Item 8 Rebate Disclosures for the Modern Supply Chain

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Not long ago, during a panel on Franchise Disclosure Document (FDD) disputes, the panelists posed a hypothetical as time was winding down: "If a franchisor is buying inventory from a supplier and gets a rebate on its purchase, is that subject to disclosure?" The majority of those present quickly answered "Yes," much to the surprise of the panel. The session ended very shortly after; there was no time for a thorough discussion of the issue and the consensus in the room went unexamined. This result was actually quite reflective of the extant writing and thinking regarding Item 8 of the Amended Federal Trade Commission Franchise Rule (Rule)[1]—which is to say, a broad conclusion in favor of disclosure without extended analysis.

While the conclusion of disclosure is easy enough to reach, the work of counsel in support of supply chain and supplier management is actually more complex. Business leaders in a supply chain are often engaged in a rapid-fire process that is increasingly driven by technology rather than deal-making. Franchisor counsel may need to offer opinions on rebates, discounts, and supplier choices that impact millions of dollars in sales and profits. Any counsel hopeful of providing comprehensive and meaningful advice must have a strong understanding of what Item 8 actually says and how it applies to the often labyrinthine workings of the modern supply chain.

In this article, we review the history and purpose of Item 8, the elements of required disclosure, and certain additional issues and risks raised by both supply chain practices and Item 8.

1. 16 C.F.R. §436.5(h).

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I. A Brief History of Supply Chain Disclosure

Franchisors usually find it necessary to provide their franchisees with quality products from suppliers they have vetted and trust. Franchisors also find it indispensable to ensure that franchisees are using trademarked goods and services (both to ensure the health of the marks and to maintain brand standards). Franchisee needs and interests (and ingenuity and entrepreneurship) are also important, and a franchisor must consider how to best utilize these to the benefit of the system. And, of course, the franchisor needs to make money for itself. These aims are often in tension, especially in the supply chain where the franchisor has a strong interest in taking advantage of the buying power represented by the franchisees.

Recognizing that franchisors may not always heed the better angels of their nature when accommodating these competing interests, and concerned that franchisees may be at risk from predatory purchasing rules or noncompetitive supply chain practices, the Rule has long included a requirement that franchisors disclose their (and their affiliates) interest in, and benefits derived from, suppliers and supplier relationships.[2] The supplier relationship disclosure was more limited in the prior version of the Rule, focused on identifying the parties and the existence of benefits for the franchisee, without details. The 1994 version of the disclosure called for (1) "the name of each person (including the franchisor) the franchisee is directly or indirectly required to do business with by the franchisor";[3] (2) a list of any "real estate, services, supplies, products, inventories, signs, fixtures, or equipment relating to the establishment or the operation of the franchisee business which the franchisee is directly or indirectly required by the franchisor to purchase, lease or rent";[4] (3) a list of the names and addresses of the persons from whom those required purchases must be made;[5] and (4) a "description of the basis for calculating, and, *if such information is readily available*, the actual amount of, any revenue or other consideration to be received by the franchisors" as consideration from the suppliers who benefit from the required purchases.[6] The objective of this disclosure was on the identity of the supplier, with the implicit assumption that the prospective franchisee would conduct its own research into the details of the purchasing requirements by contacting the suppliers directly.

The 1994 version of the Rule did not offer much information to franchisees regarding the nature of the relationships between the franchisor and its suppliers, and it did not give much detail about alternative supply possibilities. Accordingly, during the Federal Trade Commission's (Commission) review of the Rule prior to its ultimate revision of the Rule in 2008,

2. 16 C.F.R. §436.1(a)(9)–(11) (1994).
3. *Id.* §436.1(a)(9) (1994).
4. *Id.* §436.1(a)(10) (1994).
5. *Id.* §436.1(a)(10) (1994).
6. 16 C.F.R. §436.1(11) (1994) (emphasis added).

a special concern raised in comments by franchisee counsel was profiteering, whereby franchisors were arguably making franchisees uncompetitive by forcing them to pay premium prices for goods from franchisor-controlled suppliers when viable (and cheaper) alternative products or suppliers were available.[7] Franchisee counsel voiced concern about source restrictions that prevented franchisees from obtaining supplies at lower market rates and noted that franchisors failed to approve alternative suppliers or made it difficult for franchisees to find alternative sources of supplies.[8] Generally, the allegations were not about franchisors' failure to disclose source restrictions but rather about the "abusive nature" of such restrictions.[9] The Commission was also urged to expand the disclosure of supplier restrictions to require franchisors to disclose more information about their practices and intentions with respect to the provision of competitive alternative sources of supply.[10]

Commenters to the original Rule also raised the issue of financial transparency. Franchisee advocates suggested that franchisors should disclose the dollar amount of any revenues received from suppliers during the last year, and some even urged the Commission to prohibit direct and indirect "kickbacks" from third party vendors of the franchisor.[11] Ultimately, this disclosure was meant to serve an "anti-conflict of interest" purpose to put franchisees on notice that the franchisor is benefiting materially from a relationship with the supplier, which may be a motivation to require franchisees to obtain goods or services from certain suppliers without regard to potential competitive advantages for the system or cost control for the franchisees.[12]

The Commission's revisions to the Rule in 2008 focused on achieving a "full disclosure of source restrictions and purchasing obligations" to "inform prospective franchisees about critical restrictions on how they will have to operate the franchise."[13] To that end, the revised Rule required disclosure of "the criteria for approving suppliers available to franchisees" and whether "the franchisor provides material benefits to franchisees who use designated or approved suppliers."[14] The Rule also added disclosures regarding negotiated pricing and the existence of "purchasing or distribution cooperatives."[15] Financial disclosures were not expanded as significantly as relationship disclosures. Although the "feasibility" standard for financial disclosure was eliminated, the Commission did not emphasize the disclosure of actual

7. Disclosure Requirements and Prohibitions Concerning Franchising, Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule, 2004 WL 1945523, at 80 (Aug. 2004) [hereinafter *Staff Report*].

8. *Id.*

9. *See* Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, Statement of Basis and Purpose, 72 Fed. Reg. 15444-01, 15487 (Mar. 30, 2007) [hereinafter *Statement of Basis and Purpose*].

10. *Staff Report*, *supra* note 7, at 80.

11. *Statement of Basis and Purpose*, *supra* note 9, at 15488.

12. *Id.*

13. *Id.* at 15487.

14. *Id.*

15. *Id.* at 15549.

amounts of revenue or the value of benefits received, instead stating that "the highly material fact is that the franchisor receives revenues from suppliers it requires franchisees to use, not the exact dollar amount received."[16] Hence, the Rule requires disclosure of revenues and benefits from suppliers solely as a percentage of total revenues rather than insisting (as the older Rule did) on providing actual amounts of revenue where possible.[17]

II. Item 8 Disclosure Requirements

A. *Current Rule*

The current Rule begins with an overarching statement of the disclosure for the franchisee's obligation to purchase or lease certain types of goods required for the franchised business. Franchisors must disclose in Item 8 the following:

> the franchisee's obligations to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items related to establishing or operating the franchises business either from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor's specifications. Include obligations to purchase imposed by the franchisor's written agreement or by the franchisor's practice.[18]

This provision is dense and requires careful examination to determine the extent of the necessary disclosure. To begin, note that a franchisee's purchase from the franchisor or the franchisor's preferred supplier does not automatically create a disclosure obligation. The Commission's Franchise Rule Compliance Guide (Guide) states that "Item 8 covers only required purchases and leases of goods and services that are source restricted, meaning that the franchisee must make the purchases from a specific supplier or limited group of suppliers . . . ."[19] Thus, a disclosure obligation arises only if there is a mandate from the franchisor that creates an "obligation."[20] The Guide clarifies that the current Rule is focused on restricted source supply chains, regardless of whether the franchisor has a stake in the purchases and *regardless of whether the franchisee requires the product to operate the business*.

This is a critical point when analyzing any supply arrangement under the Rule to determine if it creates an "obligation." For example, under the 1994 Rule, if the franchisor requires the franchisee to sell drinks-to-go and, as a result, the franchisee must purchase straws and the franchisee purchases those

16. *Id.* at 15488.
17. *Id.*
18. 16 C.F.R §436.5(h).
19. Fed. Trade Comm'n Franchise Rule Compliance Guide 58 (2008) [hereinafter *Guide*].
20. Surprisingly "obligation to purchase or lease" is not defined in the Rule, and this omission was purposeful. The Commission decided that the phrase, which was present in the pre-2007 UFOC Guidelines, had "not previously raised any interpretive issues" and therefore that no further definition was needed. *Statement of Basis and Purpose*, *supra* note 9, at 15488 n.460. This decision did not consider the effect of the changes in the scope of the disclosure, which does, or should, raise interpretive issues for franchisor counsel.

straws from a franchisor-owned source at a substantial mark-up, a disclosure was plainly required.[21] But, while the need to buy straws is arguably "imposed by practice" under the current Rule,[22] it is not an "obligation," even with the mark-up and the franchisor's ownership of the seller, unless the franchisor explicitly requires the purchase of the specific straws sold by the franchisor or otherwise limits the sourcing of straws to only the franchisor-owned supplier or a designated group of suppliers that included the franchisor-owned supplier.[23]

As the mere fact of a franchisee-franchisor supply transaction does not trigger disclosure, it is incumbent on counsel to dig deeper into the structure of the supply chain relationships. The Rule—though lacking a clear definition—does provide the elements of a test to ascertain the existence of an "obligation" according to the purpose set forth by the Guide. This test has two parts: first, determine if the source of the product is enumerated in the Rule as a disclosable source, and, second, determine if there is a written or practical restriction on the use of alternate sources imposed by the franchisor.

The Rule identifies four potential categories of disclosable sources: (1) the franchisor, (2) a designee of the franchisor, (3) a supplier approved by the franchisor, or (4) a supplier acting under the franchisor's specifications.[24] If the supplier is an eligible supplier, then we must determine if the franchisor has created a restriction on the relevant product supply (or a restriction in favor of the relevant supplier), either enshrined in a written agreement or by virtue of the business practices of the franchisor or the franchise system.[25] We will review each element of this standard.

B. *Who Is the Eligible Supplier?*

Determining if the seller is in a disclosable category is, and ought to be, the first and easiest part of determining if a supply chain relationship triggers a disclosure obligation. Most obviously, if the franchisor sells or leases products or services directly to franchisees, or if an affiliate of the franchisor sells or leases products or services, then disclosure may be necessary.[26]

21. Disclosure was also required under the 1994 Rule if a purchase was "indirectly required" or if the franchisee was "advised to do business" with a franchisor affiliate. 16 C.F.R. §436.1(a)(9) (1994).

22. *Id.* §436.5(h).

23. There is a requirement that the franchisor disclose if it profits from the sales of any supplies to the franchisees, but this applies only if the purchase is "required," which means the result of an "obligation." As discussed below, if the franchisee elects to buy from the franchisor without coercion, then no disclosure is necessary even of profits from sales by the franchisor to the franchisees. *Id.*

24. *Id.*

25. *Id.*

26. "Affiliate" is defined as "an entity controlled by, controlling, or under common control with, another entity." *Id.* §436.1(b). This is a commonly used definition for "affiliate" that should be understood to include any parent company, sister company, subsidiary, or joint venture entity owned in whole or in part by the franchisor or any parent, sister, etc. What is less clear is whether an entity in which a franchisor has a minority interest (or where the franchisor's individual owner—if the franchisor is closely held—holds such a minority interest) is an affiliate. The key test under the definition is "control," and counsel should focus on whether the entity is subject to the actual control of the franchisor or whether it is merely an investment

Similarly, if the franchisor has designated approved or preferred suppliers, or designated one or more exclusive suppliers, then disclosure may be necessary.

Note that even this seemingly simple assessment can raise questions. The Rule assumes that the franchisor has designated the preferred supplier or that the franchisor controls the preferred supplier. If, for example, the franchisor hands responsibility for developing products to the franchisees, or to a franchisee purchasing cooperative, then it may not be the case that even a preferred supplier is a "designee" of the franchisor.[27] In such cases, the degree of restriction applicable to the franchisees regarding the selection and use of a given supplier will need to be established under the second part of this test to complete the analysis.

C. *Is There a Written Agreement or Common Practice Dictating Franchisee Purchases?*

If the seller is of a type potentially subject to disclosure, we must turn to the question of whether the franchisor has created a restricted supply chain either (1) "imposed by the franchisor's written agreement" or (2) imposed "by the franchisor's practice."[28]

An obligation imposed by the franchisor's written agreement is relatively easy to understand. Historically, many franchisors specified in writing that the franchisees must purchase particular products (often marked with the franchisor's trademark) and then designated the entity from which those products were to be purchased. Often the franchisor owned some or all of the product supplier(s) or made a profit from the sale of such goods to the franchisees by either selling the goods at a markup or through rebates. If counsel determines that the franchisees will be told in writing that they must buy all paper drink cups from Cup Company X, and that the cups will bear the franchisor's logo, then disclosure will surely follow.[29, 30]

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vehicle with its own independent management team. *FTC Amended Franchise Rule FAQ's*, Fed. Trade Comm'n, www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs #18 (last visited Aug. 28, 2019).

27. For example, in some franchise systems, the franchisor allows its franchisees to develop their own unique products or services (within certain parameters) and then is faced with the question of whether to scale up or incorporate supply of the products or services if other franchisees want to adopt the same products or services. In other instances, franchisees may push their franchisor for the use of a particular supplier or to permit the sale of a certain product or service system-wide.

28. 16 C.F.R. §436.5(h).

29. The 1994 Rule was much more focused on transactions with the franchisor or its affiliates. The disclosure included only suppliers that the franchisee was "*directly or indirectly required or advised* to do business with by the franchisor, *where such persons are affiliated with the franchisor*." 16 C.F.R § 436.1(a)(9) (1994) (emphasis added). The "advised to do business" language makes the scope of the pre-2007 disclosure much broader than the "obligated" language in the current Rule, but only within the narrow frame of purchases from entities affiliated with the franchisor. Unrelated third-party supplier sales are now plainly within the scope of the Rule.

30. Such disclosure is required unless the purchase obligation is part of the opening of the franchise and the costs are covered under the initial franchise fee, in which case it is excluded from Item 8. *Guide*, *supra* note 19, at 52.

Today, many franchisors are electing not to require the purchase of specific goods or the use of specific suppliers, opting instead to allow the franchisees to pursue generic products or to pursue a variety of sources to ensure competitive pricing. The increased use of market-based supply chains has many causes. Some franchisors may deal primarily in comestibles that can be easily purchased on the open market as fungible goods without a risk to the quality or consistency of the customer experience. Perhaps the franchisor may be a dealer in licensed products manufactured by third parties under their own trademarks and purchased in an open market. Or, the franchisor may have licensed its marks to a purchasing cooperative and empowered the franchisees to choose their own suppliers. It may be that the franchisor is courting multiple suppliers and forcing them to compete against each other for system business as a means to avoid product shortages or to drive down prices. Regardless of the exact reason, fewer franchisors now own and operate a closed supply chain than in the past, and the result is that more and more supply arrangements must be analyzed under the "practice" standard.

As with the key term "obligation," the Rule does not define the very broad concept of "franchisor's practice." The Commission gave some commentary on this question in Footnote 460 in the Statement of Basis and Purpose, "*at the very least* 'franchisor's practice' may include purchases that are recommended by the franchisor, or purchases that are prevalent among the franchisees, even if not required by contract."[31] A facile reading of this footnote would include virtually everything that a franchisee purchases under a "recommendation" standard; however, as discussed herein, the threshold for disclosure under Item 8 is requirements, not recommendations.[32]

What, then, constitutes a "practice" that imposes an obligation? The Guide specifically calls out "requirements in the franchisor's operating manual."[33] Presumably, if the franchisor mandates the use of trademarked products and then licenses only one or a limited number of suppliers, this would be a restrictive "practice" sufficient to create an obligation. However, if the "franchisees have total discretion to purchase or lease items from *any source*, but elect to purchase them from the franchisor, such purchases need not be disclosed in Item 8."[34] Thus, the franchisor can designate preferred suppliers without disclosure, provided that it does not mandate that the franchisees purchase from those suppliers. Further, the franchisor can use its purchasing power to achieve below-market prices, or secure below market pricing by

31. *Statement of Basis and Purpose*, *supra* note 9, at 15488 (emphasis added).
32. *See* notes 18 to 20, and accompanying text.
33. *Guide*, *supra* note 19, at 52.
34. *Id.* Neither the Rule nor the *Guide* states whether a franchisee-designated supplier obligation must be disclosed. As in the above example, if a franchisor licenses its trademark to a franchisee association or purchasing cooperative, then even if the result is a restricted supply chain, it is not clear that a disclosure is required. Arguably, if the franchisor approves or authorizes the restriction, even if formally undertaken by the franchisees through an association or cooperative, then there is a "designation" under the Rule. Certainly, there is a "practice" that would have a real impact on the operations of a franchisee, and it would be within the spirit of the Rule to disclose this arrangement.

offering a preferred supplier designation, but if the franchisees are free to seek out market opportunities, then no disclosure is necessary.[35]

Additionally, while the Rule may permit a franchisor to restrict the supply chain, a few states impose conditions on sourcing and supplier selection. For example, Indiana makes it unlawful for a franchisor to require franchisees to purchase products or services exclusively from the franchisor's designated suppliers when products or services comparable in quality are available from other sources.[36] Alternatively, in Hawaii, franchisors are allowed to designate suppliers if the purchasing requirement is "justified on business grounds."[37] Further, Washington permits a franchisor to restrict the suppliers from which its franchisees must purchase, provided that such restrictions are necessary for business purposes.[38] Again, franchisors should carefully consider the actual need to restrict sourcing before electing not to use an open supply chain.

D. *Specific Disclosures*

If both parts of the test for disclosure are met, then the franchisor must provide a host of specific details regarding the supply chain. As explained in the Guide, the purpose of this requirement is to ensure that the franchisor discloses "obligatory purchases, restrictions on sources of products and services, and the amount of revenue franchisors may receive from required suppliers."[39]

The Rule identifies eleven specific categories of information that must be disclosed, if applicable: (1) the identity of any goods or service that must be purchased, leased, etc.; (2) whether the franchisor, or an affiliate of the franchisor is *an* approved supplier or *the only* approved supplier of the good or service; (3) whether any supplier is owned in whole or in part by the franchisor or an officer of the franchisor; (4) the process for approving or revoking the approval of a supplier; (5) whether the franchisor issues specifications and standards to franchisees, sub-franchisees, or approved suppliers and the process for issuance and modification of those standards; (6) whether the franchisor, or its affiliates, *will or may* derive revenue or other material consideration from required purchases by franchisees; (7) the estimated proportion of these required purchases by the franchisee to all purchases and leases by the franchisees of goods and services used in establishing and operating the franchise; (8) payments from a designated supplier to the franchisor "from franchisee purchases;" (9) the existence of any purchasing cooperatives;

35. This raises the question of why any franchisor would restrict sourcing unless it was absolutely necessary. A franchisor that permits its franchisees to utilize the open market still retains sufficient power, in terms of forecasting and leveraging system-wide purchasing power, to create lucrative supply relationships for generic goods but has no obligation to disclose either the existence of such relationships or the benefits derived therefrom.

36. Ind. Code §23-2-2.7-1(1).

37. Haw. Rev. Stat. §482E-6(2)–(2)(B).

38. Wash. Rev. Code §19.100.180(2)(e).

39. *Guide*, *supra* note 19, at 51.

(10) whether the franchisor negotiates purchase arrangements with suppliers, including pricing, for the benefit of franchisees; and (11) whether the franchisor provides material benefits to a franchisee based on the purchase of products and services from particular suppliers.[40] Let's consider each of these in turn.

1. Goods and Services

The first category of information, the list of goods and services, formally includes only those that are subject to a restricted supply chain.[41] However, we recommend as a best practice that franchisors disclose all "required" goods or services "related to establishing or operating the franchised business,"[42] even if disclosure may not be strictly necessary. For example, if the franchisor requires its franchisees to use a point-of-sale system, and that system requires the use of a computer, and the computer must meet certain standards, but the franchisee can purchase it at any local retailer or wherever else it likes, then disclosure is arguably not required. Similarly, if the computer is source restricted but included in the initial franchise fee, then disclosure under Item 8 is not necessary. In practice, however, it is consistent with the spirit of the Rule and the Guide to identify in Item 8 all such necessary goods and services, even if further disclosures and details are not required.

Note that while we recommend a comprehensive list of what may be "required," we do not suggest that the franchisor offer justifications for any listed item. Although the Guide permits the franchisor to "explain in Item 8 the reason for any particular purchase requirement,"[43] there is little to be gained by using the FDD for this purpose, and much risk of incidentally disclosing strategic or confidential information that informs the setting of brand standards and the structure of the system supply chain.

It is also necessary to disclose the "estimated proportion" represented by "required" purchases of all purchases the franchisees must make "of goods and services in establishing and operating the franchised business."[44] The Rule provides no guidance on how the franchisor should determine the expected total purchases necessary to establish or operate the franchise business in excess of the "required" purchases (which are exclusive of initial purchases, which ought to be included in the total purchases). We recommend that franchisors utilize the purchases of a corporate-owned store as a point of comparison, if possible, or make a reasonable estimate based on reporting available from franchisees.

40. 16 C.F.R. §436.5(h)(1)–(11).
41. *Guide*, *supra* note 19, at 52.
42. 16 C.F.R. §436.5(h).
43. *Guide*, *supra* note 19, at 52.
44. 16 C.F.R. §436.5(h)(7).

2. Franchisor Relationship to Suppliers

It is easy enough to state if the franchisor is one of, or the only, supplier of any goods and services. Most franchisors have affiliates, either holding companies or sister companies, that act as independent sources of supply. In such cases, the franchisor should identify the nature of its relationship with the supplier, the degree of source restriction or exclusivity enjoyed by the supplier, and the goods and services which must be purchased from that supplier. Additional disclosures will also be required for these affiliates that provide products or services to franchisees in Item 1.[45]

3. Ownership Interest in Suppliers

As with the list of goods, the Rule expands its scope in this area to encompass any business in which a broad swath of franchisor personnel may have some interest. "Officer" is defined in the Guide (not the text of the Rule) to include any person with management or policy-making authority.[46] At a minimum, the franchisor should disclose interests held by any individual included in Item 2, as this should encompass all of the persons relevant to the definition of "officer" used by the Guide, though this is broader than the common meaning of that word.

The ownership "interest" that triggers disclosure covers "any percentage of direct ownership from which the officer derives income or other financial benefits."[47] The Rule requires the disclosure of any interest held by an officer in any supplier, and there is no safe harbor for *de minimis* or non-controlling ownership of a supplier.[48] Yet, in contrast to the plain text and the lack of a safe harbor, the Commission's guidance is that "[a] *de minimus* ownership interest that would not be "material" to an investment decision by a prospective franchisee need not be disclosed."[49] Franchisor counsel are left to their own judgment regarding what is or is not a "material" interest that must be disclosed. Consistent with the Commission's FAQ No. 18, we recommend disclosing direct, controlling, or significant interest in any supplier;[50] other, perhaps less direct interests must be analyzed to determine if they would be "material" according to the standard of interest to a prospective franchisee.

It is frankly unclear why no clearer definition of "materiality" has been provided. At present, the Guide creates a broad disclosure that stretches the meaning of "officer" and "interest" in order to capture only arguably immaterial minority interests in third-party companies. Nor is there any real need to capture ownership interests in the form of passive shareholding, even if

45. *Id.* §436.5(a).
46. *Guide*, *supra* note 19, at 53.
47. *Id.*
48. *FTC Amended Franchise Rule FAQ's*, *supra* note 26. "[T]here can be no fixed "threshold" level of ownership that would uniformly provide a safe harbor for officers with a financial interest below a specified level." *Id.*
49. *Id.*
50. "Generally, it can be said that the more direct an officer's ownership interest is . . . the more likely it is that the staff would deem the ownership interest to be material." *Id.*

direct, because other legal safeguards exist to prevent material conflicts of interest. For example, in many public companies a code of ethics would prevent an individual in a position of relevant authority from having an interest in a supplier or other contracting party. And the Rule itself includes a separate disclosure requirement for situations where the franchisor or its leadership has a controlling interest in a supplier and there is a risk (from the franchisee's perspective) that a conflict of interest exists. The Commission, based on its guidance and FAQ No. 18, appears to recognize the limited utility of the broad language applicable to this issue, but nevertheless leaves the burden of interpreting "materiality" and the risk of error on the franchisor.[51]

4. Approving Alternate Suppliers

The process by which franchisors approve or deny requests from franchisees for new suppliers was of special concern to franchisees when the pre-2007 Rule was reviewed and revised. Franchisees requested, and the Commission agreed to require, a large amount of information regarding the selection, approval, and revocation of alternate sources of supply.[52] The franchisor must state (1) whether it shares its criteria for selecting suppliers with the franchisees; (2) whether it allows franchisees to independently contract with suppliers who meet the criteria; (3) whether there are fees payable by the franchisees to secure approval of an alternate supplier, and what process the franchisee must follow to request approval; (4) the time period for notice to the franchisee of a decision regarding a request for approval;[53] and (5) if and how the franchisor may revoke an approved supplier once approval is given.[54]

We recommend that, if a franchisor does allow for franchisees to choose suppliers or to pursue new suppliers, it also publish the criteria for selection and approval, including timetables, to the franchisees. If the franchisor is sincere in engaging the franchisees in the supply chain process, a shared understanding of expectations and process will prevent conflict and likely result in a more efficient and effective supply chain. As there is no obligation to allow alternate suppliers or to publish the criteria for supplier selection, a franchisor

51. "Franchisors therefore would be well advised, in assessing the materiality of an officer's interest, to err on the side of disclosure." *Id.*

52. These disclosures, however, do not need to include proprietary or confidential information or sensitive strategic considerations, such as the exact basis for choosing a product or supplier. As the Staff Report states, "[A] franchisor need only disclose the general process for approving or disapproving alternative suppliers, but not the exact selection criteria themselves." *Staff Report*, *supra* note 7, at 81.

53. The length of time for reviewing requests for alternate suppliers was a key focus for franchisee lawyers during the Rule review. Horror stories were offered of franchisors taking more than a year to respond to a request for supplier approval, effectively killing such requests by tabling them. The Commission offered the disclosure of the window within which a decision will be made, without establishing limits on the time for review or forcing the disclosure of the timetable for review. *Statement of Basis and Purpose*, *supra* note 9, at 15487 n.456.

54. 16 C.F.R. §456.5(h)(4)(i)–(v).

that wants to maintain strict control should avoid creating a false impression and provide a general negative response on this issue in the FDD.

5. Specifications, Standards, and Modification

The franchisor must disclose whether it issues specifications and standards for goods and services to franchisees or suppliers, and the means it uses to issue and modify such specifications and standards. This is a simple disclosure, and we recommend that franchisors provide a general statement that it does have specifications and standards for its products and services and how it communicates the same.[55] A reservation of the right to modify and a description of how those modifications are communicated are also a must.

6. Revenue Disclosures

One of the core purposes of Item 8 is to notify franchisees that the franchisor may derive revenue, sometimes significant revenue, from sales of products and services to franchisees. Many franchisors actually make more from the sale of products and services to franchisees than royalties or other typical Items 5 and 6 fees. Arguably, the goal of the disclosure is to notify a prospect if the franchisor actually makes more of its revenue from sales to a "captive audience"[56] than from franchise fees derived from franchisee sales, or if the franchisor will value revenue from sales at the expense of competitive advantages in the cost of goods. Accordingly, while the directive to disclose revenues from product sales and leases is broad, it is not well defined and, like the concept of "required purchases," ultimately applies to only a narrow slice of potential revenues.

Two elements to the disclosure of revenue streams arise from the supply chain. The first involves a general disclosure of total franchisor revenues from franchisee purchases/leases,[57] and the second covers payments from third-party suppliers to the franchisor.[58]

The disclosure of total revenue requires a potentially complicated inquiry to determine what counts as revenue. First, we must establish that there is a "required" purchase (as discussed earlier, this means a restricted source purchasing obligation) for franchisees. Second, we must determine that there is a disclosable form of consideration. Third, the consideration must be paid to the franchisor or its affiliates. Finally, the consideration must result "from required purchases or leases *by the franchisees*."[59]

55. It would be very unusual for a franchisor to have no standards or specifications relevant to any goods or services that the franchisees may purchase. As with the first element of the disclosure, a good-faith attempt to comply with the Rule necessitates some description disclosure under this provision.

56. *Staff Report*, *supra* note 7, at 80.

57. 16 C.F.R. §436.5(h)(6).

58. *Id.* §436.5(8).

59. *Id.* §436.5(h)(6).

When deciding if there is a disclosable consideration, counsel must begin with the Rule. The plain text of the Rule is, to be blunt, unfeasibly broad: "[w]hether the franchisor or its affiliates *will or may* derive *revenue* or *other material consideration* from required purchases or leases by the franchisees."[60] Although the word "may" implies the possible need to estimate revenues, the FTC has not interpreted the Rule this broadly, and franchisors may disclose only actual revenues received along with a general description of the potential sales or leases that supply the revenues disclosed without tying specific amounts of revenue to specific sales or leases.[61]

Once we have narrowed our review to actual consideration, we are still forced to define what constitutes "revenue" or "other material consideration."[62] Direct payments of money from the franchisee to the franchisor or an affiliate is, of course, disclosable revenue. For most franchisors direct payments from franchisees is the sole, or at least the largest portion of, revenue to be disclosed. The next most common source of revenue is certainly payments from a third-party supplier—again, money payments are clearly revenue.

But is there revenue if the franchisees are not subject to a restricted supply chain structure? The answer appears to be no: if the threshold requirement of a restriction on supply is not met, then the payments from franchisees are not subject to disclosure. Nor would payments to a franchisor from a supplier, even if arising out of franchisee purchases, need to be disclosed if the purchases are not made under a restricted supplier arrangement. Accordingly, even if the franchisor takes a broad approach to identifying goods that might be subject to specifications or restrictions, there is no corresponding revenue to disclose unless an actual restriction is in place such that the franchisee purchases are not "optional."

Thus far, we have reviewed cash payments, but other forms of "material consideration" may need to be valued and included in the revenue disclosure, although it is unclear that this is actually required.[63] Among such potential benefits are discounts, rebates, and bartered goods and services (including for the benefit of corporate-owned outlets). If these benefits are subject to inclusion in revenue, the issue of valuation may not be easy to resolve.

60. *Id.* §436.5(h) (emphasis added).

61. The Guide makes clear that only an aggregate statement of revenue, taken from the franchisor's audited financial statements, is required. *Guide*, *supra* note 19, at 54–55. This is consistent with the Guide's direction on payments from third-party suppliers that "[p]ayments to franchisors from suppliers may be disclosed either as a percentage or as a flat dollar figure on an aggregate, not individual supplier basis." *Id*. at 55. The logic applies to revenues from payments franchisee purchases, despite the Rule stating that disclosure includes "revenues from all required purchases and leases of products and services" without differentiating between aggregate or specific revenues. 16 C.F.R. §436.5(h)(6)(ii).

62. For the purposes of this discussion, we assume that all consideration is delivered to the franchisor or its affiliates. Any consideration that is delivered to the franchisees is outside the scope of the disclosure, but drawing this distinction should not require legal analysis.

63. The Rule is quite ambiguous on this point, as the term "other material consideration" is used as a category of consideration apart from "revenue," but the specific disclosure of aggregate dollar amounts is limited to "revenue."

Many of these benefits may not have an obvious market value, and the methods used to determine a value may vary from franchisor to franchisor. For example, it is consistent with good-faith accounting practices to treat discounts or rebates as a reduction in the cost of goods rather than recording them as revenue, meaning it might not be possible to isolate or report the amounts received. Counsel must work closely with accounting and finance teams to ensure that the required reporting is accurate and that necessary valuations are provided.

Discounts and rebates pose an additional challenge depending on the basis for payment.[64] Although the Rule assumes that the franchisor or its affiliate or designee is selling most goods and services to the franchisee, in a modern supply chain the franchisor is often one among many resellers (even if the supply chain is limited to a small number of suppliers) that must compete for franchisee business. Under these circumstances, the franchisor may make purchases solely to meet its needs as a reseller and receive discounts or rebates from suppliers or manufacturers *not* by virtue of the access provided to the franchise system or the act of re-selling to the franchisees, but due to its own status as a customer in a competitive marketplace.[65]

The Guide makes clear that "franchisors need not report ordinary sales or volume discounts that are offered by the supplier to all buyers, including the franchisees." Unfortunately, the Guide does not say when or how to distinguish between a benefit received from ordinary sales and those that are "a result of franchisee purchases."[66] It may be advisable to apply a "but-for" causation analysis, whereby if the franchisor is only making the purchase because it intends to resell the products to the franchisees, then any purchase (and any related discount or rebate) is the "result" of a franchisee purchase. We do not agree that this is always the correct approach—while a franchisor may be acting as a reseller solely for the franchise system, this does not make every purchase decision by the franchisor the "result" of some future anticipated franchisee action. A franchisor using a capable supply management team will be making purchases for a slew of reasons that have nothing to do with the future sales to franchisees, even if the franchisor sells

64. Generally, the question of whether some consideration is based on a purchase by the franchisee will only apply to non-cash payments from suppliers to the franchisor. Cash payments for goods and services from franchisees are plainly revenue, as discussed, and to the extent that a discount or rebate is based on the pass-through sale of goods to the franchisees, the relationship to a franchisee transaction is not in doubt. The offer of discounts or other benefits to franchisor purchases for the benefit of corporate-owned locations are also plainly subject to disclosure, although, as noted, it is not obvious that such benefits must be valued and included in revenue.

65. For example, a franchisor might purchase in excess of quarterly forecasted sales for a non-perishable product that is suddenly available at a great price in the general marketplace.

66. Putting aside the need to identify, categorically, whether a discount is or is not subject to disclosure, there is the practical problem that a franchisor is unlikely to be accounting for such transactions according to these artificial types—while a franchisor can probably determine the dollar amount of discounts on inventory purchases, breaking that amount down into the share applicable to "market" purchases that do not need to be disclosed and "based on franchisee action" purchases that do need to be disclosed is almost certain to be practically impossible.

only to franchisees and every item of inventory is intended for some franchisee to later buy.[67]

Once the appropriate pool of revenue is determined, the actual disclosure is quite straightforward. The franchisor must disclose its total revenue, taken from the franchisor's audited financial statements,[68] the amount of revenue from required purchases, the percentage of total revenue represented by the revenue from required purchases, and the revenue received by the franchisor's affiliates.[69]

After disclosing total revenues, the franchisor must make a separate disclosure of the "basis for payment" from the designated supplier(s)[70] "to the franchisor from franchisee purchases."[71] The payments must be disclosed either as a range of percentages, or as a range of dollar amounts, and all payments from all suppliers may be aggregated in the disclosure. For example, if the franchisor receives a payment from three different suppliers, equal to one percent, three percent, and six percent of the value of the franchisee purchases, then the disclosure would state that the franchisor may receive payments of between one and six percent of the value of franchisee purchases. Alternatively, if the payment is better expressed in dollars (say, $1,000, $3,000, and $6,000) then the disclosure would state that the franchisor may receive payments of between $1,000 and $6,000. The franchisor can choose the format of the disclosure. The identity of the suppliers and the specific amounts attributable to each supplier need not be disclosed.[72]

7. Purchasing Cooperatives

Franchisors must disclose the existence of purchasing cooperatives, unless the franchisee is required to participate, in which case the "identity" of the

67. Inventory management practices now move at the speed of the Internet, and prices and purchase incentives (discounts and credits) can change from hour-to-hour, something that was definitely not true in the world of faxed purchase orders and carbon-copy packing slips that gave birth to the Rule and the UFOC Guidance on which the current Item 8 is based. For example, a savvy inventory manager might agree to purchase soon-to-be-obsolete stock from a supplier at a steep discount, not based on forecasted sales but because the discount will raise margin on sales sufficient to offset the likely need to dispose of some amount of product and take a future write-down. Alternatively, the franchisor might make such a purchase as a favor to a supplier, in exchange for future return credits or rebates or discounts or even just a friendly working relationship—again, where such actions are not at all motivated by expected sales to franchisees. This is all to say nothing of purchases from online marketplaces, where the volume and price points are pre-determined by algorithms—essentially computers buying from computers without the benefit of a direct human motive. This is a potentially serious issue with the "result" framework which requires some understanding of the intention of the buyer/seller with regard to the benefit at issue to determine if there is an event subject to disclosure.

68. If the franchisor does not have audited financial statements, then the sources of information used to calculate the revenue must also be disclosed. 16 C.F.R. §436.5(h)(6)(i) n.5.

69. *Id.* §436.5(h)(6)(i)-(iv). The sources of information used to calculate affiliate revenue must also be disclosed. *Id.* §436.5(h)(6)(i), n.5.

70. A supplier is intended to "capture all third parties in the manufacturing and distribution chain who may make payments to the franchisor or any of its affiliates when their goods are sold to franchisees." *Guide*, *supra* note 19, at 53.

71. 16 C.F.R. §436.5(h)(8).

72. *Guide*, *supra* note 19, at 53–54.

cooperative must also be disclosed.[73] The Rule and the Guide provide *no* direction on what must be included in this disclosure. It may be a reflection of an increase in the use of cooperatives between 2007 and 2019, but little to nothing is said about cooperatives in the Statement of Basis and Purpose or the Staff Report, and no specific details are provided about the process cooperatives use to select and approve suppliers or the rights of franchisees to participate in those processes. It may be that future revisions to the Rule will enhance the disclosures related to these increasingly critical parts of the supply chain.

8. Miscellaneous Franchisor Activities

Finally, the franchisor must disclose if it "provides material benefits" to franchisees based on the "purchase of particular products or services or use of particular suppliers."[74] Such benefits may include rights of renewal or the opportunity to purchase additional franchises.[75] Franchisors must also disclose if they negotiate purchase agreements with suppliers on behalf of the system, including pricing, but the specific price terms need not be disclosed.[76]

III. Additional Concerns

Disclosure is not the only risk that counsel advising their business partners must consider. A franchisor may bear responsibility for the conduct of its suppliers, and it may also face liability from franchisees or from the public arising therefrom.

A. *Quality Control*

Franchisors must ensure that their supply chains provide quality goods and services; even with disclosure of the relationships, franchisees may have a claim for breach of the franchise agreement if the franchisor's products are not of good quality. For example, in *Ponderosa Systems, Inc. v. Brandt*,[77] the franchisee, as defendant, won a jury verdict on its counterclaims for breach of implied warranties, breach of duty of good faith and fair dealing, and fraud.[78] The Tenth Circuit held that the district court did not abuse its discretion when admitting evidence asserted to be prejudicial to the franchisor, including evidence that the franchisor received several complaints related to the quality of the meat purchased from the franchisor's approved supplier; specifically, that it was "poor quality, poor consistency, odorous, spoiled, rotten and rodent damaged."[79] The evidence of poor quality products was vital

73. This is another example of an extra-textual regulatory requirement "imposed" by the interpretive guidance. *Guide*, *supra* note 19, at 55.
74. 16 C.F.R. §436.5(h)(11).
75. *Id.*
76. *Id.* §436.5(h)(10); *Guide*, *supra* note 19, at 55.
77. Ponderosa Systems, Inc. v. Brandt, 767 F.2d 668, 670 (10th Cir. 1995).
78. *Id.* at 670.
79. *Id.*

to the defendants in proving that the franchisor damaged their business and failed in its obligations as a franchisor. It is imperative for franchisor counsel to work with supply chain business leaders to ensure that quality controls are in place and that the goods meet minimal standards of merchantability.

B. *Customer Injury*

Franchisors have also been subject to liability from claims asserted by their franchisee's customers arising from the use of required products and services.[80] In *Plunkett v. Crossroads of Lynchburg, Inc.*,[81] a negligence claim was brought against the franchisee and franchisor, Mercedes-Benz, after a customer suffered a slip-and-fall injury. The complaint alleged that the franchisor mandated a floor finish which made it difficult to detect when liquid substances were on the floor, also making it extremely slippery, which resulted in the customer's injury.[82] In several other cases, the courts have recognized potential liability that a franchisor may have for an injury on the franchisee's premises when the franchisor controlled the particular instrumentality or design feature that caused the injury.[83] As with product quality, the decision to control sourcing or mandate products can expose the franchisor to the risks of consumer and franchisee injuries that result from the use of those controlled products and services. Franchisor counsel should be aware of potential product liability claims and work with supply chain management to ensure that risks and dangers are considered when choosing suppliers or mandating products or services.

C. *Price Discrimination*

Periodically, a franchisee will bring an action claiming that a restricted supply chain arrangement, especially one that includes rebates or payments from the designated supplier to the franchisor, is actually illegal price discrimination under Section 2 of the Robinson-Patman Act. The claims, which typically fall under the secondary category of competitive injury outlined by the Supreme Court,[84] commonly assert that the franchisor is harming the franchisees by forcing them to buy products at a price that is higher than what is available to other purchasers not subject to the franchisor's control. The franchisee usually alleges that the franchisor has agreed to deliver a captive group of buyers to the supplier at an unfair price in exchange for a rebate or other payment.

80. *Id.*

81. Plunkett v. Crossroads of Lynchburg, Inc., 2015 WL 82935, at *1 (W.D. Va. Jan. 7, 2015).

82. *Id.*

83. *See* Allen v. Choice Hotels, Int'l, Inc., 276 Fed. App'x 339, 342 (4th Cir. 2008); Hoffnagle v. McDonald's Corp., 522 N.W.2d 808, 813 (Iowa 1994); Whitten v. Kentucky Fried Chicken Corp., 570 N.E.2d 1353, 1356–57 (Ind. App. 1991); Wise v. Kentucky Fried Chicken Corp., 555 F. Supp. 991, 995 (D.N.H. 1983); Papastathis v. Beall, 723 P.2d 97, 100 (Ariz. 1986).

84. The Supreme Court has identified three categories of injury under Section 2: primary, which runs against a direct competitor of the seller, secondary, which harms competition among the seller's customers, and tertiary, which harms the end user (the buyer's customers). Volvo Trucks N. Am. Inc. v Reeder-Simco GMC, Inc., 546 U.S. 164, 176 (2006).

Although this type of claim may present a serious supply chain risk for franchisors, it has proven extremely difficult for franchisees to prevail. To establish unlawful price discrimination, the franchisee must plead, and then prove at trial, that as a result of the discriminatory pricing the franchisee has lost sales to a favored purchaser.[85] If there is no evidence of direct competition with a comparable business receiving the favorable pricing, then the claim will not succeed. Thus, in *Benfeldt v. Window World, Inc.*,[86] the franchisees that claimed harm from the system's restrictive supply arrangement needed to show that they were directly losing sales to a non-franchisee who was buying products from the same supplier under more favorable terms.[87] The mere possibility of receiving more favorable pricing outside the franchisee's restricted supplier arrangement was probably insufficient to state a claim, and the fact that the franchisor may receive an inducement to offer exclusivity, even at allegedly unfair prices, was also likely insufficient to state a claim.[88]

D. *Tying*

A second claim that is periodically raised by franchisees is unlawful tying, whereby the franchisor is alleged to have violated Section 1 of the Sherman Act by conditioning the sale of franchises to the sale of unrelated products (such as those the franchisee is required to buy from the franchisor or its suppliers). This claim has proved even more difficult than the price discrimination claim under the Robinson-Patman Act. The Third Circuit in 1997 rejected a tying claim brought against Domino's Pizza arising out of the mandatory purchase of ingredients from a Domino's affiliate.[89] The court rejected the allegation that Domino's restricted sourcing created a "market" exclusive to Domino's franchisees.[90] The Court based its decision in part on the fact that the Domino's franchisees were aware, prior to entering into the franchise agreement, that Domino's could exert control over their

85. *Id.* at 177.

86. Benfeldt v. Window World, Inc., 2017 WL 4274191 (W.D.N.C. Sept. 26, 2017).

87. *Id.* at *3. The district court dismissed the Robinson-Patman claim, despite a paragraph in the complaint alleging that "Plaintiffs competed against other window sales and installation businesses who purchased the same AMI windows, but on superior terms and without AMI's markup that was imposed exclusively on sales of windows to WW licensees/franchisees," because the plaintiffs failed to specifically "identify any disfavored Bendfeldt retailer, any favored AMI customer, any 'market area' where competition took place, or the amount or duration of any supposed discrimination." *Id.*

88. Note that the franchisee must begin by alleging that it is receiving unfavorable or uncompetitive pricing. If the franchisor focuses its supplier arrangements on offering competitive or even favorable pricing, this claim should not be an issue.

89. Queen City Pizza, Inc. v. Domino's Pizza, Inc., 124 F.3d 430 (3d Cir. 1997).

90. "Were we to adopt plaintiff's position that contractual restraints render otherwise identical products non-interchangeable for purposes of relevant market definition, any exclusive dealing arrangement, output or requirement contract, or franchise tying agreement would support a claim for violation of antitrust laws. Perhaps for this reason, no court has defined a relevant product market with reference to the particular contractual restraints of the plaintiff." *Id.* at 438.

purchasing and elected to contract with Domino's despite that knowledge.[91] The *Queen City* decision, which has been favorably viewed in other circuits,[92] has the effect of offering protection from tying claims to those franchisors who properly disclose their purchasing requirements in Item 8.

E. *Fraud*

A key factor in *Queen City* was the franchisee's awareness of Domino's power to control purchasing when it entered into the franchise agreement. It remains an open question whether a court might distinguish *Queen City* if the franchisor hid or misled a prospective franchisee about supply chain restrictions. Of course, the franchisor also risks demands for rescission or other claims for damages if there is any material omission in the FDD or failure to disclose or other alleged fraud. The simplest and most ethical remedy for this, which we whole-heartedly recommend, is to ensure that the FDD is accurate and that all material information regarding the supply chain and the franchisor's relationships is disclosed and that steps are taken to keep franchisees involved with and informed about critical supply chain decisions. And it does not hurt to secure competitive pricing for restricted source goods, if possible—as a general rule, franchisees do not bring claims if they are profitable.

Conclusion

Item 8 is not, to be frank, a "sexy" provision in the FDD. It covers matters of complexity and obscurity that are not always fully understood by counsel. Yet, counsel has an important role to play in advising both franchisors and franchisees in selecting suppliers, structuring payments, approving rebates and discounts, and deciding how much control a franchisor (or purchasing cooperative) wants or needs over the supply chain. We recommend that counsel work closely with both supply chain managers and finance managers to understand how products and services move through the franchise system and how those products and services are paid for and valued. Only by developing a thoughtful analytical framework for understanding and advising on the disclosures required by Item 8 can counsel fully protect the franchisor from supply chain risks such as franchise disclosure violation, antitrust and fraud claims, poor quality controls, and non-competitive pricing for goods and services.

91. "[T]he Domino's franchisees could assess the potential costs and economic risks at the time they signed the franchise agreement." *Id.* at 440.

92. *See*, *e.g.*, *Bendfeldt*, 2017 WL 4274191 at *5–6.