the responsibility for approving and accepting the delivery of goods. Each supply chain agreement should identify the conditions for rejecting goods and the process for returns, including the distribution of costs, the required packaging, the selection of a carrier and the means of crediting back payments for goods (whether cash or a form of purchase credit). The cost of replacement goods, and the timing for delivery of the same, should also be identified. These terms are critical for Distributors, who will often be responsible for processing the returns, tracking the inventory impacts and/or procuring replacement product. This is also an important term as between Manufacturers and Producers.

V. OTHER SUPPLY CHAIN ISSUES

A. Licensing

Licensing is a critical and underappreciated part of managing a supply chain. Many businesses ignore or delay licensing, or assume that suppliers or logistics services have the appropriate licenses without verification. This is incredibly risky, and can lead to customer complaints, fines, investigations and other costly business disruptions. This section will provide a brief overview of licensing issues that any franchisor should consider when managing both the core business and the supply chain.

i. General licensing considerations

Franchisor licensing. While many businesses need only minimal licensing, it is important to start with understanding the "home field" licensing needs. Licensing can and should include corporate registrations in both the state of incorporation and any state where business will be conducted; and local tax and business licenses (often called licenses, these are usually local taxes and failure to pay can lead to fines and penalties). A franchisor should also have all necessary business services licenses If the franchisor is franchising a service, then the franchisor will need its own permits and professional licensing from appropriate federal, state or local authorities. Strictly as to supply chain, a franchisor must determine if it is taking title to any goods in the distribution channel and must ensure that it has the appropriate licenses to handle and distribute said goods.

Franchisee licensing. Sometimes, a franchisee must do no more than mirror the franchisor's licenses. For example, if the franchisor is licensing tree removal services, then the franchisee should have all of the same licenses for tree removal and construction that the franchisor has, adjusted to satisfy local jurisdiction regulations. However, it is often the case that a franchisor must decide whether to license on behalf of the system or to require a franchisee to get its own licenses. In some fields (construction, for example) it may be necessary for the professional license to be displayed along with all trademarks and advertising—in which case the franchisor may need to take steps to register all franchisees operating under the mark under its own license. Or, the franchisor may need a professional license associated with its mark, but the franchisee may need a personal professional license in order to service customers without personal liability risk. Some licenses from regulatory agencies may signify nothing more than that the franchisor is approved for business (and as such may be fully useable by the franchisees without further action) while other licenses, especially in service businesses, may be personal to the service provider. This paper is not attempting a breakdown of every conceivable license, but each franchisor must understand the licenses required of its franchisees and, where reasonable, should consider whether the business is better served by operating under a single franchisor-held license or by requiring franchisees to secure individual licensing.

Supplier licensing. While a franchisee may be able to operate under a franchisor-held license, a supplier or vendor or logistics service will need to have its own licenses and registrations. A supply chain agreement should, at a minimum, require the supplier to provide copies of all licenses, to ensure timely renewal or maintenance of the license and should allow for termination/penalties if the supplier is unable to perform due to a licensing issue. A further consideration, as with the franchisor licenses, is whether the franchisees can (or may be required to) operate under the supplier's license for the sale of or handling of certain products and services. A few critical types of licenses that suppliers (or franchisors who handle warehouse or distribution functions) must be required to own and maintain are the following:

i. **Food/Liquor Handling**. Any business that manufactures food/liquor products requires licensing and oversight – but this is also true for any business that handles, packages or distributes food/liquor products. The licenses required may be state or federal. Factors that may impact the licensing requirements include the proximity of the warehouse or distribution center to the manufacturing center, whether the facility is owned by a licensed manufacturer or licensed wholesaler, and the nature of the products stored and distributed. The federal government has taken action in recent years to catalogue licensed wholesalers and 3PLs for easier reference, and franchisors should carefully investigate potential supply chain partners. But state licensing is not harmonized and the same facility may require licensing in one state but not in another. The costs and risks of licensing should factor into the decision of any franchisor to outsource its warehouse/distribution function or to handle it directly.

ii. **Medical Device and Drug Handling**. The concerns in this area are essentially the same as in the food space, although in medical devices these concerns will also extend to durable and manufactured goods. A franchisor utilizing regulated medical devices that are sold through a distribution channel will need to take steps to ensure that its ability to provide customer services is not compromised by a license failure in the production and distribution of necessary equipment.

iii. **Export/Import Licensing**. Franchisors often function with an entirely domestic supply chain (within whatever country they are operating in), but in a world of global supply chains this is both becoming less common and less possible. There are three major considerations in this area:

ITAR. Items covered by the International Traffic in Arms Regulations are not likely to be of concern in typical franchise businesses; if any reader happens to be involved in an arms trading franchise, they should make sure to review their ITAR obligations.

EAR. Federal Export Administration Regulations provide classifications for common consumer products that may be used for restricted or controlled purposes or that include components with such uses. Common consumer electronics, including smartphones, computers, networking equipment, audio equipment, chemicals, metals and other materials that might have both a commercial and military use are subject to EAR. Products subject to regulation may not be exported without a license, and “export” is a broad term that can include showing or delivering the regulated products to certain foreign nationals even within the United States. A full review of EAR rules and policies is beyond the scope of this paper, but a franchisor that sells or transports potentially controlled items (directly or through a distributor or logistics service) to (a) non-US citizen franchisees, (b) other countries or (c) <u>through</u> other countries, should take care to ensure that it identifies and complies with applicable notice, recording and licensing

requirements. Any distributors or 3PLs should also be required to demonstrate that they are aware of and in compliance with applicable export controls.

Food Distribution. As noted, the type of licensing required for food/drugs depends significantly on the type of storage facility and the type of products. It can also depend on the country of origin, storage or terminus. If the source of supply is a foreign country, or if the foods/drugs pass through a foreign country (or through multiple foreign countries if the supply chain passes through Europe, for example), then multiple licenses may be required, and each point in the distribution channel may be required to register and or be licensed for different functions or products. Franchisors must ensure that all international customs and export regulations are understood and compliance is enforced through the entire supply chain.

B. Remote Ordering Systems and Associated I.T. Concerns

In addition to ensuring that the licensing risks of multi-jurisdictional supply chains are met, another supply issue is that modern product distribution and transport is heavily dependent on integrated computer systems. An act as seemingly simple as opening a website, selecting some products from a drop-down menu, typing purchase information and clicking “buy” takes teams of people at multiple businesses to make possible. What was once done with color-coded carbon paper now requires coders, programmers, security experts, multi-factor authentication and barcode readers, and the associated costs and risks have increased accordingly.

We discuss below several key considerations in developing an ordering portal.

Hosting. Not long ago, many franchisors would invest in servers and maintenance, on-site at the franchisor’s facilities, that would host all of the inventory data, the website code and the programming to operate the purchase system. Today, companies are moving to cloud-based data hosting systems where third-parties host the data, the servers, the platform and other critical information. Cloud-hosting services provide security and can be more cost effective than owning or leasing servers and paying the costs of powering, servicing and operating those servers. Conversely, cloud-hosting companies often refuse to provide indemnification against data security breaches and, in fact, may pass through costs or losses associated with franchisees or vendors creating security risks. There is also the issue of data ownership; even if franchisors retain ownership of their data, the hosting company retains possession of the data and it is not always certain that the data can be easily transferred to another host. If a franchisor elects to use cloud hosting, then the service agreement must address these key points of contention and risk.

Software Licensing. Again, in the recent past a franchisor might have purchased copies of physical software or a series of individual user licenses. Today, an internet-based platform host will create an unlimited number of access credentials, perhaps separated by administrative rights. Pricing will often be based on the number of users or the degree of access, and rights/permissions/access can be adjusted easily

and without cost. As with other licenses, a critical decision for the franchisor is whether to have a single license, with access offered through that license to the franchisees, or whether to require the franchisees to secure their own licenses and access rights. Also important is whether the franchisor or the franchisee (or the distributor/3PL) controls the creation of new users and the granting of permissions/rights. Again, the correct decision depends on the needs of the business.

Credentials (Passwords). Many businesses know that third-party vendor platforms and ordering systems create tremendous security risks. It is not sufficient merely to create passwords and have policies that prohibit third-party access and use. Frankly, people are unreliable and password security is often the weakest point in any security system. Development of the ordering platform must include a multi-factor credential authentication system and a process for certifying that users understand and agree to security terms. The franchisor must also decide who, among the franchisor and 3PL/supplier/distributor, will bear the responsibility for developing, tracking and enforcing the credentialing program.

System Support/Maintenance. Again, the franchisor must decide which entity will be responsible for IT support and programming for the ordering platform. Integration with existing systems (franchisor, warehouse, franchisee, 3PL, distributor, etc.) and ongoing program maintenance is both expensive and complex, and breakdowns can cripple the movement of goods, usually at high-volume times. Establishing rates and costs, minimum levels of service availability time (i.e., system must be functional 99% of the time) and the IP ownership of customer programming or proprietary platforms is crucial.

Delivery Metrics. Franchisors must establish rules for ordering and shipping within the system, including deadlines for ordering, the distribution of shipping costs (including whether to support or favor the use of, say, ground over air, or timely routine shipping over express delivery), and the risk of loss (as between the franchisor, the franchisees, the 3PL and any common carriers). Again, 3PL performance should be specified and penalties and remedies established. While an established and specialized food distributor may have its own strict rules around ordering and delivery and storage to ensure compliance with food safety regulations, a general 3PL that handles non-perishable commercial goods will likely be able to customize almost every aspect of the process to suit industry-specific goods and practices.

Cybersecurity. The key terms already described include key cybersecurity considerations such as maintenance, hosting rights, access permissions and credential controls. Specific cybersecurity provisions are also necessary, however, to ensure that there is appropriate monitoring (attempts to hack password access systems can number in the thousands per day for even the simplest systems), trained response teams, customer service and training and, most importantly, indemnification against loss and adequate insurance. Negotiations with any 3PL or distributor must include careful distribution of risk and apportionment of the responsibility for investigation and corrective action in the event of a security breach. Insurance, though not always a

perfect product, should also be required for the 3PL and for franchisees, with the franchisor always named as an additional insured on the policy.

Having discussed various supply chain issues, we now turn to a discussion of purchasing cooperatives as a common supply chain phenomenon in franchise systems.

VI. PURCHASING COOPERATIVES

A. Key Objectives

Many franchise systems have formed purchasing cooperatives to handle purchasing services on behalf of both the franchisor and the franchisees. Cooperatives usually are formed as a result of pressure from franchisees who are unhappy with purchasing services being controlled by the franchisor. Typically, a purchasing cooperative will be a separate legal entity with a board of directors composed primarily of franchisees from different regions of the country. The franchisor will usually have board representation but will not control the board. The coop will have its own office space, equipment and staff, including executives, purchasers, logistics experts, financial and legal personnel and administrative staff. The key objectives of having purchasing services be performed by a cooperative in which both franchisor and franchisees have ownership and control include regulation of supplier income, enhanced transparency, greater fairness to all operators, and allocation of inventory and other risks between franchisor and franchisees.

Having fair, equitable, and proper arrangements in regard to supplier income is a key objective for a purchasing cooperative. There are many forms of supplier income, but all supplier income has either the actual or perceived effect of operators paying more for goods and services than they would in the absence of supplier income. Supplier income can include income, rebates, kick-backs, volume discounts, tier pricing, purchase commitment discounts, sales and service allowances, marketing allowances, advertising allowances, promotional allowances, label allowances, back-door income and various other fees and mark-ups. The most blatant forms include kickbacks; for example, if a supplier pays a franchisor official a kickback in exchange for having the supplier's products approved for the system, obviously in the absence of the kickback, the supplier could charge a lower price to system operators. Nearly as blatant: a franchisor requiring franchisees to buy generic supplies from the franchisor at a substantial markup to the price available to franchisees on the open market. That was the situation in the Domino's system back in the 1990s when franchisees had to buy nearly 90 percent of their ingredients from the franchisor at prices 25 to 40 percent above the market price. See Queen City Pizza, Inc. et al. v. Domino's Pizza, Inc., et al., 129 F. 3rd 724 (3rd Cir. 1997). The franchisees brought various claims against Domino's based on antitrust law and lost, but that is not the point; the franchisees in that system and other systems want to buy goods at a fair price and do not want franchisors to earn profits by selling them generic products at a markup.

There are far more subtle forms of supplier income, however, and it is not necessarily the franchisor that is always the party benefitting from supplier income. Here are some examples:

1. Franchisor sets up a charitable foundation and leans on suppliers to donate money, products or equipment to the foundation.
2. A large franchisee hosts a golf tournament and gets suppliers to sponsor the tournament.
3. Franchisor holds a large convention and sells sponsorships and booths to suppliers.
4. Franchisor asks a supplier to manufacture a special product which entails the supplier making equipment changes, and permits the supplier to charge higher prices for products in order to cover the equipment costs.
5. Franchisor enters into an agreement with a major beverage supplier and although beverage prices are the same for all system operators, the supplier also furnishes marketing and other services to the franchisor.
6. Supplier grants a distributor discounts based on the volume the distributor purchases from the supplier but the distributor does not pass the savings on to operators.

There are countless other examples, but all of these practices have either the actual or perceived effect of raising delivered prices to operators. There are many forms of supplier income that are entirely justifiable, but the key issues for proponents of purchasing cooperatives are control and transparency; as long as the cooperative negotiates and controls the supplier income, and as long as there is full disclosure of the nature and extent of the supplier income and its precise impact on delivered prices, then the purchasing cooperative may permit it. What the operators do not want is hidden supplier income, or having the franchisor negotiate an arrangement resulting in supplier income without the participation and signoff by the coop.

Transparency and Fairness. As mentioned above, franchisees want transparency in order to be sure that there are no hidden arrangements that result in supplier income that adversely affect the prices they pay for goods and services. Such transparency not only ensures fairness to all operators, but also tends to enhance trust between the franchisor and franchisees. If the purchasing coop conducts all negotiations with suppliers and distributors, all operators can have more confidence that there are no hidden benefits going to the franchisor or a particular class of franchisees. The purchasing coop would also be responsible for monitoring the performance of suppliers and distributors. Accordingly, all operators would have greater confidence in decisions to retain or replace suppliers and distributors.

Allocation of Risks. Franchisors and franchisees often clash over issues such as inventory management and who should bear the risk of obsolete inventory resulting from a failed product or promotion. Suppose, for example, that a franchisor thinks a new product will be a hit and orders a million units of that product from a supplier. The franchisees, for the most part, disagree and think the product will be a dud. It turns out

that the franchisees are correct and 750,000 units go unsold. The supplier has to be reimbursed and in many systems without a purchasing cooperative, the franchisor will cause all operators in the system to share the cost of the unused inventory. If there is a purchasing coop, however, there may be a protocol whereby both the franchisor and the coop will develop forecasts for a new product or promotion. If the forecasts are in agreement, then the product will be ordered in accordance with the forecast and the entire system will bear the risk of any obsolete inventory. However, if the forecasts are not in agreement, the product will be ordered in accordance with the coop's forecast, and if the franchisor wants more product ordered, then the franchisor would bear the risk of obsolete inventory resulting from the excess orders.

Obsolete inventory can also result from a specification change mandated by the franchisor. Some spec changes are "hard", i.e. go into effect on a certain date beyond which operators cannot use up their inventory of the product with the old spec, and some are "soft", i.e. operators do not have to switch to the new spec until they have used up their inventory of the old spec product. Most purchasing cooperatives will require the franchisor to be responsible for any obsolete inventory associated with a spec change unless the franchisor has previously communicated the spec change to the coop to allow operators a reasonable time to use up their inventory of the goods with the old spec.

B. Pros and Cons of Purchasing Cooperatives

The previous discussion highlights many of the advantages of having a purchasing cooperative. However, the benefits of having a purchasing cooperative are not free. Why would the system bear the cost of all the overhead associated with an independent purchasing cooperative? From a franchisee's standpoint, in the absence of a coop, all of these overhead costs should be borne by the franchisor. From the franchisor's standpoint, having an independent purchasing cooperative necessarily diminishes the franchisor's control. The franchisor cannot make unilateral decisions about selection of suppliers and distributors or the terms of the agreements with suppliers and distributors. The franchisor also will lose the ability to profit from selling products to franchisees, and will have less control over funding for conventions, less freedom to make specification changes and less ability to introduce new products or promotions. Thus, for both franchisor and franchisees, there are costs and downsides to having a purchasing cooperative. Are those costs worth the trouble?

Many systems have answered yes. In theory, a franchisor could control all purchasing functions for the system and pricing would be fair to all operators, with no hidden supplier income and/or unequal allocation of risks and benefits. However, in reality, most franchisees will not trust the franchisor to perform those functions that perfectly. Having an independent purchasing cooperative owned and controlled by both franchisor and franchisees helps to build trust that purchasing functions are being performed fairly for all operators. Recall that earlier it was mentioned that suppler income can have either the actual or perceived effect of operators paying more for goods and services than they would in the absence of supplier income. Even if it is

objectively true that certain forms of supplier income do not unfairly benefit the franchisor, many franchisees will simply not believe it, and their perception of unfair advantage to the franchisor cannot be overcome unless the franchisees themselves have some ownership and control over the purchasing function. The enhanced trust built by the purchasing coop can also induce franchisees to accept restrictions imposed by the coop on their interactions with suppliers and distributors.

Having discussed supply chain agreements, supply chain issues, and purchasing cooperatives, we now turn to discussing concerns of franchisors with respect to having franchisees actually comply with the supply arrangements in place.

VII. COMPLIANCE CONCERNS

One of a franchisor's key concerns with supplier and distributor arrangements is to ensure that franchisees comply with obligations designed to ensure that all operators properly use the suppliers and distributors approved by the franchisor. This is often crucial to preserving the level and uniformity of quality of the products or services that are ultimately sold to customers. To that end, there are many methods franchisors use to police and enforce the supplier arrangements they put in place for the system. We provide some common examples here, but best practices will vary widely based on the circumstances and nature of each franchised businesses. As a general matter, a franchisor will want to reserve the right, in its franchise agreement, to engage in any or all of these methods in its discretion.

Communicating with the Supplier. Perhaps the simplest "enforcement" method is for the franchisor to communicate directly with the supplier to resolve certain basic questions about whether a franchisee is complying with restrictions on supply. For example, if the supplier says a franchisee has not placed an order for a key product in "X" number of days or months, the franchisor may be able to discern, simply from that information, that the franchisee is either not offering/selling the required product or is purchasing the required product from an unapproved source. This can lead the franchisor to a more in-depth inquiry to determine what is happening.

Audits. The franchisor may audit the books and records of operators to determine whether they have been making the required purchases from approved suppliers, not making purchases from unapproved sources of supply, and that supplier / ordering / contact information is posted or available for use by each franchisee and its employees. In the authors' experience, franchisors may try to negotiate to conduct such inspections on an unannounced basis, but most agreements end up providing notice to the franchisee being audited.

Mystery shopper programs. The franchisor may, without prior warning, visit an operator's business, posing as a customer, in order to determine what supplies are actually being used by the operator. These activities can be a particularly cost-effective way to discover supply chain non-compliance, particularly in franchise systems that sell proprietary, branded products that are easily distinguishable from their unauthorized counterparts.

Sanctions for noncompliance. Franchise agreements and/or operating manuals of franchise systems permit the franchisor to impose sanctions upon franchisees that fail to abide by restrictions on sources of supply. Indeed, even before a prospect purchases a franchise, a franchisor should make sure its disclosures and sales representatives stress the importance of following system standards and clearly describe the penalties for non-compliance. If franchisors notice a pattern of non-compliance, they should proactively remind franchisees regularly that use of "contraband" products and services from unapproved suppliers – especially where it is not by mistake – will have serious consequences. For example, specific monetary penalties on a per violation basis may be specified in the franchise agreement where a franchisee uses unauthorized products or services. For chronic/repeated such violations, a sanction could be the loss by the franchisee of any rights to renew the franchise agreement or even outright termination.

Injunction. To preserve the relationship if possible, sometimes a franchisor can pursue an injunction to stop the non-compliant use of unauthorized products or suppliers by the franchisee. A franchisor may wish to put an end to an uncooperative franchisee's sale or use of unapproved products, or use of unapproved suppliers, yet still keep the franchisee in the system. In such instances, obtaining injunctive relief from a court may be an appropriate remedy. Generally, a franchisor may choose to seek preliminary injunctive relief (available sooner, but for a shorter time period) or permanent injunctive relief if it can show that monetary damages or other remedies available at law are inadequate to compensate for the irreparable harm to the franchise system that will occur as a result of the non-compliance by the franchisee; that the balance of hardships between the plaintiff and defendant weighs in favor of an injunctive remedy; and, that the interest of the public would not be disserved by the injunction.[4]

Notices of default. When it comes to supply chain violations, a notice of default, and the passage of a pre-defined cure period, is a prerequisite to termination in most situations in accordance with the language of the franchise agreement. Such a notice is a vehicle that may be useful to compel a franchisee's compliance with product and supply standards. Even if not required by the franchise agreement in the context of unauthorized products and supplies, a notice of default puts the issue squarely on the table and gives the franchisee a chance to consider whether continued violation is in its best interest, considering the potential consequences articulated in the notice of default—i.e., termination and the loss of his / her / its franchise. An effective default notice will include a specific cure date, be supported by documentary evidence of the supply chain violation, and not be an empty threat – that is, failure to cure should be followed by swift action, not more default letters about the same thing. Rogue franchisees need time to bring their procedures back into compliance, but open-ended

[4] For a detailed discussion regarding injunctive relief in this context and relevant case law, see, e.g., F. Joseph Dunn, Kirk Reilly and Lynette McKee, *Why Can't I Buy This Instead? The Issue of Unauthorized Products and Suppliers in Franchise Systems*, Int'l Franchise Assoc., 49th Annual Legal Symposium, May 15-17, 2016, Washington, DC.

default notices provide little incentive to cure in a timely manner. If a franchisee does comply, monitoring the removal and destruction of non-conforming goods helps to ensure complete reintegration of the franchisee into the supply chain, and helps to prevent relapse by the franchisee by imposing an extra burden it will be loathe to repeat.

Termination. Especially where supply chain non-compliance poses health or safety risks, but also when any noncompliance is serious and chronic, a franchisor should not sit idly by while it happens. When termination of a franchisee becomes necessary in these types of situations, the franchisor should act decisively. Moreover, where appropriate, the franchisor should make it clearly known to the entire system what happened, why it happened, and how seriously the franchisor takes events of non-compliance with supply chain requirements, for the sake of the integrity of the whole system.

Notwithstanding the above, it is also important for franchisors to be reasonable in considering franchisee requests to use alternative suppliers, especially for less significant items that may not be "customer-facing" or an essential part of the customer experience with the franchisor's brand.

Having discussed supply agreements, their issues, purchasing cooperatives, and how to have franchisees comply with supply arrangements, we now discuss franchise legal compliance with respect to disclosures about supply agreements by a franchisor.

VIII. PRE-SALE DISCLOSURE: FDD ITEM 8

Item 8 of a franchisor's Franchise Disclosure Document ("FDD"), provided to each prospective franchisee prior to the sale of the franchise, must disclose any sourcing restrictions, such as designated suppliers and distributors that franchisees must purchase from and any requirement that the franchisor pre-approve suppliers and distributors.[5]

These disclosures are often the subject of litigation when franchise relationships go awry. The requirements of the Federal Trade Commission's ("FTC's") Amended Franchise Rule (the "FTC Franchise Rule") in this regard merit careful attention. Disclosure must be made for each good or service subject to the sourcing restrictions. However, the franchisor is permitted to describe these various goods and services in broad terms. In addition, Item 8 must disclose the following:

[5] Specifically, the franchisor 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. For each applicable restriction on sources of products and services, the rule requires a list of specified points to be disclosed. See 16 CFR § 436.5(h).

- Whether the franchisor (or its affiliate) is an approved supplier or the sole designated supplier for a given good or service, and whether any officer of the franchisor has an interest in any approved supplier;
- How the franchisor grants and revokes approval of alternative suppliers;
- Whether the franchisor issues (and, if applicable, modifies) specifications and standards to franchisees, subfranchisees, or approved suppliers;
- Whether the franchisor or its affiliates will or may derive revenue or other material consideration from required purchases or leases by franchisees, and if so, the basis by which the franchisor or its affiliates will or may derive that consideration;
- Whether the franchisor negotiates purchasing arrangements with suppliers, including price terms, for the benefit of franchisees;
- If a designated supplier makes payments to the franchisor, the basis for such payments. A franchisor is permitted to group such payments together for all suppliers, but in some cases, it may be better to separate them out supplier by supplier, for clarity and to avoid confusion (or the perception by prospective franchisees that the franchisor is not being transparent);
- The existence of purchasing or distribution cooperatives; and,
- Whether the franchisor provides material benefits (for example, renewal or granting additional franchises) to a franchisee based on a franchisee's purchase of particular products or services or use of particular suppliers.

Accurate and appropriate disclosure of sourcing restrictions can be critical for a franchisor in minimizing confusion, anger, and possible litigation with disgruntled franchisees. Though FTC Franchise Rule does not provide franchisees with a private right of action, franchisees may sue under specific state franchise laws that treat failure to comply with the disclosure obligations of the FTC Franchise Rule as a violation of state law. Note that the failure to comply with state franchise disclosure laws may, in certain cases, carry criminal penalties, and franchisees are typically granted a private right of action under state franchise laws to sue for damages, attorneys' fees, rescission of a franchise agreement, and restitution of franchise fees. Even the franchisor's management may be subject to personal liability for failure to meet franchise disclosure obligations. In short, the franchisor should make sure franchisees know what supply requirements they are committing to follow when they sign the franchise agreement. While a more detailed description of the Item 8 disclosure requirements is beyond the scope of this paper, franchisors are urged to carefully review and update their Item 8 disclosures (if necessary, by immediately amending their FDD) whenever making a material change in their supply chain agreements or requirements.

Having discussed supply chain agreements, issues, purchasing cooperatives, compliance concerns, and pre-sale disclosure in the FDD, we now turn to another key

area of legal compliance pertaining to supply and distribution agreements: competition law.

IX. COMPETITION ISSUES

Federal antitrust law can affect the legality of certain types of supplier arrangements in franchise systems. In addition to federal antitrust law, all of the states have adopted some form of antitrust legislation. These laws tend to vary from state to state, and may differ from federal antitrust laws in important respects. That being said, most state courts look to federal precedent for guidance in interpreting their own state antitrust laws. As with federal antitrust law, a franchisor should make sure its supply chain structure does not violate these analogous state laws.

To comply with federal antitrust law, a franchisor must be careful to ensure that its supply chain structure does not violate certain basic restrictions, such as restrictions on illegal tying arrangements[6], predatory pricing, anticompetitive refusals to deal, or monopolization. This is especially true for a franchisor who desires to (i) designate or approve suppliers, (ii) receive rebates or other consideration as the result of direct or indirect purchases by franchisees, (iii) impose pricing restrictions on suppliers, or (vi) impose territorial or customer restrictions on franchisees or suppliers. Franchisees and suppliers may challenge these practices as antitrust violations under a number of theories, including illegal price fixing, price discrimination or illegal "tying". It is important to note, however, that proper presale disclosure of the practices described above in a franchisor's FDD has proven to be a critical element in defending against various antitrust claims. In addition, because many of the practices described above are specifically required to be disclosed under Item 8 of the FTC Franchise Rule (as discussed above), it is logical to assume that if properly disclosed, these practices are acceptable to the FTC (which is, after all, the entity that enforces federal antitrust law).[7]

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[6] Tying arrangements involve the required purchase of a product or service as a condition of obtaining the franchise or as a condition of obtaining another (tied) product or service – or at least, an agreement not to purchase the tied product from any other supplier. Tying arrangements can, in some cases, violate the federal Sherman Antitrust Act (15 U.S.C. §§ 1-7) in two different ways: They can violate Section 1 (less likely in a franchising context), which prohibits "contracts in restraint of trade," and they can violate Section 2, which prohibits monopolization. In addition, depending on the specific circumstances involved, franchisees may be able to challenge tying arrangements under the federal Clayton Antitrust Act (15 U.S.C. §§ 12-27), the Federal Trade Commission Act (15 U.S.C. §§ 41-58), or other federal or state laws. Generally, a tying arrangement can be problematic where the franchisee can show it is hampered in its ability to succeed as a result of an anticompetitive restriction imposed by its franchisor. However, the competitive context of the market is also relevant to the analysis, as well as the pre-contractual disclosures made to the franchisee While exploring this complex area of law is outside the scope of this paper, we invite the reader to see, e.g., Kay Lynn Brumbaugh and Allan P. Hillman, *Fundamentals 201: Antitrust Essentials for Franchise Lawyers*, Amer. Bar Assoc. 35th Annual Forum on Franchising (Oct. 3-5, 2012), Los Angeles, CA; and for an illustrative case, see *Burda v. Wendy's International, Inc.*, 659 F. Supp. 2d 928 (S.D. Ohio 2009).

[7] For example, in *SubSolutions, Inc. v. Doctor's Assocs*., 436 F. Supp. 2d 348, 355 (D. Conn. 2006), the franchisor of the Subway sandwiches franchise system ultimately prevailed in defending the adequacy of its pre-contract disclosures in which it reserved the right to change its product requirements and approved vendors and specified that it could, in its discretion, require its franchisees to purchase products from

In addition, many of the states have adopted deceptive trade practices acts or "little FTC Acts" that help supplement their antitrust laws and prohibit "unfair" or "deceptive" acts or practices. The content of the "Little FTC Acts" vary from state to state, but generally follow federal precedent in regard to competition issues. Unlike the FTC Act, however, these state acts typically grant standing to the state attorney general's office or other agencies, and to consumers, to bring a lawsuit to enforce the provisions of the act. Whether franchisees have standing under these acts to bring a claim will depend on the language of each respective act and the circumstances.

There are a handful of states with disclosure or relationship laws specifically limiting supply chain restrictions.[8] For some franchisors, such laws may have strong relevance, especially if their systems are concentrated in those states and they restrict franchisees from purchasing non-proprietary items from alternative suppliers. However, we do not explore those state laws in detail here because, in our view, those laws are unlikely to affect a franchisor's negotiation of supply agreements in most circumstances.

On the whole, it is important that franchisors take into account federal, state (and, if engaged internationally, applicable foreign) legal restrictions, and monitor any new

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particular vendors. Another example of a franchisor litigating similar issues involving the quality of their Item 8 disclosures is *C.K.H., L.L.C. v. Quizno's Master, L.L.C.,* No. 04-RB-1164, 2005 U.S. Dist. LEXIS 42347 (D. Colo. 2005), a case in which franchisees unsuccessfully tried to predicate a breach of contract claim on Quizno's Uniform Franchise Offering Circular ("UFOC," the predecessor requirement to today's Franchise Disclosure Document) Item 8 disclosure, which stated that Quizno's negotiates "arrangements with suppliers for the benefit of Franchisees, which often include volume discounts." No. 04-70918, 2006 U.S. Dist. LEXIS 69553 (E.D. Mich. Sept. 27, 2006). The plaintiffs argued that the UFOC disclosure was tantamount to a contract which Quizno's had breached by not passing on supplier rebates to franchisees. The court dismissed the count based on another UFOC disclosure in which Quizno's expressly reserved the right to receive revenue on account of franchisee-supplier transactions. The court also dismissed the plaintiff's fraud claim based on the same facts.

[8] For example: Indiana prohibits franchisors from requiring goods, supplies, inventories, or services to be purchased exclusively from the franchisor or sources designated by the franchisor where such goods, supplies, inventories, or services of comparable quality are available from sources other than those designated by the franchisor. However, this requirement does not apply to the principal goods, supplies, inventories, or services manufactured or trademarked by the franchisor, leaving the franchisor free to impose sourcing restrictions on proprietary products, and the statute permits the franchisor to publish a list of approved suppliers of goods, supplies, inventories, or services and to retain the "reasonable" right to disapprove a supplier. IND. CODE tit. 23, art. 2, ch. 2.7, § 1(1). Hawaii's franchise law permits a franchisor to impose restrictions on suppliers if the restrictions are "justified on business grounds." HAW. REV. STAT. tit. 26, ch. 482E, § 482E-6(2)(B). Iowa's franchise law requires franchisors to "allow a franchisee to obtain equipment, fixtures, supplies, and services used in the establishment and operation of the franchised business from sources of the franchisee's choosing," though the franchisor is permitted to impose "standards as to [the] nature and quality" of required goods and services. The statute provides an exception for restrictions applicable to reasonable quantities of inventory, goods or services that the franchisor requires the franchisee to obtain from the franchisor or its affiliate, in certain circumstances. IOWA CODE tit. XIII, ch. 523H, § 523H.12(1). Washington law provides that franchisors may not require a franchisee to purchase or lease goods or services of the franchisor or from approved sources of supply unless the restrictions are reasonably necessary for a lawful purpose justified on business grounds, and do not substantially affect competition. WASH. REV. CODE tit. 19, ch. 19.100, § 19.100.180(2)(b).

legislative activity in the area of competition law that could impact the legality of supply chain restrictions that franchisors impose.

X. CONCLUSION

The negotiation of supplier and distributor agreements is a key activity for franchisors seeking efficiency, economies of scale, consistency and stability for their franchise system. As we have outlined above, working with franchisees regarding the implementation of these agreements is a crucial aspect of franchising, especially as a franchise system grows in size and geographic scope. In addition, a franchisor must be aware of legal considerations in structuring and disclosing such agreements to franchisees in compliance with franchise law, competition law, and franchise disclosure requirements.