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Building an Effective Supply Chain and Distribution System

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BUILDING AN EFFECTIVE SUPPLY CHAIN AND DISTRIBUTION SYSTEM

I. The Importance of the Franchise System Supply Chain

A supply chain provides the means by which a company brings its products or services to the marketplace. A supply chain usually involves several parties, including, among others, manufacturers or raw product producers, logistics providers and distributors. For a supply chain to be effective, all of the involved parties must be aligned to common goals and the company's supply chain strategy. For the value of the supply chain to be maximized and cost savings realized, a company's supply chain strategy must be executed efficiently. A franchise system's supply chain can provide significant value to the system, but problems in a franchise system's supply chain can cause severe disruptions and derail franchisor/franchisee relationships. Therefore, a franchise system's supply chain is one of the most important factors in determining whether a franchise system functions effectively and will continue to expand.

It is no secret that competition among franchised businesses in many sectors is fierce and that many franchised businesses operate on thin margins, meaning that every dollar spent directly impacts the bottom lines of franchisees and franchisors. Improvements to a franchise system's supply chain represent one of the few opportunities for positive impact to a franchise system's financial returns that do not require increased sales, or even, depending on the strategy chosen by the franchisor, a significant investment of capital. A franchise system with a solid supply chain will usually see significant returns on its investment.

The distinct competitive advantage that a franchise system may obtain by lowering costs is often the primary reason why many franchisors pursue supply chain improvements, but it is not the only reason that a franchise system's supply chain is an important part of the system. A hallmark of franchising is the ability of multiple outlets to operate under a common name and system and to offer uniform, high quality products and services. Many parts of a supply chain contribute to help the franchise system achieve those quality goals. For example, as discussed in detail in Section IV below, many franchisors employ stringent standards for supplier approval. In addition, as discussed in detail in Section II below, many distribution agreements provide for timely delivery of products and service level agreements to support services to the franchise system. A strong supply chain is necessary for a franchise system to be able to achieve its goal of offering uniform, high quality products and services to its customers.

Franchisors are also increasingly recognizing that a reliable and strong supply chain is an important part of retaining the best franchisees and helping them to expand into multiple units, as well as in recruiting new franchisees, particularly sophisticated, multi-unit operators. Franchisees often lead the charge to improve their franchise system's supply chain, sometimes going so far as to create a cooperative or other group purchasing organization that is owned exclusively by franchisees. More and more, franchisees are sophisticated companies that bring broad and deep experience to franchise systems, and therefore expect their franchisors to employ the best strategies to help them succeed. Many franchisors recognize that an efficient supply chain is an important part of such success.

However, there are many franchise systems that do not immediately realize the potential advantages of a strong supply chain. What is problematic, however, is not a failure to realize the benefits that a strong supply chain may bring to an organization, but a failure to realize the perils associated with poor supply chain management. Beyond the positive effects of an efficient and well run supply chain, there are distinct disadvantages to an inefficient and poorly run supply chain that highlight the importance of giving a supply chain due attention. Many companies, to their detriment, place supply chain issues as a low priority until a problem causes them to focus on supply chain issues. Until a problem arises, a company may "expect the supply chain to work efficiently without interference, as if guided by [an invisible hand]." Problems may force the company (or franchise system) to then focus on the supply chain. A key distributor may suddenly become unreliable, or worse, enter bankruptcy or liquidation proceedings with little warning. Or, like Cisco in the early 2000's, a company may over commit to supply chain partners and then be forced to dispose of or repurpose excess inventory during a downturn in customer demand. In considering priorities, franchisors and franchisees should therefore be mindful of the negative impact that supply chain problems may have on the franchise system.

A. <u>Supply Chain Key to Franchisor/Franchisee Relations</u>

A franchisor's desire to carefully control supply chain activities to ensure product quality and consistency often clashes with a franchisee's desire to secure products and services at a low cost. Franchisors often recognize that a supply chain is an important part of the franchise system's and their franchisees' success, and therefore, many readily offer their franchisees seats at the table when considering significant changes to or improvements in the franchise system supply chain. Other franchisors have been reluctant to do so, which can be a source of dissatisfaction for franchisees and may ultimately undermine a franchisor's efforts to improve a franchise system's supply chain and results of the supply chain, such as better product uniformity and quality. A franchise system's supply chain offers a unique opportunity for a franchisor and its franchisees to collaborate to develop effective solutions that strengthen both of their businesses, and therefore, the impact of supply chain decisions on franchisor/franchisee relationships should not be underestimated. In addition, franchisors should be cognizant of problems that may arise if franchisees do not understand the rationale for the franchisor's decisions regarding particular suppliers, distributors or other supply chain issues. Therefore, a franchisor often best accomplishes supply chain management by keeping franchisees informed and where appropriate, involved in the franchisor's decisions.

While a franchisor may best accomplish supply chain management by involving franchisees, many problems have arisen for franchisors that unilaterally impose supply chain decisions and arrangements on franchisees, particularly when such decisions or arrangements appear to be for the franchisor's benefit, rather than for the benefit of franchisees. The most contentious (and litigated) issue involving the franchise system supply chain and franchisor/franchisee relations is often a franchisor's requirement that franchisees purchase products from a single source, which may be the franchisor. Such "captive distribution" arrangements are discussed at length in Section III below.

Though a discussion of antitrust issues is beyond the scope of this paper, it cannot be ignored that franchisees have long asserted that franchisors have violated antitrust laws by imposing single-source purchasing requirements. In *Siegel v. Chicken Delight, Inc.*, the Ninth Circuit affirmed a finding that the franchisor's contractual requirements constituted a tying arrangement in violation of § 1 of the Sherman Act. Chicken Delight's franchise agreement required that a franchisee purchase cooking equipment, dry-mix food items and trademark bearing packaging exclusively from Chicken Delight. The court, in reaching its conclusion, stated that "[o]ne cannot immunize a tie-in from antitrust laws by simply stamping a trademark symbol on the tied product." More recently, in *Queen City Pizza v. Domino's Pizza, Inc.*, franchisees unsuccessfully asserted that the franchisor unlawfully tied the sale of pizza ingredients to the sale of pizza dough. The franchisor, Domino's, sold approximately 90% of the $500 million in ingredients and supplies used by its franchisees, leaving franchisees to purchase only 10% of their supplies from outside sources. The court held that Domino's lacked the market power required to make a successful tying claim because Domino's power to require franchisees to purchase pizza dough directly from Domino's was a function of Domino's contractual powers under the franchise agreement, which had been fully disclosed to prospective franchisees before they entered into the franchise relationship. Even though franchisees have enjoyed only limited success in pursuing antitrust claims against franchisors related to supply chain arrangements and purchasing requirements, such issues frequently interrupt a franchisor's ability to focus on other issues, and can cause long lasting damage to the franchisor/franchisee relationship.

Franchisees have also attacked franchisors' recoupment of income and other benefits from suppliers to the franchise system, as discussed further in Section III below. A franchisor may receive various benefits from its supply chain, such as annual or other periodic payments from suppliers, up-front payments from suppliers or distributors (*i.e.*, an "exclusivity fee" or "sourcing fee"), contributions to marketing (such as through co-branding) or discounts for purchases made by company outlets. A franchisor's decision of whether to accept income or benefits from suppliers, what type of income or benefits to accept and how much information it will disclose to its franchisees about income or benefits that it receives from suppliers often has a significant impact on the franchisor/franchisee relationship, particularly if franchisees do not see that the income or benefits are used for the good of the whole franchise system. Like claims relating to a franchisor's requirement that franchisees purchase supplies from the franchisor, while franchisees may have only limited success pursuing legal remedies for a franchisor's acceptance of income from suppliers, this issue can cause severe disruption in the franchisor/franchisee relationship.

On the other end of the spectrum from contentious courtroom battles regarding required sources for products or rebates or other income from suppliers, are partnerships formed by franchisors and franchisees to conduct supply chain activities. Many franchise systems have found that significant franchisee involvement in the supply chain (and even franchisee ownership of the system's supply chain functions) leads to significant benefits. For example, recently established cooperatives demonstrate franchisor/franchisee partnerships, such as the Dunkin' Donuts brand's National DCP, LLC, the Wendy's/Arby's brands' Strategic Sourcing Group Co-op, LLC or the DineEquity brands' Centralized Supply Chain Services, LLC.

Good or bad, supply chain decisions greatly affect, and indeed are a key part of franchisor/franchisee relationships. Franchisors must balance their need to ensure product and service quality and uniformity with franchisees' desire for autonomy, and similarly, franchisees must balance their need for lower costs with the need for the franchise system to remain profitable as well as the need for a consistent and reliable system supply chain. Nearly every decision a franchisor (or franchisee) makes regarding supply chain functions will be influenced by the franchisor/franchisee relationship.

B. Purchasing

A supply chain includes all of the stages that are involved in fulfilling a customer request. It includes all vendors, service providers and customers. Franchise system supply chains include two primary components: (1) purchasing; and (2) distribution. Both are equally important to sourcing quality, uniform products at low prices and delivering such products to franchise outlets in a timely manner. While purchasing is often viewed as the most important part of franchise system supply chain, it is just one piece of a supply chain management strategy.

"Purchasing" includes functions that are associated with buying products and services for a franchise system. Purchasing relates closely to product quality and the total cost of securing products and services, and includes selecting suppliers, ensuring supplier reliability, developing and implementing sourcing and supply agreements, implementing forecasts and forecasting strategies and similar activities.

There are many choices for a franchisor to make when considering what type of purchasing strategies are the most suitable for a franchise system, including: (1) whether volume or group purchasing is feasible, and the best way to achieve such purchasing; (2) whether the franchisor will issue specifications for products, and then permit franchisees to choose a supplier, or instead if the franchisor will approve one or more suppliers for various products, and then provide the specifications directly to the supplier, with consideration to whether the franchise system relies heavily on perishable products, which may be best or most cheaply purchased from local or regional sources, rather than a source selected by the franchisor; and (3) whether the franchisor has the resources to be heavily involved in its franchisees' purchasing decisions and methods, or whether it would prefer the franchisees take ownership (with the franchisor carefully controlling specifications) of purchasing decisions and methods. Once a franchisor has carefully considered the types of products and services to be purchased, and the sources and means available, it can determine purchasing strategies that will best suit the franchise system given available resources.

A franchise executive or attorney confronting supply agreements will encounter distinct parties (suppliers, vendors, raw material producers and others) and issues (such as intellectual property protection and trademark use) when drafting and negotiating supply agreements. Each issue is an integral part of ensuring an efficient and reliable purchasing function for the franchise system, and is discussed in greater detail below.

C. <u>Distribution</u>

"Distribution" includes the activities that are associated with moving goods or services from a source (such as a manufacturer) to their destination (such as a franchise outlet). Like purchasing, distribution greatly impacts the final cost of products and services, and quality. Franchise systems have more choices than ever of how to best accomplish distribution of products and services to franchised outlets, and ultimately, to consumers. The following considerations are key to determining what distribution methods are a fit for a particular franchise system:

- Are the products perishable, or do they otherwise have a short useful life? If so, more efficient methods of transportation (*e.g.*, air shipment) should likely be chosen, even if more expensive.

- Do the products constitute the core of the franchise offering? Again, more efficient and reliable modes of transportation and distribution throughout the franchise system may be warranted, even if more expensive.

- If local vendors and suppliers are being used for some of the products in a franchise system, are such vendors and suppliers able to efficiently transport their products to franchisees, or should the franchisor or franchisees engage a third party to transport the products? If intermediaries, such as additional transporters or logistics providers are removed, greater efficiency can be achieved, but only if the services are still provided efficiently and at a reasonable cost.

- Is the mix of products needed for franchised outlets the type that could most efficiently be purchased from and distributed through a distributor (rather than purchasing from multiple suppliers)? This question also ties closely to the type of purchasing that is best for the franchise system.

Once a franchisor has addressed the above considerations, it will be better prepared to choose among the service providers that provide distribution services. That is, the franchisor will know whether it requires warehousemen, or only transporters, or whether the system may be best served by a third party logistics provider that provides both warehousing and transportation. Such parties may also become an integral part of the franchise system's supply chain management strategy by providing other services, such as inventory management or, in the case of a fourth party logistics provider, the coordination of multiple logistics service providers. Similar to purchasing, when negotiating agreements with these parties, a franchise executive or attorney will encounter unique issues (for example, appropriate indemnification for delivery services or damages for late delivery), as discussed in greater detail below.

D. Unique Issues in Restaurant Supply Chains

Every franchise system will want to address supply chain management at some level to ensure that core products, or even products that are ancillary to the services provided, reach franchised outlets in a cost effective and efficient manner. It is no coincidence, however, that the most attention to supply chain management is given in restaurant and similar foodservice franchise systems, where a wide variety of perishable products are needed, and such products' prices fluctuate easily if any one of a host of factors changes, such as a regional weather pattern. Restaurant supply chains present unique issues and require great attention, as seemingly small fluctuations in price can greatly impact profitability of a restaurant operating on thin margins, and even a slight delay in delivering key products or services can jeopardize a restaurant's ability to serve its customers. In addition, product uniformity and quality is critical to a restaurant franchise system's success, as is ensuring the safety of the products offered to consumers.

A restaurant system's ever-changing menu presents supply chain issues that are not found in other types of franchise systems. For example, a restaurant system will often offer limited time only (LTO) promotions or seasonal menu items. The business team that determines whether and when to offer such promotions or items must work closely with supply chain professionals to ensure that the necessary products will be readily available at a reasonable cost to franchisees. Even if LTOs are not offered, a restaurant system still may rely, in part, on seasonal suppliers for certain products.

Beyond menu changes, a restaurant system's supply chain must also properly address the transport and storage of perishable goods. A franchisor or a franchise system's franchisee-owned purchasing cooperative may be able to secure a favorable price for products by volume purchases or purchasing in advance. Such purchases ensure that the franchisor or cooperative must then find adequate storage to preserve the products.

Perishable food products also lead to an issue which, though not unique to restaurant system supply chains, is critical. That is, restaurant franchise systems must be able to accurately forecast the amount of products needed to support an LTO, seasonal offering, or even regular menu offering that features perishable products. While many product-based franchise systems face the need to forecast accurately, in restaurant systems, there is potential for greater loss of inventory (*i.e.*, unusable inventory) if a forecast is not accurate. Inventory management is critical to effectively serving a restaurant system's supply chain needs, and forecasting is the beginning of effective inventory management.

It is imperative that a franchise system offering food products or operating restaurants ensure that the supply chain functions cost effectively, as an ancillary issue can greatly impact their success. That is, if franchisees in a restaurant system are pushed to operate on too-thin margins or feel that they can achieve better prices elsewhere, in spite of a franchisor's best efforts at enforcement, franchisees may replace quality products with lower-cost products, or worse, may dilute or otherwise modify key ingredients. A franchisor must balance the need for the system to use only high-quality products with the cost effectiveness of such strategy, so that franchisees are not incentivized to reduce or modify product quality for their own gain.

Finally, restaurant systems contend with a unique issue that often grabs headlines and can have a devastating impact on maintaining a brand's reputation and goodwill if not handled correctly – food safety. Each year in the U.S. alone, 48 million consumers get sick, 128,000 are hospitalized and 3,000 die from consuming unsafe or contaminated foods. Some estimate that restaurants are responsible for twice as many illnesses as home cooks. While food contamination and unsafe handling occurs at individual restaurants, and depends on a host of factors, including the training of the food handlers, oftentimes when an outbreak occurs, multiple restaurants within one system are involved. That is, often food safety problems occur along a restaurant system's supply chain. A product may be contaminated when secured from a grower, packing plant or similar raw product supplier; or, a product may become contaminated on its way to the system's restaurants. Therefore, though not a legal requirement for all categories of food products, it is a best practice for a restaurant system's supply chain to incorporate hazard analysis critical control point (HACCP) principles at a minimum, in each restaurant, but ideally, at each point along the system's supply chain, including while foods are in transit from production facilities to outlets. HACCP is a principles-based system for managing food safety through the analysis and control of certain biological, chemical and physical hazards to food products. HACCP has the following seven principles:

(1) Perform a hazard analysis;
(2) Determine critical control points (CCPs);
(3) Determine critical limits (for example, holding temperatures of stored cold goods are generally below 40 degrees Fahrenheit);
(4) Establish procedures to monitor CCPs;
(5) Establish corrective actions;
(6) Establish verification procedures; and
(7) Establish a recordkeeping system.

HACCP represents an ideal food safety management system, but restaurant franchise systems must also be aware of new and changing regulatory requirements with respect to food safety which will require greater diligence, including, as discussed in Section VII below, the Food Safety Modernization Act (FSMA) and regulations that will result from FSMA. In short, restaurant systems are and will be expected to carefully trace food products from farm to fork and pond to plate, and immediately act both to prevent and if needed, to address, any potential contamination of food products. The need for so much detail and the ability to act quickly when a potential issue arises will continue to influence how restaurant systems shape their supply chains.

II. Components of an Effective Franchise System Supply Chain

A. Determining a Supply Chain Strategy

A franchisor has multiple options when choosing a strategy for its franchise system supply chain. The franchisor may choose to be heavily involved in the management and operation of its system supply chain, including manufacturing and distributing all products required by its franchisees. The franchisor may instead elect to fully outsource the product sourcing and distribution functions of its supply chain, whether to a broadline distributor or to a franchisee-owned supply chain cooperative (discussed further herein). Or a franchisor might choose a middle-of-the-road strategy, electing to exercise significant control over the manufacture and distribution of one or two particular proprietary products, while leaving the remainder of the supply chain management function to a third party or to its franchisees. The type of business that the franchisor engages in may affect the supply chain strategy adopted by the franchisor. A franchisor's supply chain strategy may also evolve along with the franchisor's business as it grows and develops over time.

In essence, this entire article is a discussion of the different types of supply chain strategies that franchisors may adopt for their franchise systems and the many aspects of those strategies. The following sections touch on a few key topics that influence the franchisor's supply chain strategy decision.

1. <u>Control</u>

Arguably, the most important question a franchisor must ask itself in choosing its supply chain strategy is what level of control the franchisor wants to have over the franchise system supply chain. The level of control that a franchisor chooses to exercise over the franchise system supply chain reflects the overall strategy chosen by the franchisor, because it determines the franchisor's level of involvement in the operation and management of the supply chain. That decision in turn determines the amount of financial involvement the franchisor will have in the supply chain and how the franchisor will relate to its franchisees on supply chain issues.

A franchisor may choose to outsource the sourcing and distribution function entirely to a third party, in the process giving up a significant portion of its control over the franchise supply chain. For example, a franchisor may contract with a so-called "broadline distributor" to handle all product sourcing and distribution functions for the franchise system. A broadline distributor handles all negotiation with suppliers; operates its own regional distribution centers (from which it distributes a general catalog of products to a variety of customers, not just the franchise network); manages the logistics of physically distributing products to the franchisees; and in general manages the entire supply chain function for the franchisor.

Broadline distribution obviously offers certain advantages to the franchisor, in particular the ability to avoid the burden and expense of day-to-day management and operation of the system supply chain. The franchisor is not entirely without control over the distribution function, because the franchisor can at least be assured that all of its franchisees are using the same distributor. However, this approach also generally deprives the franchisor of the ability to control the sources of products purchased by franchisees, because it is the broadline distributor that is negotiating sources of supply for the various products required by the franchise system. The broadline distributor may not be willing or able to contract with specific suppliers for specialized or proprietary products (and the franchisor may lack the leverage to compel the broadline distributor to do so). Thus, a franchisor may outgrow the use of a broadline distributor as its business evolves, or, if the franchisor needs to utilize specific sources of supply and distribution for specialized or proprietary products, broadline distribution may not be a viable option even from the franchise system's inception.

Alternatively, a franchisor may outsource the supply and distribution function to its franchisees through the creation of a franchisee-owned supply chain cooperative. The supply chain cooperative generally overtakes management and operation of the supply chain by negotiating agreements with suppliers and distributors on behalf of the franchisees (and on behalf of the franchisor for any franchisor-owned outlets), or by directly handling product distribution for the franchise system. Though the franchisor does not entirely relinquish control over the supply chain when a franchisee-owned supply chain cooperative is utilized, the franchisees generally obtain significant control over the management and operation of the supply chain, and the franchisor's influence is considerably reduced. The upshot for the franchisor is that utilizing a franchisee-owned supply chain cooperative produces many of the same cost benefits to the franchisor as using a broadline distributor, but allows the franchisor to work together with the franchisees to achieve common ground on supply chain goals and requirements. (See more detailed discussion of supply chain cooperatives generally at Section V hereof.)

Another approach a franchisor may take is to partner with a dedicated, system supply chain partner. For example, the franchisor may have a supply chain partner to manage its entire supply chain function (such as McDonald's partnership with HAVI Global Solutions) or just to manage the distribution function (such as Yum! Brands, Inc.'s partnership with McLane Company, Inc., which serves as the exclusive distributor for the majority of products purchased by Taco Bell, KFC, and Pizza Hut restaurants in the U.S.). These supply chain partners have similarities to broadline distributors in that they are third parties to whom the supply chain system (or at least fundamental aspects of the supply chain system) is outsourced, but like a supply chain cooperative the third-party partner is dedicated to the franchise supply chain's specific and unique needs. Generally, a franchisor will need a higher degree of influence and purchasing power in order to achieve a relationship with a dedicated supply chain partner, meaning that this option may become more viable and necessary to a franchisor as the franchisor's business expands and as an increased focus on proprietary and specialized products emerges. The advantage of using a dedicated system supply chain partner is that the franchisor can retain significant control over the franchise system supply chain by contracting directly with the dedicated supply chain partner for specific and unique services, while still relinquishing the requirement for day-to-day management of the supply chain.

A franchisor may also choose to exert greater control over the franchise supply by bringing a large degree of the management and operation of its franchise system supply chain in-house. Under this approach, the franchisor negotiates system product sourcing agreements directly with suppliers and, with respect to distribution, may either negotiate directly with a dedicated distributor or group of distributors, or may handle the entire distribution function on its own. While this obviously provides the franchisor with a high degree of control over the supply chain, it also requires greater expertise, time, and expense on the part of the franchisor.

Finally, a franchisor can exert the highest degree of control over its supply chain by directly handling all aspects of the supply chain function. This means the franchisor manufactures all required products and handles the distribution of those products to all of its franchisees. Increasingly, this is not a viable option for franchisors, as most franchisors find it much more efficient to outsource manufacturing of the products required for the franchise system. This approach obviously also entails the greatest level of time and expense for the franchisor, and simply may not be realistically possible for a franchisor if its franchisees require a large number of varied and non-proprietary products, or may be an option only for one or two key proprietary products.

2. <u>Funding of Resources to be Used</u>

a. <u>Internal/External</u>

The level of franchisor involvement in and control of its franchise system supply chain determines the manner in which the system supply chain is funded. If the franchisor brings the majority of the supply chain function in-house, such as by manufacturing products for the franchise system, negotiating supply arrangements directly with suppliers, and/or directly managing the distribution side of the supply chain, the franchisor will need to employ a tremendous amount of working capital both to initiate the supply chain process and for the ongoing management of the system supply chain. This includes hiring and paying employees specifically to focus on the franchisor's management of the supply chain function; acquiring and maintaining office and other infrastructure dedicated to system supply chain management; and related administrative expenses. The franchisor may have to borrow significantly to get the supply chain operation off the ground. Bringing supply chain management in-house may also result in the franchisor charging franchisees ongoing sourcing fees and similar fees on products distributed to the franchisees as well as receiving income based on franchisee purchases, which, as discussed later in this article at Section III(C), can result in significant tension in the franchisee/franchisor relationship.

By contrast, if the franchisor chooses a strategy of less involvement in and control of the franchise system supply chain, the franchisor can also largely outsource the responsibility for finding sources of funding for the system supply chain. If a franchisee-owned purchasing cooperative is utilized, the franchisees will fund the supply chain through fees charged for equity ownership interests in the supply chain cooperative and through ongoing fees imposed by the cooperative on products distributed to the franchisees.

b. <u>Possible Franchisor Profit Center</u>

Also, as discussed in greater detail in Section III(C) hereof, the franchise system supply chain can be a significant source of profits for a franchisor, and therefore a franchisor must also determine the extent to which it wants the system supply chain to function as a source of profit.

3. <u>Cost Averaging (Price Equalization)</u>

Another aspect of a franchisor's supply chain strategy involves how the franchisor will address variations in the delivered costs of products to its franchisees. Particularly for franchisors that have franchisees nationwide or across multiple regions, the final delivered cost of a given product may vary from franchisee to franchisee. This cost variation can result from differences in the cost of delivering the product to the franchisees, such as the higher cost of delivering to rural franchisees versus urban franchisees. Cost variations can also result from the fact that franchisees in different regions of the country are assigned to different suppliers or distributors, who may have different costs for the same product.

Variations in the store-delivered prices paid by franchisees can create tensions in the franchisor-franchisee relationship. If the franchisor does not implement efforts to create the same store-delivered price for required products for all franchisees, franchisees that are at a price disadvantage as a result of their geographic location or because they have been assigned to a higher-cost supplier or distributor will be unhappy. By the same token, if the franchisor attempts to equalize store-delivered costs among its franchisees, franchisees that would otherwise have a natural cost advantage will pay more for certain products than they would otherwise have to, in effect meaning that the franchisee is subsidizing the price paid by the cost-disadvantaged franchisees.

If a franchisor attempts to equalize the prices that franchisees pay for store-delivered products, it must also determine what strategy it will use to achieve price equality. For franchisors that control the distribution function, the franchisor may be able to take title to goods required by the franchise system and re-sell those goods to franchisees at equal prices nationwide by charging a uniform price. Purchasing cooperatives that control the distribution function can also employ this strategy, often with the approval of the system's franchisees. The franchisor might also attempt to require its broadline distributor (if the franchisor has the leverage) or its dedicated system distributor to adjust pricing nationwide so that franchisees can be assured of paying the same price.

For franchisors that do not control the distribution function for the entire system or that have not designated a single system distributor, another option is to attempt to more evenly spread product costs amongst the franchisees by carefully pairing suppliers and distributors (based on factors such as freight expense from a given supplier to a given distributor). A franchisor can also institute efforts to more evenly spread the distribution of higher cost products among all franchisees, so that franchisees pay more equal prices for inputs. While these tactics are unlikely to result in totally equal prices paid by franchisees, it can create significant improvements in store-delivered cost variations.

Finally, franchisors can seek greater price equality among franchisees by requiring distributors to collect different sourcing fees for the same products from different suppliers (in order to equalize the cost paid by each franchisee), or by engineering transfers of funds at either the supplier level or distributor level from those with lower-costs to those with higher costs so that these cost discrepancies are not passed on in the prices paid by franchisees. The difficulty with this approach is that contractual restraints may restrict transfers of funds or the imposition of additional sourcing fees by distributors, or the distributors or suppliers may be unwilling to engineer funds transfers or impose additional sourcing fees.

B. Selection of Suppliers and Distributors

1. Approval Process

Generally, supplier approval is the prerogative of the franchisor. Even in systems that utilize purchasing cooperatives or other purchasing organizations to manage or otherwise conduct the franchise system supply chain, supplier approval remains a right and obligation of the franchisor. Approved suppliers are suppliers or other vendors that a franchisor has identified, investigated and approved to provide their products or services to the franchise system supply chain. Franchisees are typically required, pursuant to the terms and conditions of the franchise agreement, to purchase only from approved suppliers.

A franchisor should maintain an effective and efficient supplier approval process to maintain control over the quality of products and services that are delivered to the retail outlet. An effective and efficient supplier approval process allows the franchisor to create a duplicable business model that is easily recreated by franchisees that ensures that the consumer has a consistent experience from one retail outlet to another. This consistency reinforces the brand and increases consumer confidence in the brand.

The franchisor usually conducts a battery of testing prior to approving a supplier. Generally, a supplier approval process will include a thorough investigation of: (i) the supplier's ability to meet and maintain the franchisor's applicable quality assurance requirements; (ii) the financial wherewithal of the supplier and other risk assessments including location and supplier processes; (iii) the quality and cleanliness of the proposed manufacturing facility; (iv) the ability of the supplier to produce the products in accordance with the product specifications and other requirements; (v) the ability of the product to be readily reproduced in the retail outlet; and (vi) the quality and appearance of the product itself which may include test groups and/or sensory testing.

In the supplier approval process, a franchisor might charge a fee for reviewing and evaluating a proposed supplier. This fee will often cover the out-of-pocket costs incurred by franchisor for the supplier approval process or other cost associated with the review and approval of the proposed supplier.

Recommendations for supplier approval may be submitted by members of the franchise system supply chain. The purchasing cooperative or other purchasing organizations often develop relationships with suppliers, understand the abilities of the supplier community and are generally a good source of supplier approval recommendations. In addition, the supplier approval process may allow franchisees to submit proposed suppliers for review and approval by the franchisor. The process for a franchisee to submit proposed suppliers for approval may be set forth in the franchise agreement.

Franchisors will regularly monitor approved suppliers and will reject approved suppliers who let their quality control fall below the specified standards. Approved suppliers that fail to meet the quality control requirements are rejected because continuing with such suppliers effects brand integrity and inhibits optimal franchisee performance.

2. <u>RFP Process</u>

A request for proposal (RFP) is a process to allow potential suppliers to submit a bid to provide products or services to a company. Prior to sending out an RFP, it is important that the supply chain team has clearly identified what product or service they are seeking. If there are other criteria that may eliminate suppliers from consideration, such as the financial strength of the supplier, that should be included in the RFP as a point of inquiry. The company should include a timeline of events from the submission of the RFP to suppliers through supplier selection. Finally, it should be clear within the sourcing team prior to the RFP beginning what criteria will be used, and how they will be used, in selecting a supplier partner.

a. <u>Preparation for RFP</u>

In order to create an effective RFP document, the company's supply chain organization should first develop a strong understanding of the product or service being sourced. As outlined by the consulting group A.T. Kearney in various articles and presentations on successful strategic sourcing processes, this will include taking steps to:

- Profile the product or service category in order to reach a decision on which products or services are likely to be sourced from the same suppliers;

- Create a sourcing plan by defining actual needs, determining opportunities for changes in the product or service currently provided, and identifying any gaps;

- Identify industry structure, market segmentation and a list of viable suppliers; and

- Develop sourcing strategy, which will likely result in the issuance of an RFP, but the market information gained in the prior steps may show there is only one viable supplier and direct negotiations with that supplier may commence.

b. <u>Contents of RFP</u>

The RFP document itself needs to contain a detailed outline of the product or service that is being sought. If an RFP is being issued on a proprietary product, each supplier should be required to sign a nondisclosure agreement prior to receiving any specifications for that product. The RFP should also clearly state that the final specification for any product developed by the winning supplier will be the proprietary property of the company requesting the bids. If the goal of the RFP is to locate cost savings from different suppliers, the company may also provide an option for the potential suppliers to identify variations from the current product specification and their corresponding pricing variances.

The RFP should include inquiries about the supplier which would be considered in evaluating the responses. In addition to basic information like the longevity of the supplier's business operations, financial information, and distribution capabilities, this would be a vehicle for determining other less concrete qualities about the supplier. If the franchisor has a goal of working with a certain percentage of minority or women-owned businesses, for example, this could be included in the information requested. The supplier should also be asked to provide references in the industry and its qualifications to do business with the company.

The RFP should request pricing responses based on the specifications provided for a product or service requested. As noted above, the supplier could also be given the option to recommend changes to the specifications of a product in order to achieve cost savings. The pricing for products may vary based on the quantity purchased, and a breakdown of this should be requested in the response. If international suppliers are being considered, the RFP should also specify the currency to be used in providing pricing.

The RFP should also include a detailed timeline of the process, from the date that the RFP is issued, when responses are due, through the date when a final decision will be made. Other steps that may need to be outlined include requests and delivery dates for samples of products from select suppliers, any in person meetings that may need to occur, and dates by which any follow up information will be requested. Of course, timing may vary once the process begins and it is best to keep suppliers notified of changes in the overall timeline if any delays occur.

A contact person, both for questions and to deliver the final responses, should be clearly identified. If a specific mode of delivery of responses is desired, that should be communicated in the RFP as well.

c. Decision Making

Each item of information requested in the RFP will be used to reach the ultimate decision on choosing the supplier. The information gathered by the supply chain team during the preparation process can help establish the weight of each criterion. Clearly the price component of the RFP will have a strong weight in the decision making. Depending on the market, however, the stability of the supplier may be just as important as submitting the best price. The questions that will be included in the RFP should be drafted in a way that will provide the best, most concise answers from potential suppliers in order to allow the weighting of the criteria to be effective.

C. Master Supply and Distribution Agreements

The franchise system supply chain is dynamic and involves constant flow of information, goods and funds between several different entities. The franchise system supply chain not only includes suppliers, distributors and retail outlets but also the franchisor, purchasing organizations and third party logistics providers, among others. Information, goods and funds flow in both directions in an effective franchise system supply chain.

Some franchise system supply chains utilize little or no standard agreement documentation. Goods may be purchased using handshakes, electronic mail or telephone conversations. Other franchise system supply chains purchase goods using a series of inconsistent purchase orders, order acknowledgements and invoices that are each oriented toward the interest of the issuing party. The fundamental problem with informal supply arrangements is the franchisor cannot ensure a certain and constant supply of the goods and supplies needed by the franchise system on terms that are known and enforceable.

An effective and efficient franchise system supply chain often views its supply chain agreements as a strategic advantage, investing considerable resources in their development, negotiation and implementation. There are many different strategies that may be utilized to document the various relationships in the supply chain. There is not a one-size-fits-all solution and the applicable system's objectives, goods, geographic location, resources, competition and other factors should all be considered when developing an appropriate franchise system supply chain documentation strategy.

Master supply and distribution agreements are just one of the franchise system supply chain documentation strategies. Master supply and distribution agreements are often utilized by larger regional and national franchise systems. These types of agreements generally provide that the applicable supplier or distributor will provide the goods or services pursuant to standardized terms and conditions to the entire system or a particular geographic region.

1. Master Supply Agreements

A master supply agreement is a harmonized contract between the supplier and the authorized purchaser for the sale and purchase of certain goods to be delivered to a distributor or other authorized purchaser. Master supply agreements standardize contracts in a franchise system supply chain and make them easier to administer, negotiate and monitor. An effective franchise system supply chain may utilize master supply agreements to ensure that provisions important to the success and protection of the system are documented. Usually the master supply agreement is negotiated with the supplier during the beginning of the relationship after the supplier is approved but before goods are purchased from the supplier.

No discussion of a supply agreement would be complete without being placed within the context of the Uniform Commercial Code ("UCC"), specifically article 2 of the UCC dealing with the sale of goods. Article 2 governs each step of a transaction for the purchase and sale of goods from general obligations to construction of a contract to performance, breach and remedies. Every state, with the exception of Louisiana, has adopted some version of UCC article 2 with minor variations. An in-depth analysis of UCC article 2 is beyond the scope of this paper, but the following topics are some of the topics that should be considered in a master supply agreement for an effective franchise system supply chain. This list is not intended to be exhaustive.

a. Parties to the Agreement

The parties to the master supply agreement should be clearly identified by their proper legal name and state of incorporation or formation. Generally, rights under an agreement only run to the entity that is a party to the agreement. The parties to the agreement should have the ability and authority to receive the benefits of and responsibility for the performance under the agreement.

b. Terms and Conditions

The UCC makes it clear that the mere existence of additional or different terms contained within preprinted purchase orders and acknowledgement forms that otherwise purport to be an agreement will not prevent such forms from operating as an offer and acceptance and consequently being a legally recognizable contract consisting of the terms the parties expressly agree to, additional terms not objected to that do not materially alter the bargain and to the extent that the terms conflict such terms are replaced with the UCC gap-fillers. The UCC gap fillers may or may not be favorable to the franchise system supply chain. In any event, the acceptance must still qualify as a "definite and seasonable expression of acceptance" to form such a contract. Accordingly, the acceptance must be sent within a reasonable time following the offer. Further, there must be some point at which the terms in the purported acceptance so diverge from the terms of the offer that there is not an acceptance at all. This set of circumstances is commonly referred to as the "Battle of the Forms," referring to the exchange of forms containing different terms that frequently take place between parties in transactions involving the sale of goods.

If a contract is formed by the exchange of purchase orders, acknowledgment forms or other such writings by merchants under the UCC, then any additional terms in the acceptance document will become part of the contract unless those terms materially alter the offer, or unless the offeror has specifically indicated either in its offer or after receiving acceptance that the offer is limited to its terms. When the acceptance includes different rather than additional terms, the knockout rule applies which ignores the conflicting terms and looks instead to the UCC gap-fillers for those terms.

In the case in which the parties exchange forms but the forms themselves do not make a contract under the UCC, either because the terms are too divergent or because the acceptance was expressly made conditional on the offeror's assent to the different or additional terms which was not forthcoming and the two sides proceed to perform anyway, then the conduct of the two parties serves to establish the existence of the contract. The terms that govern such a conduct-formed contract are those terms on which the writings of the parties agree, together with the UCC gap-fillers.

A purported acceptance with non-matching terms will not operate as an acceptance and form a contract between the parties if the offeree makes it clear that its acceptance of the offer "is expressly made conditional on the offeror's assent to the additional or different terms contained in the acceptance." When that language or something similar is used, then there is no contract formation until the offeror gives its specific assent to the offeree's additional or different terms.

Language should be added to the master supply agreement that provides that unless the parties sign an agreement that expressly amends the provisions of the master supply agreement, no purchase documentation including, but not limited to, purchase orders, order acknowledgements and invoices may supplement or vary the terms of the master supply agreement and the terms of the master supply agreement supersede the terms of any purchase documentation. This type of provision could prevent the "battle of the forms" issue and will allow for the consistent application of favorable terms and conditions with respect to the purchase of goods by the franchise system supply chain.

c. <u>Prices</u>

The master supply agreement should include a method to reasonably determine the price. Methodologies to determine the price for goods include, but are not limited to, fixed pricing, cost plus pricing, formula pricing and open pricing.

i. Fixed Prices

Fixed prices are when prices for goods remain the same during a negotiated specific time period. The franchise system supply chain is gambling that the price for the applicable good will continue to rise due to demand, underlying commodity price increases, weather or other factors and the supplier is gambling that the price will continue to fall during the negotiated time period therefore increasing the profitability of the negotiated arrangement. The underlying master supply agreement should not be coterminous with the fixed price time period. The master supply agreement should allow for the fixed price of goods to be updated, agreed to by the parties in writing and incorporated into the master supply agreement without the need to renegotiate the entire agreement.

ii. Cost Plus Pricing

Cost plus pricing is calculated by determining the cost required to produce the good and then adding a negotiated mark-up or profit margin for the supplier. Cost plus pricing methodologies require complete transparency into the manufacture and production of the good. Cost plus pricing is usually seen when a supplier has a facility dedicated to the manufacture of a specific good for the franchise system supply chain.

iii. Formula Pricing

Formula pricing is utilizing a formula or other agreed mechanism to determine price. The formula would need to be clearly set forth in the master supply agreement. A common formula pricing example would utilize information from a publicly traded market to obtain the price of a commodity required to produce the good. The formula could require that the final trading price of the commodity as of the close of the market on Tuesday be inserted into the formula to determine the price for the good for the following week. All other cost components in the formula would remain static and therefore the negotiated formula would determine the good's price for the following week and the process would repeat itself during the term of the master supply agreement. Issues with formula pricing include instances when the market price for the underlying commodity is unjustifiably high or low or if the formula itself is overly complicated and causes high administrative costs.

iv. Open Pricing

Open pricing is when the parties decide that instead of trying to determine a fixed price, cost plus price, formula price or other pricing mechanism at the time the master supply agreement is negotiated, one party is allowed to set a reasonable sale price for the goods at or near the time such goods are sold to the franchise system supply chain. The UCC allows for open pricing in agreements that previously would have been voided for indefiniteness for leaving out the price for the goods. Accordingly, a contract is valid despite the failure to fix a price if the parties intended for the contract to be valid. Open pricing is common among industries that deal in commodities that wildly fluctuate in price such as gasoline or steel. The party charged with setting the price is required to act in good faith.

d. Terms of Payment

Payment terms are the arrangement in which the authorized purchaser under the master supply agreement will pay the supplier for the contemplated goods. Prompt pay discounts are also often negotiated. For example, the notation "2% 10, net 30" indicates that a 2% discount can be taken by the purchaser if the payment is received in full within 10 days of the dispatch of the good, and that full payment is expected within 30 days.

e. Purchase Commitment

Without an express written volume or other purchase commitment, the master supply agreement should not obligate the franchise system supply chain to purchase goods. The master supply agreement should provide that the supplier will sell to the franchise system supply chain such goods as each authorized purchaser severally orders on the terms and conditions set forth in the master supply agreement but should not commit to a specific volume. If a volume or other purchase commitment is appropriate for the applicable business arrangement with the supplier (e.g. proprietary, unique or other products that cannot be readily sold outside of the franchise system supply chain), any volume or purchase commitment should be in writing and expressly provide the contracted volume of goods and other terms of the specific volume or other purchase commitment.

f. Title and Risk of Loss

Risk of loss is the provision to determine which party should bear the burden of risk for damage or destruction of the goods after the sale but before the goods are delivered. At common law and under the Uniform Sales Act, risk of loss was generally made to turn on the location of title. The UCC allows the parties to contractually allocate or otherwise shift the risk of loss to one party or the other regardless of who possesses title. When determining who bears the risk of loss, how the good will be transported and the party in the best position to insure against potential loss should be analyzed. In any event, when the risk of loss shifts from the supplier to the authorized purchaser should be identified in the master supply agreement.

g. Term

The master supply agreement can have a specific defined term with a clear expiration date or be evergreen. An evergreen term allows the master supply agreement to continue or otherwise be automatically renewed until either party takes an affirmative step to terminate the agreement pursuant to the termination provision. A franchise system supply chain may choose to use one or both terms when negotiating master supply agreements with suppliers. If a defined term is used, procedures should be implemented by the franchise system supply chain to prevent the master supply agreement from expiring unnoticed.

h. Termination

i. General Right to Terminate

A right to terminate the agreement, or termination for convenience, reserves the right of either the franchise system supply chain or the supplier to terminate the master supply agreement upon written notice. The notice required to terminate for the supplier should be longer than the time required for the franchise system supply chain because of the need for the franchise system supply chain to identify and establish a new supplier and preserve continuity of supply. Due to required lead times to manufacture goods, finished goods inventory and other issues, the franchise system supply chain may need to agree to a reasonable inventory repurchase obligation when negotiating the general right to terminate.

ii. Termination for Cause

The franchise system supply chain should preserve the right to terminate the master supply agreement for cause. Breach of the master supply agreement, issues with the safety or quality of goods, actual or potential damage to the reputation of the franchise system supply chain or the unauthorized use of names or trademarks are all reasons to terminate the master supply agreement for cause.

i. Cover Rights

Cover rights allow the franchise system supply chain to order similar goods from a different supplier if the contracting supplier is unable to provide the contracted goods in the applicable time frame contemplated in the master supply agreement and charge that incremental cost of obtaining such similar goods to the contracting supplier. Continuity of supply is a major consideration for any franchise system supply chain. The franchise system supply chain should be able to exercise its cover rights if: (i) the goods are not sent or received with the agreed upon time frame; (ii) the goods are defective or nonconforming; or (iii) the supplier is out of stock of the applicable goods.

j. Compliance with Laws

The master supply agreement should require the supplier to comply with all applicable laws, ordinances, rules and regulations. If the goods will be sold internationally, the supplier should be required to manufacture, process, fabricate, label and produce the goods in accordance with applicable international law.

k. Warranties

Warranties can be "expressed" or "implied." According to the UCC, an express warranty is created by "(a) Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain…or (b) Any description of the good which is made part of the basis of the bargain creates an express warranty that the good shall conform to the description." An implied warranty is a warranty that is presumed to be a part of the agreement for the purchase and sale of goods irrespective of whether the seller has made an affirmation of fact or promise in writing or orally. It is important to remember that the express warranty will not mean that other implied warranties do not apply; however, the franchise system supply chain should carefully consider whether to rely on implied warranties or make them express in the master supply agreement. To disclaim an implied warranty from the master supply agreement, the disclaiming language must be conspicuous. In order to satisfy the "conspicuousness" requirement of the UCC, many agreements utilize large, capitalized and bold print stating that, "**ALL OTHER WARRANTIES EXPRESS OR IMPLIED, INCLUDING THE WARRANTIES OF FITNESS FOR A PARTICULAR PURPOSE AND MERCHANTABILITY ARE HEREBY DISCLAIMED**." The master supply agreement should contain a litany of different warranties applicable to the goods purchased including, but not limited to, the following:

i. Warranty of Merchantability

In all sales of goods, unless expressly excluded, the supplier warrants to the authorized purchaser that the goods are merchantable. Merchantable means that the goods: (i) would pass without objection in the trade under the contract description; (ii) are of fair, average quality within the description; (iii) are fit for the ordinary purposes for which such goods are used; (iv) are of even kind, quality and quantity within each unit or lot and among all units or lots involved; (v) are adequately packaged and labeled; and (vi) conform to the promises or affirmations of fact made on the container or label.

ii. Fitness for a Particular Purpose

The UCC implies the warranty of fitness for a particular purpose unless it is expressly disclaimed. Under the implied warranty of merchantability, sellers warrant that their goods are fit "for the ordinary purposes." Sellers do not warrant that materials are fit for any particular purpose, however, unless the seller has reason to know the purpose for which the materials will be used and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods. The master supply agreement should expressly provide that the franchise system supply chain has informed the supplier of the purpose in which the goods will be used and is relying on the supplier's skill or judgment to furnish suitable goods.

iii. Warranty of Materials and Workmanship

The warranty of materials and workmanship is generally a limited warranty in which the supplier warrants that the goods will be free from defects in materials and/or workmanship.

iv. Warranty of Title

All sellers of goods provide an implied warranty that the buyer will get good title of the goods, free and clear of any liens.

v. Warranty Against Infringement

Any seller who is a merchant regularly dealing with the applicable goods warrants that the goods will not violate any patents or infringe on any other rights of third parties. However, if the franchise system supply chain provides the specifications for the goods to be manufactured, the franchise system supply chain is warranting to the supplier that these specifications do not violate any patent or other third party rights. This could be an issue when specifications for goods are issued by the franchisor or other member of the franchise system supply chain. To avoid the unintended consequence of the franchisor making a warranty to the supplier for each specification for a good, language should be added to the master supply agreement that provides that the specifications will not constitute a warranty, express or implied, by the franchise system supply chain.

l. Indemnification

The indemnity provision is generally one of the more negotiated provisions in the master supply agreement but it also serves as the principal method of protection and recovery to the franchise system supply chain. The master supply agreement should contain a very detailed indemnification and hold harmless provision that covers each party in the franchise system supply chain including the distributor, franchisor, franchisee and any purchasing organization. The indemnification obligations should cover not only the breach of the master supply agreement but any damage or loss that arises from the preparation, processing, manufacture, completion, delivery, operation, consumption or use of the goods. The indemnity provision should survive the expiration or earlier termination of the master supply agreement.

m. Insurance

The master supply agreement should set forth the minimum required types and amounts of insurance required of the supplier to participate in the franchise system supply chain. These insurance requirements are generally set by the franchisor after an analysis of the type of goods manufactured by the supplier, financial wherewithal of the supplier and system penetration of the good in the system among other factors. The master supply agreement should require a fully complying certificate of insurance upon execution of the agreement and annually thereafter to ensure compliance with the insurance requirements.

n. Financial Information

One of the major inhibitors to continuity of supply is supplier bankruptcy. The master supply agreement should require the supplier to provide the franchise system supply chain with financial statements and other financial information at least annually so that the financial health and wherewithal of the supplier can be ascertained. The franchise system supply chain uses this information to make contingency plans and strategies to ensure continuity of supply.

o. Product Recall

A product recall is a request to return or destroy a good, usually due to concerns about the safety or quality of the good. A product recall can be initiated by a governmental entity, the supplier, the franchisor or the franchise system supply chain. Product recalls are generally taken very seriously because of the costs associated with recalls, including the damage to brand name and reduced confidence in the applicable brand. The master supply agreement should have a product recall provision that attempts to balance the cost of implementing the recall with the necessity to perform the recall efficiently and effectively. Generally, this balance is reached by requiring the supplier to promptly perform the recall procedures with the cost associated with such procedures to be determined and allocated at some later date. If subsequent to a recall, it is determined that the supplier was not negligent or otherwise responsible for the safety or quality issue associated with the good, the provision could provide that the supplier would not have to pay for the recall.

p. Inspection

In order to facilitate the franchisor's quality assurance function, the master supply agreement should contain a provision that allows for the inspection of the supplier facility and the goods during their manufacture, processing and/or preparation. The cost of inspections could be borne by the supplier as the cost of doing business with the franchise system supply chain, the franchisor as part of its franchisor function, a purchasing organization as part of its good procurement function or as otherwise agreed.

q. Confidentiality

A robust confidentiality provision should be included in the master supply agreement. The supplier may be provided with confidential and proprietary specifications, recipes and/or formulae concerning goods that could be materially detrimental if such information where disclosed to third parties. The confidential information needs to be broad enough to cover several different means of information disclosure including electronic mail, visual or sensory as done in supplier taste tests.

r. Third Party Beneficiary

A third party beneficiary is a person who is not a signatory to the master supply agreement, but has the legal right to enforce the terms and conditions of the agreement. The franchise system supply chain may consider adding certain parties of the franchise system supply chain as third party beneficiaries to the master supply agreement. These third party beneficiaries might include the approved distributors, the franchisees, and the franchisor. This would allow an injured authorized purchaser to enforce the terms and conditions of the master supply agreement directly against the supplier without the executing party having to be directly involved in the litigation or dispute.

s. Force Majeure

The force majeure provision excuses the claiming party from performing for some stated period of time because of events or occurrences out of the reasonable control of such parties. Careful consideration should be paid when drafting the force majeure provision of the master supply agreement. Events such as material increase in the underlying commodities should not give the supplier the right to be excused from providing goods at the negotiated fixed price. However, the public fear of an event or the anticipation of an event may excuse the franchise system supply chain from a volume commitment. For example, if there is a mad cow disease outbreak and the public demand for beef plummets, a carefully drafted force majeure provision could excuse the franchise system supply chain from any applicable volume commitment.

2. Master Distribution Agreements

A distributor is generally a company that purchases goods and resells and distributes those goods to retail outlets. The distributor serves as an intermediary between suppliers and the retail outlets. The distributor usually procures pallets and bulk inventory quantities from suppliers that are shipped to the distributor's distribution center where the pallets and bulk inventory are broken down to case size to distribute to the applicable retail outlets.

There are different types and sizes of distributors. As discussed in Section II(A) above, a broadline distributor will generally service a wide variety of customers with a wide variety of goods. A system distributor will generally inventory a narrow selection of goods for certain customers such as a single or closely related restaurant system. Distribution companies can range in size from a one-trailer operator that provides produce to a local retail outlet to a large national broadline distributor that provides distribution services to a multi-unit quick service restaurant system.

Generally, a master distribution agreement is a contract between the distributor and the purchasing entity or franchisor for the resale and distribution of certain goods to retail outlets. Master distribution agreements standardize contracts in a franchise system supply chain and make them easier to administer, negotiate, standardize and monitor. The following are some of the topics that should be considered in a master distribution agreement for an effective franchise system supply chain. This list is not intended to be exhaustive.

a. Parties to the Agreement

The parties to the master distribution agreement should be clearly identified by their proper legal name and state of incorporation or formation. Generally, rights under an agreement only run to the entity that is a party to the agreement. The parties to the agreement should have the ability and authority to receive the benefits of and responsibility for the performance under the agreement.

b. Distribution Area

The geographic territory to which the distributor is responsible to provide services needs to be clearly defined. Factors such as the number of retail outlets in the geographic area, distribution lane optimization, existing customer base, supplier location, freight cost and other information should all be considered. Designating a territory that is too large may sacrifice service levels but designating a territory that is too small may compromise economies of scale.

c. Purchase Commitment

The distributor will be purchasing and distributing goods to the system pursuant to the master distribution agreement. The master distribution agreement should provide certain express parameters and commitments with regard to the purchase and distribution of such goods.

i. Approved Goods

The master distribution agreement should provide that the distributor will purchase and distribute only those goods expressly approved for use, sale and/or consumption in the system by the franchisor or the franchise system supply chain, as applicable. Goods that are not approved should not be provided by the distributor to the retail outlet.

ii. Proprietary Goods

Certain goods may be proprietary or otherwise unique to the system. Proprietary or unique goods should not be distributed, sold or otherwise provided to any party outside of the franchise system.

iii. Substitutions

Distributors may have several different types of the same goods in their inventory including their own goods manufactured pursuant to their private label. When or if the distributor may substitute these goods for approved goods should be clearly set forth in the master distribution agreement.

iv. Inventory Management

Certain inventory management policies and practices that minimize obsolete inventory should be included in the master distribution agreement. For example, the distributor may not have more than thirty days worth of inventory of any given good as determined by a rolling three month average without the express written consent of the franchise system supply chain.

v. Promotions and Limited Time Offers ("LTOs")

Goods subject to promotions or other LTOs introduce new and unique issues for a distributor as compared to the base goods distributed in the normal course of business. There is a greater risk for obsolete inventory or to run out of goods prior to the end of any promotion or LTO. How to manage the promotions and LTOs as well as who is financially responsible for obsolete inventory or expedited procurement costs if the distributor runs out of goods should be detailed in the master distribution agreement.

d. Purchase Documentation

The master distribution agreement should require that the purchase of goods from the suppliers for ultimate sale and delivery to the retail outlets be effected through and governed by the terms and conditions of the master supplier agreement and related documentation. The warranties and other protections of the franchise system supply chain would protect the distributor from defective or non-complying goods manufactured by supplier and the warranties and other protections would be passed through to the retail outlets.

e. Distributor Mark-up

How the distributor is compensated for providing the distribution services should be documented in the master distribution agreement. The distributor's compensation could be a per-case fee, a percentage of the landed cost of the good (e.g. the cost to get the good from the supplier to the distribution center) or such other method determined by the parties.

i. Pack Size Changes

A material change on an individual stock keeping unit (SKU) basis to pack size, case weight or case cube for goods may have a favorable or an adverse affect on the distributor mark-up. What is considered material and how to resolve this issue should be contemplated in the master distribution agreement.

ii. Change in Storage or Delivery Requirements

As with pack size changes, material changes in storage or delivery requirements may impact the distributor mark-up or the overall economics of master distribution agreement. What is considered material and how to resolve this issue should be contemplated in the master distribution agreement.

iii. Efficiency Gains

Depending on the term of the master distribution agreement, technology, productivity or other supply chain efficiency gains may significantly reduce the cost of providing distribution service to the franchise system supply chain. Examples include electric tractor trailers or advances in refrigeration that lower the cost to cool and transport refrigerated goods. A provision should be added to the master distribution agreement that would allow the franchise system supply chain to share in these efficiency gains.

f. Inventory Pricing Policies

The master distribution agreement should clearly set forth how the price the distributor will resell the goods to the retail outlets will be determined. The price of the goods could be based on a weighted average that is smoothed out over time, the distributor landed cost for such good or such other mutually agreed to method.

i. Price Manipulation

The inventory price policies should be drafted in such a manner as to prevent price manipulation that benefits the distributor. For example, if the distributor price is adjusted each calendar month and the landed cost for the good increases, the distributor could immediately adjust the price of the good to the retail outlet upward on the first of the month even though the current inventory of goods were purchased at the lower price. If the landed cost for the good decreases, the distributor could wait to the end of the month to adjust the price downward and therefore sell goods to retail outlets at the higher price. A properly drafted inventory pricing policy provision could prevent such price manipulation.

ii. Deviated Pricing

A requirement that the distributor administer a "deviated pricing" program if requested by the franchise system supply chain and the applicable supplier should be included in the master distribution agreement. Deviated pricing is usually applicable to national branded goods where the sell price to the retail outlet is less than the price the applicable supplier charges the distributor. The distributor subsequently bills back the difference between the price paid by the distributor and the price charged the retail outlets and provides proof of sale to the retail outlet to the supplier on a weekly or monthly basis.

iii. National Priced Goods

A requirement that the distributor administer "national pricing" programs if requested by the franchise system supply chain and the applicable supplier should be included in the master distribution agreement. National pricing programs are applicable to goods where the sell price to the retail outlets are set by the supplier and the handling fee for distributing these goods is paid by the supplier directly to the distributor.

g. Terms of Payment

Payment terms in the master distribution agreement are the arrangements in which, subject to the distributor's credit standards and policies, the retail outlet will pay the distributor for the contemplated goods and their distribution. Often times prompt pay discounts are also negotiated. For example, the notation "2% 10, net 30" indicates that a 2% discount can be taken by the purchaser if the payment is received in full within 10 days of the delivery of the goods, and that full payment is expected within 30 days.

h. Service Level Requirements

The master distribution agreement at its core is a service agreement in which the distributor agrees to provide certain distribution services to the applicable retail outlets. As a service agreement, the master distribution agreement should require compliance with certain minimum service level requirements including, but not limited to, commonly measured items such as on-time delivery, delivery compliance, and perfect orders. Over the term of the agreement the service levels should increase as the distributor becomes more efficient at providing the distribution services to the applicable retail outlets.

i. Deliveries

The master distribution agreement should contemplate several different types of deliveries of goods and any associated cost of such deliveries. The franchise system supply chain and the distributor need to determine the most efficient basis to deliver goods to the retail outlet based on location and the goods required to operate the business. A brand that requires a fresh food good may require more frequent delivery as compared to a concept in which food goods are delivered frozen with an extended shelf life.

i. Delivery at Outlet

Many times the distributor makes a delivery to the retail outlet once or twice per week during business hours. A retail outlet manager or other employee is present to inspect delivery and ensure that the ordered goods conform to the goods actually delivered. If there is an issue with a good delivered, it can be rejected and placed back on the tractor trailer for return to the distribution center.

ii. Key Drop Deliveries

Key drop deliveries are deliveries by the distributor to the retail outlet after business hours. After the retail outlet is closed for the evening, the distributor enters the facility and places the goods in the designated location. Key drop deliveries allow the distributor to optimize its route in the most efficient manner because there is not a time in which the delivery must be made and deliveries do not obstruct the customers experience or otherwise take time and attention away from retail outlet employees. Issues with key drop deliveries include the safety of the driver who is working after hours, pests entering the retail outlet if the door is propped open as the driver transports goods into the retail outlet, accidently setting off alarms or other security systems, and the safety of the premises in the event the driver does not properly secure the retail outlet after leaving.

iii. Hot Shot/Expedited Deliveries

Generally a hot shot or expedited delivery is a special delivery of an essential good that is needed by the retail outlet or mistakenly not delivered during a scheduled delivery. The master distribution agreement should set forth who is responsible to pay for the hot shot/expedited delivery. The master distribution agreement may allow for a limited number of free hot shot/expedited deliveries or otherwise attempt to align the need for the hot shot/expedited delivery with the entity responsible for such delivery. For example, if the distributor forgets to place an essential good on the truck for the delivery, the distributor would pay for the hot shot/expedited delivery.

iv. Blackout Windows

Blackout windows are different periods of the day when delivery of goods are prohibited. The blackout windows generally correspond to the retail outlets' busiest periods such as lunch and dinner times for quick service retail outlets. The master distribution agreement should set forth the applicable blackout windows, if any.

j. Specifications and Standards

The franchise system supply chain and/or the franchisor will establish specifications and standards for handling, quality and other requirements for the goods. The distributor should be prohibited from selling or delivering any goods under the master distribution agreement unless the goods meet the applicable specifications and standards for goods as modified from time to time and such goods are supplied by an approved supplier. At a minimum, the distributor should maintain goods within the applicable temperature requirements, supply goods to retail outlets free of any damages, and deliver goods within the applicable shelf life matrix.

k. Credit Standards and Policies

The need for the distributor to protect itself from at-risk customers needs to be balanced with the franchise system supply chain's goal of continuity of supply. What credit standards and policies are applicable, both when a franchisee joins an established distribution arrangement and on an ongoing basis, and what happens when a franchisee is unable to pay its distribution invoices when due should be clearly detailed in the master distribution agreement. Any credit standards and policies should be applied in a consistent and non-discriminatory manner among all of distributor's customers not just the customers affiliated with the franchise system supply chain. In addition, instead of the distributor suspending distribution to an at-risk retail outlet that defaults on its payment obligations, a detailed prepay/cash on delivery option with a prepayment plan should be available to the retail outlet to allow for continued operation.

l. Financial Statements

The master distribution agreement should require the distributor to provide the franchise system supply chain with financial statements and other financial information so that the financial health and wherewithal of the distributor may be ascertained. The franchise system supply chain uses this information to make contingency plans and strategies to ensure continuity of supply for retail outlets.

m. <u>Provision of Information</u>

The franchise system supply chain needs information concerning demand, usage, availability, costs, inventory, quality, etc. to effectively manage the supply chain. An important source of this information is the transactions between the distributor and the retail outlets. The master distribution agreement should require a free flow of information from the distributor to the franchise system supply chain or to the designated third party information processor. The information provided by the distributor should be provided at no cost if such information or reports can be prepared by the distributor in its ordinary course of business. If the provision of information or reports causes significant alteration to distributor’s ordinary record keeping or reporting capacities or is not readily available to the distributor using its current data processing or information systems, then the information and reports should be provided at a reasonable cost agreed to by the distributor and the franchise system supply chain.

n. <u>Term</u>

The master distribution agreement should have a specific defined term with a clear expiration date. The length of the initial term, the length of any renewal term, automatic renewal and any conditions of renewal such as retail outlet drop size should all be discussed and documented in the master distribution agreement.

o. <u>Termination/Expiration/Nonrenewal</u>

The master distribution agreement should provide how and at what level the agreement may end. There are several different ways the agreement can end pursuant to its express terms. The master distribution agreement may be terminated with or without cause, expire at the end of the term or otherwise not be renewed at the end of the initial term or one of the renewal terms, if any. It is important that the master distribution agreement have several methods of ending in order to properly incentivize the distributor to perform in accordance with the service level requirements.

i. <u>Termination of Master Distribution Agreement</u>

The master distribution agreement should allow for termination in the event that there are material issues at the distributor level such as bankruptcy, disapproval by the franchisor, or distribution of unapproved goods to the retail outlets.

ii. <u>Termination at the Distribution Center Level</u>

If the master distribution agreement provides for distribution services to a broad area with multiple distribution centers, the master distribution agreement should allow for termination at the distribution center level. Issues that could cause the master distribution agreement to be terminated at the distribution center level include quality assurance or service level failures at the specific distribution center.

iii. <u>Termination at the Retail Outlet Level</u>

The master distribution agreement should also allow for termination at the retail outlet level in the event that the retail outlet is closed, divested or its location (at the end of a lane or distribution route) causes material failures in the service level requirements.

iv. Termination by the Distributor

The distributor may also insist on the right to terminate the master distribution agreement if the franchise system supply chain files bankruptcy or for other material breaches of the master distribution agreement.

p. Transition Services

The master distribution agreement should provide for certain transition services to be provided by the distributor at the expiration or earlier termination of the agreement. The form of master distribution agreement should provide that the incumbent distributor will sell to the successor distributor and the successor distributor will purchase from the incumbent distributor the merchantable goods purchased for the system. The price of the goods sold from the incumbent distributor to the successor distributor should be the incumbent distributor's landed cost.

q. Force Majeure

The force majeure provision excuses the claiming party from performing for some stated period of time because of events or occurrences out of the reasonable control of such parties. Careful consideration should be paid when drafting the force majeure provision of the master distribution agreement. Events such as material increase in the diesel fuel should not give the distributor the right to be excused from providing distribution services at the negotiated mark-up.

r. Warranties

Generally, the distributor will refuse to provide any express warranties and insist on disclaiming the implied warranties of merchantability and fitness for a particular purpose for goods purchased from approved suppliers and distributed to the retail outlets. Claims based on distributor's negligence, willful misconduct or its manufacturer of the goods should not be restricted or disclaimed. A careful balance between damages caused by the action or inaction of the distributor and those caused by a third party such as a supplier should be obtained.

s. Indemnification

The indemnity provision is generally one of the more negotiated provisions in the master distribution agreement. The master distribution agreement should contain a detailed indemnification and hold harmless provision that covers each party in the franchise system supply chain including the supplier, franchisor, franchisee and any purchasing organization. The indemnification obligations should cover not only the breach of the master distribution agreement but also any damage or loss that arises from the negligent provision of the distribution services. The indemnity provision should survive the expiration or earlier termination of the master distribution agreement.

t. Approved Distributor Status

The master distribution agreement should require that the distributor maintain its approved distributor status throughout the term of the agreement. Failure to maintain the approved distributor status may result in a for cause termination of the master distribution agreement. Approval of a distributor usually involves confirmation of the financial wherewithal of the distributor, quality assurance inspection of the applicable distribution facility and distributor's operations in general and a fully executed master distribution agreement.

u. Insurance

The master distribution agreement should set forth the minimum required types and amounts of insurance required of the distributor to participate in the franchise system supply chain. These insurance requirements are generally set by the franchisor after an analysis of the financial wherewithal of the distributor, history of the distribution area awarded to the distributor, and other factors. The master distribution agreement should require a fully-compliant certificate of insurance upon execution of the agreement and annually thereafter to ensure compliance with the insurance requirements.

v. Fuel Surcharge

It is not unusual for a distributor to insist upon a fuel surcharge to account for the fluctuations in fuel costs that may occur during the term of the agreement. The fuel surcharge should adjust both upward and downward depending on the cost of fuel for the applicable measurement period under the agreement. The parties would look to the Report of Weekly Retail On-Highway Diesel Prices published by the Energy Information Administration of the United States Department of Energy or such other third party reporting service for the cost of diesel fuel prices during the applicable measurement period under the agreement.

w. Perishable Agriculture Commodities Act

The master distribution agreement may cover the sale of perishable agricultural commodities, as that term is defined by the federal Perishable Agricultural Commodities Act (the "PACA"). All fresh and frozen fruits and vegetables which have not been processed beyond cutting, combining and/or steam blanching are generally considered perishable agricultural commodities. All perishable agricultural commodities sold pursuant to the master distribution agreement would be sold subject to the statutory trust authorized by Section 5(c) of the PACA. The supplier of these commodities retains a trust claim over these commodities and all inventories of food or other goods derived from these commodities and all proceeds thereof until full payment is received.

x. Product Recall

A product recall is a request to return or destroy a good usually due to concerns of the safety or quality of the good. A product recall can be initiated by a governmental entity, the supplier, the franchisor or the franchise system supply chain. Product recalls are generally taken very seriously because of the cost associated with the recalls including the damage to brand name and reduced confidence in the applicable brand. The master distribution agreement should have a product recall provision that attempts to balance the cost of implementing the recall with the necessity to perform the recall efficiently and effectively. Generally, this balance is reached by requiring the distributor to promptly perform the recall procedures with the cost associated to be determined and allocated at some later date. If subsequent to a recall, it is determined that the distributor was not negligent or otherwise responsible for the safety or quality issue associated with the good, the provision could provide that the distributor would not have to pay for the recall.

y. Freight Management Program

The management of the freight expenses associated with the transportation of goods from the supplier to the applicable distributor may serve to reduce the landed cost of the goods. If the inbound freight expenses are being actively managed by the franchise system supply chain, a provision requiring cooperation and participation in the franchise system supply chain's or designated third party logistics provider's freight management program should be included in the master distribution agreement.

3. Consistency of Agreements

Each master supply agreement and master distribution agreement will be negotiated with unique suppliers and distributors with their own concerns and comments. To the extent possible, master supply agreements should be consistently negotiated and applied to suppliers and master distribution agreements should be consistently negotiated and applied to distributors. Inconsistent terms in the applicable agreements could cause confusion, inconsistent application or other negative unintended consequences. Consistent agreements allow for the intended protection of the system and its confidential or proprietary information. The franchise system supply chain should provide periodic training for the applicable parties negotiating the agreements including provisions that may be revised or otherwise removed from the agreements without compromising the intended protections of the agreements.

D. Mechanics of Purchasing and Distribution

At the beginning of the supply chain are the suppliers. These are the manufacturers or vendors that make the good or provide the service. Once the good is manufactured or produced, it must then be transported to the next step in the supply chain. Logistics providers are the third party transportation companies that deliver the good inbound from the supplier to the distribution center. Distributors usually take goods in bulk from suppliers and deliver a bundle of related goods to the retail outlet. The retail outlets order the necessary goods from the distributor's order guide and the goods are delivered by the distributor to the retail outlet where they are sold to the end user or consumer. Each step in the supply chain requires communication to order, deliver and pay for the applicable goods.

1. Ordering Mechanisms

There are several different methods to order goods depending on the relationship of the parties in the supply chain and the technology utilized by the parties.

a. Purchasing Documents

A traditional method of ordering goods is through the use of purchasing documents such as purchase orders, order acknowledgments and invoices. As between a distributor and a supplier, the distributor may issue a purchase order that specifies the type, amount, delivery method and other necessary information for a good. The supplier reviews the purchase order and, if acceptable, issues an order acknowledgement. Subsequently, the goods are shipped and an invoice for the goods is issued by the supplier to the distributor. Each of the purchasing documents may have terms and conditions that are oriented toward the interest of the issuer. As discussed above, if the franchise system supply chain is utilizing a master supply agreement, the "battle of the forms" issue can be avoided.

b. Telephone, Facsimile or Electronic Mail

A master distribution agreement may authorize the use of a variety of forms of communication to order goods from any link in the supply chain. For example, a retail outlet may order goods from an approved distributor by placing such order via telephone, facsimile or electronic mail, subject to the master distribution agreement.

c. Electronic Ordering/Website

Many members of the supply chain utilize electronic ordering or websites to facilitate orders. The entire order guide could be available on the internet for the customer to log on and place an order for goods. Electronic ordering helps in preventing misunderstandings or other mistakes in other forms of order mechanisms because it allows the purchaser to review and confirm its final order.

2. Acceptance and Revocation

Acceptance generally occurs when the authorized purchaser has a reasonable opportunity to inspect the goods. The master supply agreement should clarify that acceptance does not occur until the goods have reached their final place of use or consumption, i.e. the retail outlet. The issue here is that in many franchise system supply chains the goods are sold by the supplier to a distributor. The goods are often times shrink wrapped on a pallet and rarely inspected by the distributor. The first real opportunity to inspect the goods is when they are delivered to their final place of use or consumption. Once the authorized purchaser has accepted the goods, its rights and duties change dramatically. The most important consequence of acceptance is that the authorized purchaser is obligated to pay the purchase price for the goods. Revocation follows acceptance and prevents the initial acceptance by the authorized purchaser from binding the buyer to the agreement. The authorized purchaser may revoke his acceptance of a good whose non-conformity substantially impairs its value. The authorized purchaser's right to revoke acceptance is dependent on the presence of express or implied warranties. There can be no non-conformity if there is no warranty to which the good must conform. This is one of the many reasons that the warranties in the master supply agreement, even the applicable implied warranties, should be expressly set forth in the document.

3. Invoicing and Payment

The UCC provides that payment is due for goods supplied at the time and place of delivery, unless the parties have agreed otherwise. The terms of payment are generally set forth in the master supply or distribution agreement. The payment provisions of the master supply and distribution agreements are actually granting more time for payment than otherwise exists pursuant to transactions for goods without agreements governed by the UCC. The terms of payment provision of the master supply and distribution agreements should provide when payment is due. For example, payment may be thirty days after the delivery of the goods or thirty days from the date of the invoice. In any event, if payment is not received when contractually due, the master supply and distribution agreement may require interest on the past due amounts. Interest could be a set percentage or such other amount legally allowed to be imposed, whichever is lower.

4. Remedies for Nonperformance

a. Seller's Remedies

Pursuant to the UCC, if the authorized purchaser pursuant to the master supply or distribution agreement fails to make a payment due or wrongfully rejects goods or repudiates the contract, then the seller may: (i) withhold delivery of further goods; (ii) stop any delivery that is under way, resell the good and hold the buyer responsible for any damages (such as the costs of sale and any loss on the sale); (iii) recover lost profits; or (iv) cancel the contract. The master supply or distribution agreement may contemplate additional remedies such as interest on late payments.

b. Buyer's Remedies

If the supplier or distributor fails to make a delivery or the goods delivered are defective, the authorized purchaser may, pursuant to the UCC, reject the goods, cancel the contract and (i) obtain "cover" goods (substitute or replacement goods) or (ii) recover damages for the non-delivery. The authorized purchaser also can recover damages for the defects in any accepted goods. This would be a breach of warranty claim. The authorized purchaser's damages for non-delivery would be the difference between the market price at the time the buyer learned of the breach and the contract price, plus any allowable incidental and consequential damages.

c. Limitation of Liability

The parties may contractually agree that remedies may be limited for any breach of the master supply and distribution agreement by a party. One common requested example is the disclaimer of implied warranties. The franchise system supply chain should carefully consider whether or not to allow the remedies otherwise available for nonperformance to be limited or otherwise disclaimed in the master supply and distribution agreements.

III. Special Issues Impacting a Franchise System Supply Chain

Even if franchise systems do not necessarily operate a unique type of business – for example, many restaurant systems are not franchised – a franchise system may face special issues when implementing procedures or standards that are commonplace in similar businesses. Many franchise systems rely upon one or more proprietary items to set themselves apart from competition. In such systems, a franchisor must carefully control the proprietary items to ensure quality and protection of intellectual property. In such a situation, a franchisor may decide that captive distribution is the best means to distribute a product, particularly one that comes from a single source or that the franchisor produces, to the franchise system. A franchisor may even make money on captive distribution, presenting a source of discontent for franchisees. Finally, franchisors (or a franchise system's advertising or similar fund) may receive income, or rebates, or other benefits from supplier. Such so-called supplier income is certainly not unique to franchise systems, but when multiple, independent business owners are involved, not all of whom may directly benefit from such income, special issues must be addressed.

A. Proprietary Items

A "proprietary item" or "proprietary product" in a franchise system is a product for which the franchisor owns or is exclusively licensed to use all intellectual property, including formulae or specifications, technology and patents. A proprietary item may be one that was developed by the franchisor, or one that the franchisor has acquired rights to through other means, such as the purchase of the formula or specifications from another company, or through co-development with a supplier. The franchisor is either specifically licensed to use the proprietary item (or underlying technology, patent or similar intellectual property) or exclusively owns the proprietary item and its underlying intellectual property.

A proprietary item or series of proprietary items benefits a franchise system by setting it apart from its competition. Often, a franchise system may be built around a specific proprietary item or series of items. Proprietary items can provide a significant benefit to franchisees, and are often a selling point for franchisors to sell additional franchises. Proprietary items can also serve as an additional source of revenue for franchisors, as the franchisor may retain a percentage of the price that its franchisees pay for proprietary items purchased from an approved supplier, or in many instances, the franchisor is the manufacturer of the proprietary item.

Proprietary items provide significant benefits to franchise systems, but also require planning and careful execution to ensure that the franchisor's intellectual property is protected and to ensure that the franchisor/franchisee relationship is also respected and protected. Since many franchisors manufacture or carefully control the manufacture of proprietary products, and to cover the cost of such services and oversight, such franchisors often retain a margin based on franchisees' purchases of proprietary items. Such margins must be carefully managed to balance the franchisors' efforts with the franchisees' need for lower costs.

1. <u>Protection of Intellectual Property</u>

A franchisor either owns or is exclusively licensed to use the formulae, specifications, technology or even patents associated with proprietary items. Often, a franchisor may not own formal rights to the intellectual property contained in a proprietary item, such as a patent to create the item. A franchisor's protection of the proprietary item therefore relies upon its ability to protect the trade secrets and confidential knowledge associated with the item. The loss of or disclosure of such intellectual property may eliminate the proprietary nature of the item, or jeopardize a franchise system's ability to continue to obtain a competitive advantage by offering the item. Therefore, the protection of intellectual property associated with a proprietary item is of paramount importance for not only the franchisor, but its franchisees as well. Protection of intellectual property is best addressed on three levels: (1) protection from and by franchisees; (2) protection from and by suppliers; and (3) protection from disclosure to or theft by third parties.

a. <u>Franchisees</u>

In an ideal situation, franchisees in a franchise system automatically will recognize the value of proprietary items not just to the franchisor, but to the system as a whole, and will go to great lengths to protect information related to proprietary items from theft by employees or third parties. Unfortunately, at times franchisees not only fail to recognize the value of proprietary items as protectable for the good of the franchise system, but even desire to utilize the intellectual property related to proprietary items to either replicate such items at a lower cost, or to utilize the intellectual property for other purposes. In a franchise system with one or a series of proprietary items, a franchisor must draft franchise agreement provisions, enforce such provisions and manage the franchisor/franchisee relationship with the goal of protecting any intellectual property related to proprietary items. The franchisor should give attention to information that may be disclosed through operations and similar manuals, and also agreement provisions that would help the franchisor enforce its intellectual property rights.

i. <u>Information Contained in Manuals</u>

A franchise system's operations manual may contain key information about proprietary items. For example, as to equipment, a manual may contain detailed assembly instructions, or troubleshooting instructions, which may reveal key properties of the item or underlying technology. To mitigate the risk of exposing too much information about a proprietary item in a manual, the franchisor should take the following steps:

- Assembly and similar instructions should be thorough enough to guide franchisees and their personnel as needed, but should not contain overly-detailed information that could be used to reverse engineer a proprietary item, or which reveals underlying trade secrets or technology.

- The franchise agreement should specifically limit the franchisee's use and sharing of the manual, and should specify how the franchisee is to store manuals. Only key personnel should be permitted to access a manual. When not in use, a single copy of a manual should be stored in a secure place. Or, if feasible, the franchisor should consider whether it is feasible to require that manuals be stored electronically, and password protected.

- The franchisor should coach franchisees on the potential effects of inadvertently losing track of manuals or releasing manuals to employees without a need to know the information, or to third parties, and on the best ways to preserve the confidentiality of the manual.

ii. <u>Reverse Engineering</u>

"Reverse engineering" is "starting with [a] known product and working backward to divine the process which aided in its development or manufacture." At a minimum, a franchise system with one or a series of proprietary items should contain a clear prohibition on a franchisee or its personnel reverse engineering or otherwise attempting to obtain information about or replicate a proprietary item. A concise example of such a provision is the following:

> Franchisor retains all rights, title and interest in and to all Proprietary Products and all product specifications which may be disclosed to Franchisee or utilized by Franchisee pursuant to this Agreement. Franchisee shall not reverse engineer, decompile or disassemble any Franchisor product, including, but not limited to, any Proprietary Product. Franchisee shall take all steps necessary to ensure that no employee reverse engineers, decompiles or disassembles any Franchisor product, including, but not limited to, any Proprietary Product. Notwithstanding anything to the contrary in this Agreement, Franchisor shall have the right to terminate this Agreement, and seek all remedies at law and in equity which may be available to Franchisor for violation of this Section, upon belief or proof that Franchisee, any current or former employee of Franchisee or any owner, agent or other representative of Franchisee, has violated this Section and has not ceased and cured such violation within 48 hours after Franchisee receives notice from Franchisor.

Effectively prohibiting reverse engineering is critical to ensuring the protection of intellectual property related to a proprietary item because the law does not protect the owner of intellectual property related to a proprietary item (short of a patent) from disclosure by reverse engineering. That is, without an express prohibition, reverse engineering can be considered "discovery by fair and honest means."

iii. <u>Injunctive Relief</u>

Many franchise agreements provide for alternative methods of dispute resolution, such as arbitration or mediation. Often, such provisions contain carve outs permitting the franchisor to seek immediate injunctive relief for certain issues, such as the protection of trademarks or goodwill. Similarly, a franchise agreement should provide for injunctive relief that is broad enough to extend to matters related to proprietary items. The agreement should provide that the franchisor may seek immediate injunctive relief for a violation of any prohibition on reverse engineering, or for the improper disclosure of any confidential information, including any information relating to proprietary items.

iv. Non-Competition Restrictions

Last but not least, covenants not to compete should not be overlooked as a means to protect a franchisor's proprietary information related to proprietary items. An effective covenant will prohibit a franchisee from using information that it learns about the proprietary item in future business endeavors, for at least a long enough period for the information to be, perhaps, less valuable. As discussed thoroughly in other publications, the covenant must be tailored to be enforceable in the jurisdiction where the franchisee is domiciled.

b. Suppliers/Manufacturers

Some franchisors that own the intellectual property rights related to proprietary items also produce such proprietary items themselves. Often, however, a franchisor will outsource the production of proprietary items to third party suppliers or manufacturers. In addition, a franchisor may develop new proprietary items for the franchise system by partnering with willing and capable suppliers. Franchisors therefore must put considerable effort into establishing and maintaining relationships with reliable and trustworthy suppliers and manufacturers. To avoid the inadvertent use of proprietary information by the supplier or manufacturer for other purposes, the franchisor must clearly specify in the franchisor's agreement with the supplier the confidential nature of information related to proprietary items, and must push for ownership of any new intellectual property rights related to the proprietary items.

i. Due Diligence/Supplier Assessment

As much as franchise practitioners would like to advise their clients that a solid contract is the best protection against the misuse of proprietary information related to proprietary items or other matters, the best defense against misuse of information begins before pen is put to paper on any agreement with a thorough assessment of the potential supplier partner. The following background should be part of the assessment of a supplier or manufacturer that will be entrusted with the responsibility of producing and/or developing proprietary items:

- Location of supplier; potential corruption: While certainly not determinative, the supplier's location and reputation in such locale should be taken into consideration before entering into a new relationship, as many suppliers are in locales with a reputation for weak intellectual property protection. For example, is the supplier located in a country that is known to have significant levels of corruption? If so, do the franchisor's local contacts in such country (hired or otherwise) have information about the leaders of the supplier company, and whether they are linked to any corrupt activity?

- Financial capability/solvency: A financially solvent supplier will not only prove to be a more reliable long-term partner for a franchise system, but such supplier will also have less temptation to misuse the information with which it is entrusted to produce and/or develop proprietary items.

- Security protocol: Is the supplier committed to protecting the franchisor's proprietary item and information related to such item? Consider whether the supplier limits the number of personnel/employees with access to confidential information, and what means (physical and electronic) the supplier has in place or is willing to put in place to protect confidential information. For example, key information should be password protected, with the supplier able to trace which employee(s) access such information. Rather than a single group of employees constructing an entire proprietary item, perhaps the supplier will use different groups for components of the proprietary item, to reduce the likelihood that personnel are able to replicate the proprietary item.

- References: The franchisor should check available references on the supplier, and consider whether companies that the franchisor considers as peers or reputable have used the supplier for similar partnerships.

ii. Co-Development Agreements

Once a franchisor has decided to partner with a supplier/manufacturer based on a level of comfort with the results of the franchisor's due diligence and assessment of the supplier, the franchisor will either want to enter into a co-development agreement or production agreement with the supplier of proprietary items. A "co-development agreement" is an agreement through which two parties contribute resources to develop one or more products and bring such products to market. In the context of a franchise system, a supplier brings manufacturing and product development capabilities to the relationship, while a franchisor brings a ready channel of distribution for the new product(s) to the relationship. A co-development agreement will usually anticipate that the franchisor does more than obtain a license to intellectual property by its distribution of the new proprietary item or through payment for such license. Rather, such agreement will often contemplate significant marketing of the proprietary item and a partnership between the franchisor and supplier.

There are two distinct approaches to intellectual property rights for a franchisor entering into a co-development agreement with a supplier, including: (1) the franchisor will own new intellectual property created by the supplier and/or franchisor as a result of the relationship; or (2) the franchisor will have a license (for a proprietary item, such license will generally need to be exclusive) to use the intellectual property. Whether the franchisor owns new intellectual property, or holds a license to use such intellectual property, will depend upon what the franchisor contributes to the relationship, whether the new intellectual property is based on its existing intellectual property and the overall strength of the franchisor to bargain for ownership or a license.

iii. Production (Supply) Agreements

If a franchisor has previously developed (or been licensed the use of) a proprietary item, and owns (or holds an exclusive license to use and exploit) specifications related to a proprietary item, the franchisor may engage a supplier under a production agreement (*i.e.*, supply agreement). The production agreement, or supply agreement, provides the terms under which the supplier manufactures proprietary items meeting the franchisor's specifications. Other than quality and reliability, a franchisor entering into such an agreement will have confidentiality and protection of proprietary information as its primary concern.

To ensure sufficient protection of information related to a proprietary item, a supply agreement's confidentiality provisions should go beyond a generalized nondisclosure agreement and should be tailored to the parties' specific circumstances and the jurisdiction(s) where the franchisor may need to enforce the agreement. For example, a provision specifying that the supplier will protect the franchisor's specifications in the same manner that the supplier protects its own confidential information could be inadequate because the supplier may not sufficiently protect its own information, or its usual practices may change over time. The supplier's use of the franchisor's specifications and other confidential information related to proprietary items should be strictly limited to the supplier's activities under the supply agreement. Under no circumstance should the supplier be permitted to use all or part of the information to serve its own interests or to serve other customers. Similarly, just as a franchise agreement will usually specify that a franchisee should share information with personnel on a "need to know" basis, a supply agreement should specify that only the supplier's key personnel should be informed of the franchisor's confidential information. If the information is truly key to the franchisor's success, the franchisor may even require that different persons have pieces of the information, without any one person having full knowledge of the specifications or other information related to a proprietary item.

In addition to carefully tailoring confidentiality provisions in a supply agreement to ensure that the franchisor's information related to a proprietary item is sufficiently protected, the franchisor should consider the time period for which it will be able to enforce the rights. Ideally, confidentiality obligations would survive any expiration or termination of the agreement, in perpetuity. However, unending protection of confidential information may not be obtainable in all jurisdictions. Or, it may be necessary for the franchisor to, again, carefully tailor the obligations so that they are not viewed by a court in a different jurisdiction as an unreasonable restraint on the supplier's business activities. Where needed, a franchisor should seek the advice of counsel familiar with any foreign laws that may be applied to an agreement to ensure that confidentiality provisions are carefully tailored, have sufficient consideration and are otherwise enforceable.

c. <u>Third Parties</u>

A franchisor that owns a secret recipe, formulation or other proprietary item will likely be subject to attempts of copycatting by its competitors and other third parties. Given how quickly information travels in a digital age, it is imperative that the franchisor do all that it can to lessen the risk that its proprietary information will end up in the hands of a third party. There are many strategies for protecting information related to proprietary items from disclosure to or use by a third party, including registering any rights such as patents (or copyrights), monitoring the use of the information and activity within the marketplace, and swift enforcement when an unauthorized disclosure or use occurs.

A franchisor is likely to consider information relating to proprietary items (such as formulae or specifications) to be its trade secret. A trade secret is information that "derives independent economic value, actual or potential, from not being generally known to" third parties and the franchisor must use "efforts that are reasonable under the circumstances to maintain its secrecy." Therefore, a franchisor's efforts to protect information about proprietary items that the franchisor considers to be trade secrets are a significant part of the franchisor maintaining its claim to the information.

i. <u>Registration of Rights (e.g., Patents)</u>

Patent law seeks to promote innovation by giving an inventor exclusive property rights in its invention for a limited period of time. That is, for the duration of the patent, the inventor essentially holds a monopoly over the patented concept. Like other businesses that develop key proprietary products, many franchisors seek patent protection for proprietary items. Notable examples include: patents for a rotary floor cleaner (Service Master Industries); salad bar designs (McDonald's); packaging (McDonald's); tire tread designs (Bandag Incorporated); and a method and system for delivering individually targeted promotions on demand (Blockbuster).

A full discussion of the circumstances under which a franchisor may seek a patent for a proprietary item or components of a proprietary item is beyond the scope of this paper. However, franchisors should keep in mind that if available, a patent may provide the strongest protection against misuse or theft by third parties. A franchisor seeking or holding a patent related to a proprietary item should also be aware that the franchisor may need to seek similar protection in countries other than the United States to fully protect the patented product in those countries.

Depending on the nature of information related to a proprietary item, copyright protection may also be available. For example, copyright protection may be available to protect proprietary software.

ii. Monitor Activity

To protect information about proprietary items from misuse or theft by third parties, a franchisor must carefully monitor activity related to such information. The franchisor's efforts should begin with monitoring its own employees, and limiting the number of employees with access to the information, as doing so limits the potential for inadvertent disclosure of information to third parties. The franchisor should also monitor third parties, such as vendors, that may obtain access to the information.

There are many options available to franchisors to monitor information to ensure that their own employees (or even franchisees) do not disclose the information to third parties or expose the information in a way that it might be disclosed to third parties. For example, the franchisor may elect to keep only physical copies of the information to greatly reduce the risk that it could be exposed to a third party. By doing so, the franchisor is able to monitor who has access to the information, and when, and is more easily able to control the number of persons with access to the information. Or, the franchisor may prefer to have the information in an electronic format so that the franchisor can carefully monitor who access the information, and when. Although not foolproof, there are security measures available to protect electronically stored information, including separate passwords to access individual documents, or limiting which personnel have access to a document, or even encryption of the information.

Franchisors should also monitor third parties the franchisors have contracted with (including suppliers providing proprietary items) to ensure that the confidentiality obligations contained in the applicable agreement have been complied with, and to ensure that all confidential or proprietary information is returned or destroyed (including deletion from electronic resources) upon the expiration or termination of the agreement. Franchisors should ensure that the information is returned promptly (*e.g.*, within 72 hours for critical information) and should request documentation, if possible, of the destruction or deletion of confidential information upon expiration or termination of an agreement. Finally, to the extent practicable, the franchisor should continue to watch and monitor the third party to determine whether any information was compromised.

Franchisors should not overlook the internet as a place where information about proprietary items, such as a recipe or specifications, may appear. A franchisor should monitor or have a third party monitor the internet to detect leaks of information. A franchisor may also work with search engines and similar parties to seek the removal of information that has been improperly disclosed.

iii. Enforcement

A franchisor must use reasonable efforts to enforce restrictions on the disclosure and use of information that the franchisor considers trade secret, or risk losing its rights in the information. With respect to proprietary items, a franchisor may use results of its monitoring activities to enforce its rights against third parties. A franchisor's enforcement activities may include actions against third parties with which it has contracted, and also against other third parties it suspects of improperly using or stealing information related to proprietary items.

2. Private Labeling

A franchisor may contract with a supplier for the manufacture and production of certain private-label products, which are products manufactured by one company for offer under another company's brand. For franchisors, it is often more efficient to contract with a specific supplier to manufacture a proprietary product for sale under the franchisor's label than it is for the franchisor to manufacture the product itself. The franchisor may distribute private-labeled products solely to outlets within its franchise system or may also distribute the product through other channels of distribution (such as chain-restaurant products offered in grocery store freezer sections).

A franchisor utilizing a third-party supplier to manufacture a proprietary, private label product must also be vigilant to protect the intellectual property and trade secrets associated with that product. Typically, a single-source supplier is used for private label products, and the supplier is provided a limited license to use the franchisor's trademark on the private label products it is manufacturing.

3. Franchisor as Manufacturer

It is increasingly uncommon for a franchisor to serve as the manufacturer of the inputs purchased by its franchisees. Franchisors correctly view a fully-integrated supply chain that encompasses even the manufacture of the products sold by its franchisees as an inefficient system of operation. It is generally not even possible for "business-format" franchisors (like restaurant franchisors) to be fully-integrated. This is because business-format franchisors are really just selling the right to use the franchisor's trademark and products, and the franchisee is the one ultimately putting together the finished product (e.g., fast-food hamburgers) for sale at the retail level.

With respect to a franchisor's proprietary and private-label products, however, franchisor manufacturing is more common. The market for "Cincinnati-style" chili provides a prime example. The leading franchisors of Cincinnati-style chili, Skyline Chili and Gold Star Chili, both require all of their respective franchisees to purchase all of their chili for their restaurants from franchisor-owned commissaries where the chili is produced and from which it is supplied to the entire franchise system. Franchisor manufacturing and self-distribution of a critical proprietary product provides multiple benefits as seen in the Cincinnati-style chili model. Manufacturing their respective types of Cincinnati-style chili at their own commissaries allows each franchisor to more-closely guard a secret, proprietary recipe and also more effectively control and monitor the manufacturing process and the quality of the product being supplied to franchisees and, ultimately, consumers.

B. Captive Distribution

1. Overview

"Captive distribution" is a term used narrowly to refer to a distribution function owned and operated or otherwise tightly controlled by a franchise system supply chain. Captive distribution usually but not always is accompanied by corresponding control over the sourcing function, and thus this Section also necessarily discusses franchisor control over sourcing of products from the franchise system along with the franchisor's control of distribution of those products. Franchisors utilize captive distribution to assure system supply, to promote uniformity of product quality and service, and to ensure that franchisees present a consistent end product to the brand's customers. Captive distribution also allows a franchisor to leverage the purchasing power of the franchise system to obtain better pricing on inputs. Captive distribution is often also a source of revenue and profit for franchisors.

While captive distribution may have benefits for both the franchisor and franchisees in a franchise system, it can also be a source of conflict between a franchisor and its franchisees. This is particularly true when a captive distribution arrangement is not transparent and is a significant source of profit for the franchisor. This tension may result in franchisees bringing legal challenges to the franchisor's captive distribution arrangement.

Many franchisors avoid owning and operating a system distributor because distribution is not a core franchisor expertise, because distribution systems require substantial invested and working capital, and because the franchisors want to avoid credit and other operating risks.

2. <u>Forms of Captive Distribution</u>

The most direct way for a franchisor to control a supply chain is to bring supply and distribution functions "in-house." Under this approach, the franchisor (whether directly or through a subsidiary or affiliate) requires its franchisees to purchase goods and services directly from the franchisor. The franchisor serves as a single-source distributor for the products that franchisees are required to purchase, while negotiating directly with the vendors that supply the product that the franchisees require. Self-distribution allows the franchisor to leverage the buying power of the franchise system to achieve lower costs on required products. The franchisor can seek a return on its capital tied up in distribution and a further profit through mark-ups on sales to franchisees. On the other hand, requiring franchisees to purchase all required products directly from the franchisor prevents the franchisees from negotiating supply and/or distribution arrangements that the franchisee might find more favorable.

A variation on captive distribution occurs when a franchisor designates a third party distributor as the dedicated, system-wide distributor for the entire franchise system. In this scenario, the franchisees are required to purchase all proprietary and non-proprietary products from the designated distributor. This is the captive distribution approach taken by YUM! Brands, Inc. (the parent company of the Taco Bell, Kentucky Fried Chicken and Pizza Hut concept companies). Currently, the Yum! system utilizes McLane Company, Inc. to serve as the "exclusive distributor for the majority of items" used by Yum! concept restaurants, including all franchisor-owned restaurants as well as "a substantial number of franchisee and licensee stores" for each of the Yum! concepts. This is also the approach taken by the McDonald's franchise system, which uses HAVI Global Solutions (formerly Perseco) as its dedicated system-wide supply chain manager. As with franchisor self-distribution, using a single distributor for the franchisor's entire system allows a franchisor to leverage the franchise system's buying power for the benefit of all of the system's outlets, but inhibits franchisees from individually negotiating supply and distribution arrangements for their own businesses.

Still another variation occurs when a franchisor partners with a dedicated, franchisee-owned supply chain cooperative to serve as the distributor for the entire franchise system. This is the method employed by Dunkin' Donuts restaurants in the U.S. National DCP, LLC, a cooperative owned by Dunkin' Donuts franchisees, is a separate supply chain cooperative that engages in purchasing, warehousing, and distribution of substantially all of the food and supplies for U.S. Dunkin' Donuts stores as well as some international stores. Dunkin' Donuts does not fully control National DCP, but does have certain contractual rights regarding supplier approval and quality assurance, and is represented on the National DCP board.

In lieu of captive distribution, a franchisor may allow franchisees to purchase only from a set of designated suppliers. Under this approach, the franchisor (or a supply chain partner) negotiates exclusive arrangements with specific suppliers from which franchisees are required to purchase. This is a common approach where the franchisor does not necessarily want to supply or distribute products itself, designate a single distributor, or participate heavily in the supply chain, but still wants to exercise control over the franchise supply chain. A provision requiring franchisees to purchase from "designated suppliers and distributors" is common in franchise agreements for restaurant franchise systems.

Franchisors may utilize a mixture of the methods referred to above. A franchisor may require franchisees to purchase only one or two specific proprietary products distributed directly from the franchisor, while designating specific suppliers for other proprietary products and allowing franchisees to purchase non-proprietary products from suppliers of each franchisee's choosing. For example, U.S. franchisees of Papa Johns International, Inc. are required to purchase tomato sauce and dough from one of the company's "Quality Control Centers" throughout the United States, while franchisees are permitted to purchase other required products from Papa Johns' QC centers or other approved suppliers.

3. <u>Benefits of Captive Distribution</u>

Franchisors do not become involved in the supply chain process without reason. The following excerpt from Domino's Pizza, Inc.'s most recent annual report explains the advantages of captive distribution from the franchisor perspective:

> In addition to generating significant revenues and earnings…we believe that our vertically integrated dough manufacturing and supply chain system enhances the quality and consistency of our products, enhances our relationships with franchisees, leverages economies of scale to offer lower costs to our stores and allows our store managers to better focus on store operations and customer service by relieving them of the responsibility of mixing dough in the stores and sourcing other ingredients….
>
> Because we source the food for substantially all of our domestic stores, our domestic supply chain segment enables us to leverage and monitor our strong supplier relationships to achieve the cost benefits of scale and to ensure compliance with our rigorous quality standards. In addition, the "one-stop shop" nature of this system, combined with our delivery accuracy, allows our store managers to eliminate a significant component of the typical "back-of-store" activity that many of our competitors' store managers must undertake.

The Domino's annual report emphasizes one of the primary rationales for franchisors engaging in captive distribution: ensuring uniform quality and consistency throughout the franchise system. A franchisor does not operate all of the businesses operating under its trademark. Contractually requiring franchisees to purchase all required products from the franchisor or designated suppliers helps to ensure that franchisees across the entire franchise system sell consistent end-products to customers, meaning that no matter what store a customer walks into, the customer will know what to expect. Significant franchisor involvement in the supply chain also allows the franchisor to regulate product safety above and beyond regulatory requirements. All of these benefits ultimately inure to the franchisor and the franchisee by protecting the franchisor's brand and enhancing the brand's goodwill with its customer base.

Lower pricing is another purported benefit of captive distribution. As noted in the Domino's excerpt, a franchisor that requires franchisees to purchase from the franchisor, an exclusive distributor, or a limited number of exclusive suppliers can "leverage economies of scale" arising from the franchise system's purchasing power, resulting in lower prices.

The first benefit of captive distribution mentioned in the Domino's excerpt is the generation of "significant revenues and earnings" from franchisee purchases. For some franchisors, the supply chain essentially operates as a separate (and profitable) line of business.

4. Drawbacks of Captive Distribution

Captive distribution is not without its disadvantages.

Franchisor-owned distributors require a large capital outlay on the part of the franchisor, both in terms of physical assets such as warehouses and trucks, and for working capital to fund ongoing operations. The capital required for a franchisor-owned distributor belies one of the core reasons that companies franchise in the first place: shifting capital requirements to franchisees.

As discussed above, captive distribution can be a significant source of tension in a franchise system. Franchisors typically assert that they are undercompensated for their efforts. Franchisees focus service and price concerns directly on the franchisors and worry that the franchisor is making an inappropriate profit at their expense. Distrust and tension resulting from captive distribution is not without expense, particularly if franchisees bring legal action against the franchisor.

Franchisees may conclude, correctly or incorrectly, that they can purchase certain products (particularly non-proprietary products) from vendors other than the franchisor and/or its designated distributors at a lower cost. A franchisee might have a relationship with a vendor for a particular product that it is unable to leverage because of the constraints of the franchise contract. Where a franchisee sees no benefit from captive distribution, conflict can occur in the franchisee's relationship with the franchisor.

5. Legal Aspects of Captive Distribution

a. Disclosure of Captive Distribution Arrangements

The Federal Trade Commission's ("FTC") amended franchise rule (the "Amended Franchise Rule") imposes certain disclosure obligations on franchisors that engage in captive distribution. Item 8 of a franchisor's Franchise Disclosure Document ("FDD") 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. These disclosures must be made for each good or service subject to the sourcing restrictions, though the franchisor is permitted to broadly describe these various goods and services. Item 8 must also disclose whether the franchisor 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. The franchisor is also required to disclose "whether the franchisor negotiates purchasing arrangements with suppliers, including price terms, for the benefit of franchisees."

Proper disclosure of sourcing restrictions can be a critical ally for a franchisor. Though the Amended Franchise Rule does not give franchisees a private right of action, franchisees may sue under specific state franchise laws that treat failure to comply with the disclosure obligations of the Amended Franchise Rule as a violation of state law. Failure to comply with state franchise disclosure laws may 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 disclosure obligations.

b. State Franchise Law Restrictions on Captive Distribution

Franchisors engaging in captive distribution should be aware of the four states with franchise laws specifically limiting franchisor supply chain restrictions. Indiana prohibits franchisors from "[r]equiring goods, supplies, inventories, or services to be purchased exclusively from the franchisor or sources designated by the franchisor where such goods, supplies, inventories, or services of comparable quality are available from sources other than those designated by the franchisor." This requirement does not apply to "the principal goods, supplies, inventories, or services manufactured or trademarked by the franchisor," leaving the franchisor free to impose sourcing restrictions on proprietary products. The statute also 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." Thus, a franchisor selling franchises in Indiana may need to make an exception to its supply chain restrictions with respect to non-proprietary goods and services.

Hawaii's franchise law permits a franchisor to impose restrictions on suppliers if the restrictions are "justified on business grounds." Unfortunately, there is no case law interpreting the types of "business grounds" that will justify franchisor-imposed supply chain restrictions, but the lack of decided cases may indicate that such restrictions are rarely challenged under Hawaii's franchise law.

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. This clearly prohibits a franchisor from imposing any requirement that franchisees purchase exclusively from the franchisor or any designated suppliers. The statute does provide 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, but only if the goods or services are central to the franchised business and either are actually manufactured or produced by the franchisor or its affiliate, or incorporate a trade secret owned by the franchisor or its affiliate." The extent of this exception's application is unknown, however, because there appear to be no cases interpreting the Iowa statute.

Finally, Washington approaches the topic from a competition perspective, providing that franchisors may not "[r]equire 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." Though the Washington courts have not directly interpreted this statute, at least one commentator has noted that the intent of the statute is to prohibit only sourcing restrictions that would amount to an illegal tying arrangement under federal antitrust law, meaning that the statute has little actual impact in practice.

c. Breach of Contract

A franchisor utilizing captive distribution must ensure that a requirement to purchase from the franchisor does not violate the franchise agreement. A franchisee challenging a captive distribution arrangement will commonly add a breach of contract claim to its franchise law and antitrust law claims. The best way for a franchisor to avoid a breach of contract claim is to draft the provisions of its franchise agreement relating to the supply chain to provide the franchisor with broad discretion, including the right to require franchisees to purchase all products from the franchisor. Even if the franchisor does not intend to impose severe supply chain restrictions on franchisees, it may subsequently wish to change its business model to be more restrictive. This broadline approach is the one most commonly taken by franchisors today both with respect to FDD pre-sale disclosures and franchise agreement provisions relating to supply chain restrictions.

C. Payments to Franchisor (*i.e.*, Supplier Income)

1. Overview

Franchisors frequently receive remuneration from the franchise system supply chain either by selling products directly to franchisees at a mark-up or by receiving payments or benefits from the franchisor's designated suppliers and distributors ("supplier income"). Supplier income can be a significant source of revenue and profits for a franchisor. As discussed below, supplier income payments can take several different forms, some of which may be more transparent or less controversial than others.

Supplier income based on franchisee purchases can be a significant source of tension between a franchisor and its franchisees. Franchisees may feel that the franchisor is taking advantage of the franchisees' contractual obligation to purchase from suppliers designated by the franchisor in order to extract additional revenue and profit, while subjecting the franchisees to less competitive pricing from the designated suppliers. The franchisees may also feel entitled to share in some portion of this supplier income since it is based on franchisee purchases.

The following discussion will explore the various forms of supplier income arising from franchisee purchasing. It will also explore franchisee legal challenges to supplier income arrangements, and will consider ways to make supplier income more appropriate and transparent for the betterment of the franchisor-franchisee relationship.

2. Types of Supplier Income

a. Mark-ups on Franchisor-Supplied Products

For franchisors that engage in captive distribution, an important source of revenue is the mark-up that the franchisor charges on its sales of products to franchisees. The mark-up covers the franchisor's sourcing and distribution expenses and typically is intended to provide a profit. Although this is not true "supplier income" (because the payments received by the franchisor are not from third party vendors), it is still an example of a franchisor receiving revenue based on franchisee purchases.

Franchisors frequently apply mark-ups to proprietary products manufactured and supplied directly by the franchisor to cover the franchisor's costs with respect to product research and development, manufacturing, and protection of intellectual property for the product. For example, as discussed in Section III(B) above, Skyline Chili, which manufacturers chili for its restaurants, imposes a mark-up on the chili it provides to its franchisees to cover costs related to the manufacture of the chili, and also to provide income to the franchisor.

As noted above, franchisees may feel that the franchisor is using mark-ups to extract undue profits at the expense of the franchisees that are required to purchase from the franchisor. However, these mark-ups can be important in terms of covering the franchisor's costs associated with managing the supply chain or supplying a particular product to the franchisees. When these mark-ups are properly disclosed to the franchisees at the outset of the franchise relationship, they become part of the economic bargain between the franchisor and the franchisee.

b. Supplier Access and Exclusivity Fees

Franchisors may extract revenue from the supply chain by requiring suppliers or distributors to pay a lump-sum amount to the franchisor to gain access to a franchise system's market. Franchisors may also charge up-front fees to suppliers in exchange for the franchisor's commitment to a long-term purchasing arrangement with the supplier and/or to provide the supplier with exclusivity with respect to a particular product. Though these are generally one-time payments made at the beginning of the supplier relationship, it is still income that the franchisor is extracting based on franchisee purchases at the expense of the franchisees' freedom to seek out other suppliers that may provide more competitive pricing.

Despite the tensions that can be introduced to the franchise relationship, there may be legitimate reasons for a franchisor to charge an access or exclusivity fee. These fees allow the franchisor to determine which suppliers are serious about serving the franchisor's supply chain. Vendors that are willing to pay up-front to garner access to a supply chain have an immediate investment in the success of the relationship with the franchise system.

c. Vendor Rebates

Vendor rebates are a common form of supplier income. The supplier agrees to pay the franchisor continuing rebate payments based on the franchise system's purchasing from the vendor; the rebates may be tied to the number of franchisees purchasing from the vendor or the franchise system's overall volume of purchases. Rebates can be a significant source of revenue for a franchisor.

However, "rebate" is not the only term commonly used to refer to these payments. Disgruntled franchisees who feel that the franchisor is extracting revenues and profits from the supply chain at the expense of allowing the franchisees the freedom to seek out better pricing from other available suppliers may instead refer to vendor rebates as "kickbacks" and even "bribes." This difference in terminology is an outward expression of the conflict and distrust that vendor rebates can introduce into the franchise relationship.

d. Discrimination in Prices

An indirect way in which designated suppliers for a franchise system can provide rebates to the franchisor is by allowing the franchisor to purchase from the vendor for franchisor-owned outlets at a lower discounted price than is offered to franchisee outlets. Franchisors often rationalize discounts based on the franchisor's greater volume than any of the franchisees or as indirect compensation for assisting a supplier in "customizing" the product or equipment for the franchisor's system. It is not surprising that franchisees often become disgruntled about receiving disparate pricing treatment from a vendor. Nonetheless, the lower prices charged to the franchisor-owned outlets can serve to indirectly enhance a franchisor's profitability and may be used in lieu of direct rebates from the vendor to the franchisor.

e. <u>Marketing Fees</u>

Franchisors may also receive supplier income in the form of marketing fees and commitments from suppliers. This is common when the franchisor has agreed to feature the vendor's brand and products in the franchise system's stores. Such arrangements are frequent with carbonated beverage vendors, coffee suppliers, and suppliers of particular food products such as condiments. The vendor pays marketing fees to the franchisor to promote the supplier's branded product in the franchise system's outlets. These arrangements may be a significant source of advertising revenue for the franchisor, which can benefit the franchise system as a whole. Franchisees, however, may feel that they are entitled to all or a portion of the marketing consideration that franchisors receive from brand partners.

f. <u>Conventions and Meetings</u>

Suppliers and distributors customarily help fund franchise system conventions and meetings approved by either franchisors or franchisee associations through charges for the privilege of having a vendor booth and sponsorships of convention speakers and events. While booth fees tend to be modest, sponsorships can involve six figure commitments which immediately impact vendor prices. (It should also be noted that large franchisees often seek to defray the expense of organizational meetings and events by seeking vendor sponsorships.)

g. <u>Quality Assurance</u>

Customary fees paid to franchisors in connection with supplier and distributor approval applications and franchise quality assurance programs tend to be non-controversial. However, franchisees often object to inclusion of research and development expenses in the cost of goods, especially when a supplier has reimbursed a franchisor for franchisor expenses. From the franchisee point of view, franchisors should pay for system research and development in consideration of franchisee royalties.

3. Legal Aspects of Supplier Income

a. Disclosure of Supplier Income Arrangements under the Amended Franchise Rule

As with captive distribution arrangements, the Amended Franchise Rule requires franchisors to disclose supplier income arrangements in Item 8 of the franchisor's FDD. A franchisor must also disclose payments made by suppliers to an advertising fund, trademark-specific franchisee association, or any other third party controlled directly or indirectly by the franchisor or an affiliate and any payment or benefit that a franchisor may receive as a result of franchisee purchases, which may include volume discounts not available to all franchised businesses. Payments to franchisors from suppliers may be disclosed either as a percentage or as a flat dollar figure on an aggregate, not individual supplier, basis.

Item 8 further requires a description of the "precise basis" with respect to the revenue and other benefits from suppliers, which description must include:

- The franchisor's total revenue;
- The franchisor's revenues from all required purchases and leases of products and services by franchisees;
- The percentage of the franchisor's total revenues that comes from purchases or leases required by the franchisor;
- The revenues received by affiliates of the franchisor from purchases or leases required by the franchisor; and
- The estimated portion of the franchisee's required purchases and leases to all purchases and leases by the franchisee in establishing and operating the franchise.

Also like with captive distribution arrangements, disclosure of the franchisor's sources of supplier income can provide a franchisor with important protection from legal challenges brought by franchisees. If the franchisor is transparent about supplier income in the FDD and drafts clear provisions in the franchise agreement that grant the franchisor broad rights to obtain revenue in the form of supplier income based on franchisee purchases, then supplier income becomes part of the economic bargain that the franchisee is agreeing to by signing the franchise agreement. Furthermore, drafting clear disclosures that put the franchisee on notice of supplier income arrangements will protect the franchisor against enforcement actions by regulatory authorities under both federal and state franchise law, as well as claims by franchisees under state franchise law.

b. State Franchise Law Restrictions on Supplier Income

Of the four states that restrict captive distribution arrangements generally, three place specific restrictions on supplier income. Indiana prohibits franchisors from obtaining "money, goods, services, or any other benefit from any other person with whom the franchisee does business, on account of, or in relation to, the transaction between the franchisee and the other person, other than for compensation for services rendered by the franchisor, unless the benefit is promptly accounted for, and transmitted to the franchisee." There does not appear to be any exemption or exception to this rule, though it is has not been judicially interpreted. Thus, franchisors with franchisees in Indiana may need to make an exception to the franchise contract eliminating supplier income payments or agreeing to share any supplier income payments with the Indiana franchisees, unless the franchisor can demonstrate that the payments are for services provided by the franchisor.

Washington 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 such benefit is disclosed to the franchisee." Thus, unlike Indiana, Washington permits the franchisor to collect vendor rebates and other supplier income based on franchisee purchases so long as the arrangement is disclosed to the franchisees, which dovetails with the disclosure requirements of the Amended Franchise Rule. Hawaii's statute mirrors the Washington statute by prohibiting supplier income payments based on franchisee purchases "unless the franchisor advises the franchisee in advance of the franchisor's intention to receive such benefit." Thus, in Hawaii and Washington, a proper Item 8 disclosure in the FDD should allow the franchisor to avoid liability associated with a supplier income arrangement under the franchise laws of those states.

c. **<u>Breach of Contract and Implied Covenant of Good Faith and Fair Dealing</u>**

Franchisees have also challenged supplier income arrangements as a violation of the franchise agreement. As several decisions have demonstrated, the courts will look to the language of the franchise agreement to determine whether franchisors are permitted to receive supplier income and whether franchisees are entitled to share in any supplier income payments. Where there is no indication from the contract that the franchisees are entitled to share in any vendor rebates received by the franchisor, courts will generally not be receptive to a franchisee's breach of contract claim.

In *Little Caesar's Enterprises v. Smith*, a group of franchisees sued Little Caesar's, alleging that the franchisor had failed to share certain rebates and discounts that suppliers had paid to the exclusive distributor for the franchise system in breach of the franchise agreement or, alternatively, the implied covenant of good faith and fair dealing. The court granted summary judgment to Little Caesar's, finding that the franchise agreement did not contain any requirement that the supplier income payments be credited to the franchisees. The court also rejected the franchisees' argument that the failure to share these payments and discounts with the franchisees violated the implied covenant of good faith and fair dealing, finding that Little Caesar's had no discretion in the contract over whether to share the supplier income payments and discounts with the franchisees, thus meaning that its performance under the contract was not violating any element of good faith and fair dealing under Michigan law.

Another illustrative breach of contract case is *Dunkin' Donuts Inc. v. N.A.S.T., Inc.* In *N.A.S.T.* the franchisor, Dunkin' Donuts, sued a franchisee, who responded with several counterclaims, including a breach of contract claim based on Dunkin' Donuts' failure to allocate certain advertising rebates received by Togo, an affiliate brand of Dunkin' Donuts, under a distributorship agreement between Dunkin' Donuts, Togo, Baskin-Robbins (another sister brand), Allied Domecq QSR (an association affiliated with each of the three sister brands) and PepsiCo. Dunkin' Donuts had a "Marketing Operating Philosophy" document that provided that if any of the sister brands received a rebate from a supplier contract, the rebate income would be spilt proportionally among the brands' respective advertising funds. No pro rata distribution of the rebates received by the Togo brand was received by the Dunkin' Donuts advertising fund, and the plaintiff franchisee alleged a breach of the franchise agreement.

The court disagreed, finding that the actual franchise agreement made no mention of allocating vendor rebates received by affiliate brands. The court held that the operating philosophy document cited by the franchisee was "not a contract between Dunkin' Donuts and [the franchisee]," and the document even provided that "it is not intended to supersede or take the place of any terms contained in the franchise agreement…." The lesson from *N.A.S.T.* is that if franchisees expect to share in any vendor rebates or other forms of supplier income, that right should be set forth clearly in the four corners of the franchise agreement or another agreement with the franchisor.

Supplier income disputes between franchisors and franchisees may also result in litigation over the terms of agreements between the franchisor and franchise system suppliers, rather than the franchise agreement itself. In May of 2009, Burger King's national franchisee association brought a class-action lawsuit on behalf of Burger King's franchisees against the franchisor, Burger King Corporation, and the system's soft drink vendors, the Coca-Cola Company and Dr. Pepper/Snapple Group, Inc. The complaints filed by the franchisee association alleged that the franchisees, which had been receiving certain "Restaurant Operating Funds" ("ROFs") directly from Coke and Dr. Pepper/Snapple under the soft drink vendors' respective agreements with Burger King Corporation, stopped receiving those payments after the franchisor declared that it would be diverting 40% of the ROFs from the franchisees to itself to increase national advertising spend. The franchisees, which were not parties to either of the vendor soft drink agreements, sought a declaratory judgment that the franchisees were intended third party beneficiaries under the soft drink agreements and that Burger King Corporation and the two soft drink vendors had no right to divert the franchisees ROF payments to the franchisor for any purpose without the franchisees' consent. The lawsuit was dropped when Burger King Corporation agreed to augment its national advertising dollars from other sources and allowed the franchisees to continue receiving all of the ROFs they had been receiving prior to the lawsuit, but not until after much antagonism between Burger King Corporation and its franchisees and a lot of negative press coverage, along with the expense of the litigation itself.

d. <u>**Fraud and Misrepresentation Claims**</u>

Franchisees have also challenged supplier income arrangements under theories relating to fraud and misrepresentation. These claims tend to be made in a variety of different ways, including claims of violations of specific anti-fraud provisions under state franchise laws, violations of the Amended Franchise Rule (for failure to properly disclose a "kickback" arrangement) utilizing the private right of action under state franchise laws for violations of the Franchise Rule, common law fraud, and federal and state RICO statutes. The level of success that franchisee plaintiffs have had with such claims has generally depended upon whether the franchisees provide sufficient evidence that the franchisor failed to disclose or otherwise mislead franchisees about the existence and nature of supplier income. Where franchisees can demonstrate that the franchisor has not provided sufficient disclosure of vendor rebates or other supplier income, franchisees can generally survive a franchisor's motion to dismiss or motion for summary judgment. However, where the franchisees are unable to demonstrate actual evidence that they were defrauded or mislead about vendor rebates, courts are naturally less receptive to fraud-related claims.

Recent litigation by franchisees of the Moe's Southwest Grill chain illustrates how fraud and related claims can arise in the supplier income context. Certain Moe's franchisees brought suit against the franchisor and its founder, Martin Sprock, alleging fraud, a violation of Georgia's civil RICO statute, and negligent misrepresentation, among other claims relating to an undisclosed vendor rebate arrangement. The franchisees alleged that in 2001 Moe's had coordinated with Chain Reaction Marketing ("CRM") to run Moe's food supply chain and distribution network. CRM (through various regional distributors) charged franchisees a 2% commission on purchases for their restaurants, and it was undisputed that Sprock knew about the arrangement and had approved of it. By August of 2002, a separate entity (SOS Foodservice Consultants) had been set up to house the supply chain arrangement and Martin Sprock's financial interest in the arrangement (a share of the SOS profits), though there was some factual dispute as to whether Sprock's financial interest in the arrangement was reached in 2001 or not until after SOS had been formed in late 2002. Sprock did not receive any distributions until 2004. The Moe's franchise disclosure documents for 2001 – 2003 did not disclose that SOS was an affiliate of Moe's or that Sprock had an ownership stake in SOS, and stated specifically that "[n]either we nor any of our affiliates will derive any income from [franchisees'] purchases."

Moe's brought a motion for summary judgment on the plaintiffs' fraud, negligent misrepresentation and Georgia civil RICO counts, but in a recent ruling the motion was denied by the district court. With respect to the fraud count, the defendants argued that the failure to disclose Sprock's SOS interest in the franchise disclosure documents for 2001 through 2003 was not intentional, because Sprock did not expect to receive distributions from SOS, and was "amazed" when he did, meaning that the defendants lacked intent to deceive, a required element of a fraud claim under Georgia law. However, the court noted that the FTC franchise rule required the franchisor to disclose any income "to be received," and that there was a question of fact as to whether Sprock knew of the arrangement to share proceeds as early as 2001, which the court found sufficient to deny the motion for summary judgment as to the fraud claim. The court relied on the same questions of fact regarding when SOS was created, when Sprock obtained an interest in the distribution arrangement, and whether the plaintiffs were damaged by the non-disclosure, to deny the negligent misrepresentation claim. Finally, on the RICO claim, the court found that there was a question of fact as to whether the "predicate act" required by RICO (in this case, "theft by deception") occurred, given that there was a question as to whether Sprock knew of his ownership interest in the distribution arrangement as early as 2001 and failed to disclose it in the franchise disclosure document, and thus the court denied the motion for summary judgment on RICO.

The Moe's litigation, which has been ongoing since 2008, provides a clear example of how supplier income arrangements, when not fully disclosed, can result in expensive and protracted litigation, as well as damage to the franchisee-franchisor relationship.

4. Supplier Income Best Practices

As mentioned, supplier income is frequently a source of conflict in the franchisor-franchisee relationship. The best way for a franchisor to prevent supplier income arrangements from creating this tension and distrust is to ensure that all supplier income received by the franchisor on account of franchisee purchasing is transparent and appropriate.

a. Importance of Transparency

Transparency with respect to supplier income is a necessary focus for the franchisor because, first and foremost, federal and state franchise laws require that the franchisor make pre-sale disclosure of supplier income sources in the FDD. As discussed above, failure to make careful disclosures about supplier income to the franchisees can result in civil and criminal penalties from federal and state regulators and claims under state franchise laws by franchisees. At the very least, a franchisor can spend a lot of money litigating franchisee claims around supplier income that clear pre-sale disclosures and franchise agreement terms could have avoided.

Making clear disclosures and drafting broad franchise agreement provisions ensures that potential franchisees understand that supplier income forms a basis of the economic bargain around the sale of the franchise, and franchisees cannot later reasonably complain that they were unaware or uninformed of the types of supplier income the franchisor might negotiate for and receive from the franchisees or designated suppliers and distributors. While this approach might deter some potential franchisees from entering into the franchise relationship, that outcome is preferable to having a disgruntled franchisee that feels mislead and later embroils the franchisor in costly litigation.

b. Legitimizing Supplier Income

Being transparent about existing and potential sources of supplier income in the FDD and franchise agreement may bring the franchisor into compliance with applicable laws, but it will not necessarily prevent disgruntled franchisees from bringing expensive legal claims or alleviate the conflict in the franchisor-franchisee relationship that supplier income can create. Franchisees may still regard vendor rebates and other forms of supplier income as undue benefits for the franchisor at the expense of higher prices for franchisees. Thus, ensuring that the types of supplier income the franchisor receives are appropriate can go a long way towards preventing supplier income arrangements from souring the franchisor-franchisee relationship.

One way to legitimize supplier income payments is to simply restrict the types of payments that the franchisor is permitted to receive. The following are types of supplier income that franchisees will generally regard as appropriate:

--Marketing and promotional allowances from vendors that are distributed pro rata among the franchisor and franchisees based on purchasing volume;

--Discounts and rebates that are provided to franchisees as well as the franchisor pro rata based on purchasing volume;

--Higher prices for goods or equipment charged by approved suppliers to amortize the approved suppliers' expenses related to research and development of new goods and equipment (preferably with approval by the franchisees);

--Reasonable fees (not exceeding a franchisor's actual costs) charged to approved suppliers and distributors in connection with the approval/disapproval process and in connection with quality assurance;

--Benefits to the franchisor in the form of product development ideas or consumer research provided by approved suppliers and approved distributors in the ordinary course of business that does not impact the cost or other terms for the sale of goods or equipment from those suppliers and distributors;

--Supplier income and other benefits solicited or managed by the franchisor to sponsor franchisee conventions or other franchisee meetings, where the franchisees have approved the supplier income or benefits;

--Supplier income related to the franchisor's proprietary products to the extent permitted under the franchise agreement; and

--Supplier income for specific products or from specific suppliers or distributors that is approved by the franchisees.

The franchisor and franchisees can agree, whether in a franchise agreement or a separate agreement, to enact these constraints on supplier income by contractually providing that the franchisor will not accept any form of income, compensation, or other benefits of any kind from any supplier or distributor to the franchise system other than the types of supplier income specifically listed in the agreement. These constraints can be established outside a franchise agreement in the relationship agreement between the franchisor and the franchise system's supply chain cooperative, in agreements between the franchisor and the system's franchisee association, or in a written policy of the franchisor. They may also be reflected in agreements with approved suppliers and distributors.

While these types of contractual constraints do limit the flexibility of the franchisor as to receiving and keeping the many types of supplier income that can be an important source of revenue for the franchisor, the franchisor can still negotiate with franchisees as to specific sources of supplier income that are particularly important for the franchisor. By opening the lines of communication between the franchisor and the franchisee on the issue of supplier income (whether through a supply chain cooperative or through direct agreements between the franchisor and its franchisees), all parties can reach an understanding around what types of supplier income benefits the franchisor will be entitled to receive and keep, what it must share with the franchisees, and what is altogether off limits. When franchisees feel that they are a part of the process, the franchise system as a whole benefits.

IV. <u>Keeping the Franchisor-Franchisee Relationship Intact</u>

As discussed in Section I above, successfully addressing supply chain issues is a significant part of establishing and maintaining a mutually beneficial and amicable franchisor-franchisee relationship. Supply chain issues shape many franchisor-franchisee relationship issues, and can derail an otherwise peaceful franchise system. To help maintain a successful franchisor-franchisee relationship, transparency as to supply chain practices is of significant importance. Such transparency can be achieved by thorough disclosure of supply chain practices and by effectively addressing supply chain issues in franchise agreements, in addition to keeping communication between the franchisor and franchisees open and collaborative.

A. <u>Disclosure of Supply Chain Practices</u>

While Item 8 of the FDD requires disclosures related to the restrictions on supply chain practices with respect to the franchise system, franchisees may argue that simply requiring pre-sale disclosures to prospective franchisees does not provide adequate information regarding supply chain practices during the term of the franchise relationship. Nonetheless, the Amended Franchise Rule and the North American Securities Administrators Association, Inc. ("NASAA") 2008 Franchise Registration and Disclosure Guidelines only require certain pre-sale disclosures related to: (i) the goods and services subject to supply restrictions; (ii) the suppliers; and (iii) the revenue derived from the supply chain. To protect themselves from costly nuisance litigation, franchisors should make all of the required disclosures in a way that is broad enough to give the franchisor flexibility and control of the system's supply chain practices while accurately describing such practices.

1. <u>Purchases of Goods and Services</u>

To help ensure quality and consistency, hallmarks of a strong franchise system, franchisors establish standards and specifications for certain goods and services used in the development, improvement, and operation of the franchised business, and may arrange for the direct and indirect sources of supply of most of those items. Franchisors must make separate disclosures for each good or service that the franchisor restricts by either: (i) limiting the source of the product to designated suppliers or a list of approved suppliers or (ii) imposing comprehensive specifications for the product.

Any obligation imposed on franchisees by franchisors to purchase or lease goods, services, or supplies from specific suppliers must be disclosed in Item 8. In other words, Item 8 only covers required purchases and leases of goods and services that are restricted to a specific supplier or a limited group of suppliers. If franchisees may procure goods or services from any supplier, then no Item 8 disclosure is required. Required purchases may include "fixtures, equipment, inventory, computer hardware and software, real estate, and any other purchase necessary to establish or operate the franchised business." For purposes of Item 8, the purchase or lease of goods or services that are provided to franchisees, included in the initial franchise fee, and disclosed in Item 5 or Item 6 need not be disclosed.

If a franchisor issues specifications and standards for products, then the franchisor must disclose how it provides this information to franchisees. A common approach is for the franchisor to update the confidential operating manual.

2. <u>Suppliers</u>

Required purchases may be supplied by the franchisor, its designee, suppliers approved by the franchisor, or suppliers with products that meet the franchisor's specifications. Item 8 requires disclosures related to suppliers from whom franchisees must purchase a particular good or service and suppliers from whom franchises may purchase certain goods or services. Typically, proprietary products must be purchased from the franchisor or its designee while other products may be purchased from a list of approved suppliers who meet the franchisors standards and specifications.

Franchisees argue that supply-chain restrictions limit their ability to find the most cost-efficient suppliers and distributors, but franchisees typically have the ability to present alternative supplier to franchisors. Despite franchisee concerns, franchisors have discretion to approve or disapprove a proposed alternative supplier in order to protect the quality and uniformity of the franchise system. Item 8 requires disclosure related to the fees payable and the process of obtaining approval of alternative suppliers. Specifically, the following must be disclosed:

- Whether the franchisor's criteria for approving suppliers are available to franchisees;
- Whether the franchisor permits franchisees to contract with alternative suppliers who meet the franchisor's criteria;
- Any fees and procedures necessary to secure approval from the franchisor to purchase from alternative suppliers;
- The time period in which the franchisor will notify the franchisee of approval or disapproval of an alternative supplier;
- How approvals are revoked; and
- Whether the franchisor issues specifications for goods or services and, if so, how the franchisor may modify the specifications.

Franchisors are required to disclose if the franchisor or its affiliates are among the suppliers that the franchisor will approve for a particular product or if they are the only approved supplier of a particular product. Franchisors are also required to disclose any supplier in which an officer of the franchisor owns an interest.

3. Revenue Derived from the Supply Chain

As previously discussed at Section III(C)(3)(a) hereof, Item 8 requires disclosure by a franchisor of any revenue or other material benefits received from a third-party supplier.

4. Additional Item 8 Disclosures

a. Purchasing Cooperatives

Item 8 requires the disclosure of any purchasing or distribution cooperatives. If a franchisee is required to participate in a purchasing or distribution cooperative, then the franchisor must identify the cooperative. If participation is voluntary, the franchisor need not identify the cooperative, but it should disclose that one or more of these cooperatives exist.

b. Negotiated Prices

Item 8 requires franchisors to disclose whether they negotiated purchase agreements with suppliers, including price terms, for the benefit of franchisees.

B. Setting Clear Expectations in the Franchise Agreement

A franchisee is required to operate the franchised business in accordance with the franchisor's uniform operating standards. In most instances, the franchisee is required to purchase the various products and services required for the franchise business from a list of approved suppliers, which list may include the franchisor. These requirements help assure the quality, safety, and consistency of the goods and services associated with the franchised business and protect and enhance the image of one of the franchisor's most valuable assets, its marks.

The franchise agreement typically gives the franchisor complete discretion to impose various restrictions on the supply chain. Some franchise agreements leave franchisees with the option to use their own suppliers or distributors if the good or service meets the franchisor's standards and specifications; however, the franchisor may require that the proposed supplier or distributor pass a stringent approval process. Franchisors may develop and modify their standards and specifications periodically, so the franchise agreement should provide the franchisor with this flexibility. The following is a sample franchise agreement provision limiting the franchisee's role in the supply chain while giving the franchisor broad flexibility to manage the supply chain:

> We reserve the right to require you to purchase merchandise and other products, supplies, furniture, fixtures, equipment and services used in the development or operation of the Franchised Business only from suppliers that we designate or approve (which may include or even be limited to us, our affiliates, other restricted sources or some combination of these), and then use them or offer them for sale (as applicable) in the Franchised Business. You may not manufacture, use, sell, or distribute, or contract with any party other than us or our affiliates to manufacture, use, sell, or distribute, any merchandise or

> equipment bearing any of our marks without our prior written approval, which we may withhold in our sole discretion. We have the right to derive revenue from you and to derive revenue and receive payments from manufacturers and suppliers on account of sales to you and to use all such amounts we receive without restriction for any purposes we deem appropriate.

Often the franchise agreement provides for automatic termination upon violation of provisions such as the one set forth above. Franchisors may permit the franchisee to cure such a violation depending on the severity of violation.

1. <u>Selection of Additional Suppliers and Distributors</u>

For goods or services that are not proprietary but must consistently meet objectively defined quality standards, or brand-name requirements, franchisors may approve one or more suppliers or distributors and allow franchisees to propose additional suppliers or distributors. A franchisor's approval of additional suppliers and distributors may be conditioned on numerous requirements and the franchisor's approval may be temporary if the additional supplier or distributor does not consistently meet the standards imposed by the franchisor. The franchisor may condition its approval of an alternative supplier or distributor on a variety of factors, including any one or more of the following:

- Ability to supply goods or services consistently meeting the standards and specifications of the franchisor;
- Ability to deliver goods or services on a timely basis and in the required quantities;
- Adherence to all applicable health and safety regulations and laws;
- Willingness and agreement to permit the franchisor or its designee to make periodic inspections (including taking samples at no charge and photographing operations), reasonable in respect to frequency, time, and manner of inspection, to assure the supplier's or distributor's continued conformity to specifications and product safety standards;
- Verified compliance with applicable sanitation standards and good manufacturing processes;
- Financial condition and business reputation;
- Ability to provide value through pricing, support of initiatives to enhance quality and competitive attributes, commitment to innovation, and other methods;
- Ability to advance the franchisor's social and environmental initiatives, policies, or standards;
- Potential for conflicts with other commitments made by the franchisor (exclusivity);
- Ability to maintain the confidentiality of the franchisor's information;
- Ability to comply with the franchisor's standard terms and conditions; or

- Information technology standards.

If an alternative supplier or distributor is ultimately approved by the franchisor, the franchisor may require such supplier or distributor to execute a supply agreement requiring compliance with the franchisor's standards, specifications, and policies.

a. Process

If a franchisee wishes to source restricted goods or products from alternative suppliers or distributors, such franchisee should make a request to the franchisor for approval to purchase restricted products from the proposed vendor. In response to such a request, the franchisor may conduct varying degrees of evaluation to determine if the proposed supplier or distributor is appropriate for the franchise system. Often the franchisor reserves the right to withhold approval of an additional vendor for any reason in its sole discretion. If the franchisor determines that a new supplier or distributor is necessary or appropriate, the franchisor will evaluate the proposed supplier or distributor based on the franchisor's criteria; however, if the franchisor determines that there is a need or requirement that the proposed supplier or distributor cannot meet or an exclusive supply relationship already exists, the franchisor will likely forgo a detailed evaluation.

In order to make a determination regarding approval, the franchisor may require submission of specifications, information, or samples of products, materials, forms, items or supplies. The franchisor may conduct testing in-house or submit such items to an independent testing facility. The franchisor may also, from time to time, inspect any supplier's or distributor's facilities and products to assure proper production, processing, storing, and transportation of equipment, products, supplies, or materials to be purchased from the supplier or distributor by the franchisee. Permission for such inspection may be a condition of the continued approval of such supplier or distributor. The franchisor may, in its discretion, elect to withhold or revoke approval of the supplier or distributor.

The franchisor should advise the franchisee whether the proposed products or vendors meet its expectations within a reasonable time. The franchise agreement typically prohibits the franchisees from selling or offering to sell any restricted products from a proposed additional supplier or distributor until written approval has been granted by the franchisor.

b. Timeline

The evaluation and decision making process may take anywhere from 30 to 180 days, but could take longer depending on various factors. Some franchisors generally state that they will advise the franchisee of its approval or disapproval of a vendor within a reasonable time; however, larger franchisors often set a specific timeline for approval or disapproval. Regardless, franchisors need time to conduct sufficient evaluation and analysis of proposed additional suppliers and distributors, and the time required for testing and evaluation depends on a number of factors, including the nature of the item or service and whether the franchisor or an independent laboratory will perform the testing. In order to start the clock on the approval or disapproval process, franchisees may be required to submit *all* required information. If some of the required information is out of the franchisee's control, the franchisor may have additional time to make a determination while the franchisee coordinates the required information with the proposed vendor.

c. Costs

When the franchisor incurs costs or expenses in connection with the approval of an alternative supplier or distributor, the franchisor will pass such costs and expenses on to either the franchisee or the proposed vendor. The costs and expenses passed on by the franchisor are typically limited to actual costs, but even the actual costs may be onerous if the franchisor requires lengthy or complex testing. If a franchisor requires ongoing testing, quality assurance reports, facility inspections, or any other certifications the franchisor deems necessary, the franchisor will pass all such costs on to the franchisee or the proposed vendor.

d. Franchisee Participation In the Approval Process

Franchisee participation may be limited to submitting a written request to the franchisor requesting approval of a particular supplier or distributor. Alternatively, franchisee participation will be more involved if market testing or focus groups are critical to the evaluation process. The extent of the franchisee's request for approval has varying degrees of participation as well. The franchisee may be required to submit samples of the proposed supplier's products to the franchisor, together with evidence of conformity with the franchisor's standards and specifications, or the franchisee may simply provide the connection between the vendor and the franchisor.

V. Franchisee Participation in Supply Chain Arrangements

A. Purchasing Cooperatives

For many franchise systems, purchasing cooperatives may be an appropriate vehicle to grow and support a strong and efficient supply chain. When structured and operated effectively, a franchise system purchasing cooperative can reduce its members' costs, achieve economies of scale, result in additional income to members based on their volume of use of the cooperative, and provide for joint collaboration between the franchisor and its franchisees.

As described in a recent article in the *Franchise Law Journal*, "[a] franchise purchasing cooperative acts as the sole purchasing agent for its members and commonly has the following characteristics:

- It is owned and democratically controlled by its members, which can be the franchisor and franchisee entities.

- It provides products and services to its members and not the general public, such as specific distribution services for a franchise system and proprietary products required by the franchisor.

- It returns benefits (e.g., patronage dividends) to its members on the basis of use of the cooperative's services.

- It permits franchisees greater participation in supply chain matters such as governance and purchasing decisions."

The formation and operation of a purchasing cooperative requires careful planning and oversight. Attention must be paid to the tax structure and planning of the cooperative, as well as the entity and ownership structure of the cooperative and the control and management of the cooperative (for example, one-member, one vote). Thought must also be given to the manner in which the cooperative will be funded both initially and on a going-forward basis (such as through direct membership fees, withholding a portion of member profits, or assessing fees on products sold or purchased through the cooperative). Because of the potential financial and legal pit-falls, it is imperative that a franchise system that wants to establish a purchasing cooperative engage qualified legal and financial counsel with experience and expertise in both the formation and operation of purchasing cooperatives.

B. Advisory Boards and Franchisee Councils

A franchisee advisory board or franchisee council (collectively, "FAC") is a group of existing franchisees and is designed to provide the applicable franchisor with advice, counsel and suggestions with regard to any number of topics including purchasing, advertising, operations, products and services. Members of a FAC are usually either appointed by the franchisor or elected by the franchisees. In either event, the members of the FAC should represent all types of franchisees in the system. There should be multiple-unit operators as well as single-store franchisees. Both large and small markets should be represented. This diversity allows the FAC to give meaningful input across a wide spectrum of the applicable franchisee system.

If the members of the FAC are appointed by the franchisor, it may be perceived by many franchisees that the FAC doesn't truly represent the perspective of the franchisees and is solely a rubber stamp body of the franchisor. On the contrary, some franchisors believe that allowing FAC members to be elected by franchisees makes it difficult to accomplish the desired diversity and doesn't allow for a rotation of members because certain franchisees repeatedly get elected to the FAC. The size, make-up and how members are placed on the FAC will vary from franchise system to franchise system.

Generally, FACs do not have any legal authority with regard to the franchisor, and the decisions and recommendations that are made by the FAC are not binding on the franchisor. The FAC is generally established to encourage communication, creativity, inventiveness and responsiveness from the franchisees. An FAC is a formalized method of coordinating the franchisor-franchisee relationship and of also coordinating activities among franchisees. FACs provide a forum and a coordinated voice to communicate with the franchisor, but the franchisor retains the final decision making authority with regard to any topics discussed at the FAC.

FACs should generally avoid price discussions because of the antitrust implications related to price-fixing. FACs must also be careful when it comes to denying other franchisees admission to the FAC, which could be perceived as an illegal boycott in violation of federal and state antitrust laws.

If done correctly, FACs are effective tools for allowing the franchisor to learn more about its franchisees' needs, creating better programs and garnering greater support from the franchisee community.

VI. Vendor Code of Conduct

Companies face increasing pressures from their consumers and the media to show they are engaging in responsible business practices. Often the behavior of a company's suppliers can be attributed to the company itself, which can result in a backlash against the company if unethical behavior or unfair labor practices are discovered on the part of a supplier. Establishing a vendor code of conduct can help protect a company from damage to its reputation. There are many examples of enacted Vendor Codes of Conduct readily available on the internet, including those of McDonald's, Burger King and Pizza Hut.

A. Contents of a Vendor Code of Conduct

At a basic level, Vendor Codes of Conduct seek to ensure that a vendor treats its employees fairly and engages in safe manufacturing practices. The precise provisions of a company's code should be tailored to include any concerns specific to its industry, but the most commonly addressed matters are:

1. Compliance with all applicable laws. Many codes will specifically call out laws related to minimum wage and working hours. For a company with an international supply chain, this is especially important to give the company confidence that its vendors will be held to the relevant standard in the country where such vendor operates.

2. Humane treatment of employees, which includes the specific requirements of:

    a. Voluntary employment. Employees will not be forced to work for a supplier, and the supplier will not engage prison or slave labor. Again, this is of greater concern for companies with an international presence in their sourcing organization and especially where suppliers are located in developing countries where such practices are more common.

    b. No child labor. All workers must be of the legal age of employment for the type of work performed and in the country where the vendor operates

    c. Safe and healthy work environment. The supplier must give its employees access to potable water, safe well-lit work areas with adequate ventilation, and ensure that emergency exits are available. If a supplier is likely to provide dormitory style living environments for its employees, these provisions will elaborate on acceptable conditions for such housing.

3. Supplier will not discriminate in hiring, or engage in abusive or harassing behavior to its employees.

B. Enforcement of Codes of Conduct

The Vendor Code of Conduct should include language outlining how the codes will be enforced. A company could require that the supplier police itself. In that case, it would be prudent for the company to develop a checklist which the supplier will be required to use. Alternatively, the company may wish to complete audits itself, or hire a third party for such purpose. Either of these options would result in expense to the company but also provide greater assurance that suppliers are in compliance.

The consequences of noncompliance should either be included in the Code of Conduct, or clearly communicated to a supplier prior to engaging in an audit. There may be certain provisions for which a violation would result in immediate termination of the supply relationship, such as violations of any health codes. For other violations, a reasonable cure period may be allowed after which the supplier will be reassessed.

It is important for a company to make its suppliers clearly aware of what its Vendor Code of Conduct contains. A franchisor may attach the code to its purchasing agreements, either as an exhibit or by reference. Alternatively, a franchisor may require that its vendors sign a separate acknowledgement of the code of conduct. If a vendor has not expressly signed off on the Code of Conduct, monitoring and enforcement could become harder to manage.

C. Model Codes

A number of international groups and industry organizations have provided some guidance on what could be included in Vendor Codes of Conduct. These include:

- UN Global Compact
- UN's Universal Declaration of Human Rights
- UN Convention Against Corruption
- ISO 14000, which addresses environmental issues
- SA 8000, which addresses decent working conditions
- Fair Labor Association
- Electronic Industry Code of Conduct
- International Labor Organization Code of Practice in Safety and Health
- International Labor Organization International Labor Standards
- OECD Guidelines for Multinational Enterprises

VII. Administering the Global Supply Chain

Given the global reach of franchise systems, and the efficiencies that may be realized through overseas manufacturing, it is probable that most franchise systems will address legal issues related to administering a global supply chain. Local differences in law and culture impact international transactions and must be accommodated or used to enhance the relationship. In entering into arrangements with international suppliers or to ship products into or from the United States from another country, or for the outsourcing of services, many significant issues may arise. This Section addresses a few of the significant issues that a franchisor may encounter; however, there are many other aspects to address in a global supply chain, including assessments of the impact of another country's laws and regulations on the supply chain arrangement, including duties and taxes that may significantly alter the financial benefits of such an arrangement. As a preliminary matter, when administering a global supply chain, import and export issues and regulations, and U.S. laws with extraterritorial application should be addressed.

A. Import/Export Issues

Depending on the type of product to be imported into the U.S. or exported from the U.S. or another country, a franchisor may need to devote significant attention to addressing import and export requirements. A broad array of U.S. laws impact the importation of products to the United States. Certain products, such as food products, may be subject to regulation by multiple federal agencies and subject to complex regulations. Products are also commonly subject to country of origin labeling requirements, which as to certain products, such as consumer electronics, can be complex. A franchisor should consider whether products are subject to import restrictions in the U.S. (or abroad, as applicable). If so, the franchisor should consider whether any U.S. Environmental Protection Agency or other environmental or hazardous material import prohibitions or requirements may apply.

B. Extraterritorial Application of U.S. Law

The Supreme Court has expressed that "Congress has the authority to enforce its laws beyond the territorial boundaries of the United States." Many U.S. laws have extraterritorial application, including antitrust laws, securities and trademark laws, among others. There is a presumption against the extraterritorial application of U.S. law. The party that asserts the application of U.S. law to events occurring outside of the United States bears the burden of overcoming such presumption. The presumption against extraterritorial application of U.S. law can be overcome by a clear expression of Congress' intent to extend the law beyond U.S. borders. Factors that must be considered include the text of the statute in question, its structure and its legislative history. Although there is a presumption against the extraterritorial application of U.S. law, some laws expressly state Congress' intent to address extraterritoriality and others are commonly applied extraterritorially such that their application is not in doubt.

When doing business with a foreign franchisee, franchisors typically include provisions in their franchise agreements aimed at ensuring compliance with certain U.S. laws with extraterritorial application, including the Foreign Corrupt Practices Act ("FCPA") and similar laws targeted to the prevention of corruption, terrorism and boycotts. When doing business with an international party in the context of supply chain arrangements, franchisors should similarly address compliance with such laws and include provisions in supply and logistics agreements aimed at ensuring continued compliance with such laws.

The FCPA prohibits the bribery of foreign officials and imposes certain accounting and record keeping obligations on publicly traded companies. The FCPA's anti-bribery provisions make it a crime for any person to offer, promise, authorize or give anything of value to a foreign official, with corrupt intent, to obtain or retain business or an improper business advantage. Of note in certain relationships, including supply relationships, are "grease" or similar payments made to facilitate transactions. Such payments can be construed as the bribery of a foreign official, and therefore must be addressed and reviewed to avoid a failure to comply with the FCPA. A franchisor cannot ignore potential FCPA violations, as "willful blindness" is not an excuse under the law and the franchisor's knowledge of a violation may be established if it is aware of the probability of the existence of corruption.

The FCPA broadly defines a foreign official to include any employee or agent of a foreign government or foreign-owned or -controlled entity, an official or candidate of a foreign political party, or any employee of a public international organization. The FCPA prohibits giving money or gifts to foreign officials, whether entertainment, any tangible or intangible object, services or facilities, other than those given for promoting or demonstrating a company's products or services. For such action to constitute a violation of the FCPA, the government must prove that money, a gift or another thing of value was given with the intent to receive something of value in return.

Exceptions to the FCPA are narrow. While some "grease" payments are permitted (for example, if the payment is legal and customary in the foreign country and the foreign official is ministerial or clerical), a U.S. franchisor should not rely upon an exception to the FCPA without careful review of the legality of the payment. Due to the difficulty of construing exceptions to the FCPA, and the risk that may arise if an exception is interpreted improperly, many franchisors instead choose to adopt a more restrictive policy against payments. A franchisor may also require a party that it is contracting with to certify such party's compliance with the FCPA, even if the party is not a U.S. party. The Department of Justice has made the FCPA available in several languages to assist with compliance by foreign parties.

In addition to the FCPA, a franchisor must ensure that it does not do business with prohibited persons. The Office of Foreign Assets Control ("OFAC") of the U.S. Department of Treasury administers and enforces economic and trade sanctions based on U.S. foreign policy and on U.S. security goals against certain foreign countries and regimes, terrorists and other threats to U.S. security, foreign policy or the U.S. economy. OFAC applies to all U.S. citizens and permanent resident aliens and all U.S. entities and their foreign branches. A franchisor that is conducting international supply arrangements must also ensure that those it is doing business with are not "Specially Designated Nationals" with whom transactions are prohibited. Therefore, a franchisor must ensure, and require international suppliers and logistics providers to ensure, that no persons involved in the transaction are Specially Designated Nationals, or SDNs. There are commercially available compliance software programs to assist with this task.

Finally, franchisors must be aware of anti-boycotting laws, which restrict U.S. companies from participating in foreign boycotts that are not supported by the U.S. Typically, a boycott issue will arise if a company is asked to provide information about its relationships with a particular foreign country's government as a condition of receiving government permits, customs clearances and other approvals. Therefore, a franchisor should require that any international supplier or logistics provider with which it contracts provide it with notice of and refer any request for information about the company's relationships with other parties back to the franchisor. The franchisor can then assess the request, and determine whether it may respond or whether it must alert the U.S. Department of Commerce or Internal Revenue Service.

C. Food Safety Modernization Act (FSMA)

The Food Safety Modernization Act ("Act") changes the U.S. food safety system from mostly reactionary to largely proactive. The Act applies to most food and beverage companies regulated by the Food and Drug Administration ("FDA") in the food service industry. It addresses food safety issues, facility registrations and inspections, food product recalls, and traceability requirements for food products.

Under the Act, the FDA now has the right to access records related to food articles that it believes are or are likely to be adulterated and/or that have a reasonable probability of causing serious adverse health consequences or death to humans or animals. Additionally, food facilities will be required to register with the FDA and renew their registration every two years. If the FDA determines that food manufactured, process, packaged, received, or held by a registered facility has a reasonable probability of causing serious adverse health consequences to humans or animals, it can suspend that facility's registration. A facility may not lawfully operate so long as its registration is suspended. Food facilities will be required to identify and implement preventative controls to significantly minimize and prevent hazards that could affect food manufactured, processed, packaged or held by the facility and to ensure such food is not adulterated.

The Act increases the frequency of required inspections for all registered facilities and permits the FDA to assess and collect certain fees relating to re-inspection of facilities that do not pass inspection the first time. Additionally, the FDA now has the authority to mandate a recall of unsafe food, whereas previously, product recalls were technically voluntary. This recall authority is triggered when the FDA determines that there is reason to believe that a food article is adulterated or misbranded, which is a lower standard than previous law.

VIII. Conclusion

Building an effective franchise system supply chain can be a complex exercise involving input from multiple experts and representatives of both a franchisor and its franchisees, as well as an exercise that may require counsel to develop creative legal solutions and negotiate agreements with multiple providers. The rewards of an effective franchise system supply chain justify the means and resources used to create the supply chain, and an effective supply chain provides lasting benefits to a franchise system. Competition among franchise systems will continue to be fierce, and those franchise systems that successfully align the parties involved in the supply chain – from the franchisor and franchisees to suppliers and logistics providers – are likely to continue to benefit from their investment in the franchise system's supply chain and a positive impact to the bottom lines of franchisees and franchisors.

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R. James Straus is a member in the Louisville, Kentucky office of Frost Brown Todd LLC. Mr. Straus concentrates his practice on general business planning and problem solving for private and public companies, the buying and selling of companies and other strategic transactions, antitrust analysis and supply chain design, franchise law, and the representation of financial institutions and their directors and advisors. Mr. Straus represents purchasing organizations for a variety of participants in the restaurant industry. He served as a Captain in the United States Marine Corps and is a Vietnam veteran. Mr. Straus earned his B.A. cum laude from Yale University and his J.D. from the University of Chicago Law School.

SUZANNE TRIGG

Suzie Trigg focuses her legal practice on product distribution and other supply chain issues. She has represented franchisors, restaurant systems, consumer product manufacturers and distributors, medical device manufacturers and other companies conducting supply chain initiatives.

Suzie's experience includes representing and establishing purchasing cooperatives and similar buying groups, structuring agreements with vendors and logistics providers, and addressing issues specific to restaurant and foodservice companies, including food safety issues. Suzie frequently drafts and negotiates franchise, license, product distribution and logistics agreements and counsels clients on regulatory compliance issues.

Suzie also draws upon her background in public policy to represent the interests of businesses contracting with or under inspection by government agencies. Prior to practicing law, Suzie served as Legislative Director for a member of the Texas House of Representatives.

Suzie is a member of the ABA Forum on Franchising, has authored several articles on franchise issues, and has given presentations at conferences held by the International Franchise Association (IFA) Legal Symposium and National Cooperative Business Association. Suzie is also a member of the Food and Drug Law Institute and International Association for Food Protection.

Suzie holds a JD, with honors, from the University of Texas School of Law, where she participated in the *Texas Environmental Law Journal*. Suzie has a background in agriculture and graduated from Texas A&M University with a Bachelor of Science in Animal Science.