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**Contractual and Business Aspects of
Structuring Supplier Agreements**

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TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	BUSINESS ISSUES	1
A.	Supplier Selection.....	1
1.	Product and Service Quality	1
2.	Supplier Capacity	2
3.	Product and Service Price.....	2
B.	Contract Issues.....	3
1.	Contract Structures.....	3
2.	Term	4
3.	Volume Commitments/Incentives	4
4.	Rebates	4
5.	Warranties	5
6.	Indemnities/Limitations on Liability.....	5
C.	Private Labeling	6
III.	LEGAL ISSUES	6
A.	Franchise Regulatory Issues	6
1.	FTC and State Disclosure Obligations	7
2.	State Restrictions	10
B.	UNIFORM COMMERCIAL CODE	12
1.	Warranties	12
2.	Risk of Loss and Insurance	17
3.	Passage of Title	19
4.	Remedies.....	19
C.	Antitrust	23
1.	Tying.....	23
2.	Robinson-Patman Act.....	27
3.	State Law Claims.....	29
D.	Intellectual Property	30
1.	Trade Secrets	30
2.	Trade Dress	31
3.	Copyrights.....	32
E.	Common Law	32
1.	<i>Team Tires Plus, Ltd. v. Heartlein</i>	32
2.	<i>Tubby's #14 Ltd. v. Tubby's Sub Shops, Inc.</i>	32
IV.	CONCLUSION	33

CONTRACTUAL AND BUSINESS ASPECTS OF STRUCTURING SUPPLIER AGREEMENTS¹

I. INTRODUCTION

Establishing supplier relationships for franchise systems raises a number of business and legal issues. In developing supplier relationships, franchisors must consider supplier capabilities, and determine how those capabilities match their development goals. They must analyze their capacity to handle administrative and logistical tasks to determine how best to structure the contractual relationships with suppliers to minimize total costs and maximize benefits to the entire franchise network.

Negotiating and structuring agreements which reflect the business terms of the relationship can be challenging, not only in complexity, but also in reaching a resolution that will benefit the franchisor, its franchisees and the franchise system, and which will provide adequate incentive for the supplier to participate in supplying the system. Small systems in early stages of development will have less negotiating power based on projected purchase volumes than larger systems. Because franchise systems generally grow dynamically, smaller systems may expect increased leverage in supplier relationships as their systems grow. Conversely, as a franchise system grows, an individual supplier, if relatively small, may become unable to satisfy requirements for products and services. Broadly speaking, then, in establishing a viable supply system, franchisors need to analyze their system's geographical spread and volume needs and need to analyze possible suppliers' capabilities, including their ability to meet system needs for reasonable delivery time.

In addition to the numerous business issues that franchise system supply relationships present, such relationships may be particularly sensitive from a legal perspective as well. Such relationships may be impacted by state and federal statutes and regulations that cover presale disclosure. In addition, several states have relationship laws which will impact the ability of the franchisor to negotiate and structure commercial supply relationships. Because supply relationships are by their nature commercial relationships, the Uniform Commercial Code, adopted in many states, will typically control commercial terms of supplier relationships that are not specifically covered in the supply agreements. Supply arrangements are also impacted by federal and state antitrust laws, which may impact structuring and pricing decisions.

II. BUSINESS ISSUES

A. Supplier Selection

1. Product and Service Quality

After thoroughly analyzing its own state of development in terms of number of units opened and operating, growth plans, geographic dispersion, availability of warehousing facilities and administrative capacity for monitoring and handling supply relationships as a middleman, the franchisor must address a number of considerations in selecting appropriate suppliers for its network. Most critical to the public perception of the franchise system's brand will be the quality

¹ Mr. Maslyn would like to thank Renata Manzo, Counsel in Hunton & Williams' Richmond, VA office, for her assistance in preparing the portion of this paper relating to the UCC and Ashley Johnson, an Associate in the firm's Raleigh, NC office, for her assistance in preparing the portion of this paper relating to antitrust issues.

of goods and services. The supplier must have the capability consistently to provide products and/or services which meet or exceed the franchise system's quality standards. If the supply of quality branded goods is important to the franchisor, the franchisor must be careful in selecting suppliers who will enhance the attractiveness of its own brand. For example, if the franchise system is one of delicatessens, it may be important for the franchisor to have available branded products which, in the minds of the consuming public, are of the highest quality. Similarly, such a franchise system may want to select and sell branded beverages which, again, comport with the public perception of quality. In some instances, suppliers of branded merchandise will be unwilling to permit a franchise system to sell goods and/or services of its competitors as a condition for entering into a long-term supply agreement. Accordingly, the franchisor will need to select the supplier that best meets its needs.

2. Supplier Capacity

Another critical issue in choosing a supplier or suppliers will be the supplier's capacity to meet the needs of the system not only in its current state but as the franchisor projects it to evolve during the term of the supply contract. For example, if the franchise system is a local system in a single metropolitan area, and has no plans to expand beyond its current city or state, the franchisor may be comfortable using a local supplier who will have the capacity to meet the needs of its entire system. On the other hand, a regional franchisor may anticipate expanding beyond its current region in a relatively short period of time and certainly within the term of a supply agreement. As a result, the franchisor will need to select a supplier who can not only meet its regional needs but has the capacity to meet the needs of the franchise system as it expands beyond its initial region.

If the supplier lacks the capacity to serve a growing system, the franchisor will be confronted with the need to establish supply arrangements with one or more additional suppliers. Such arrangements with multiple suppliers are not inherently problematic but do present challenges. The franchisor will need to ensure that all its suppliers provide products or services that are of consistent quality. The franchisor will need to ensure that its contracts with multiple suppliers have consistent terms and conditions. Inconsistent terms and conditions, particularly price differentials, may adversely affect the economic performance of one group of franchisees in relation to another.

3. Product and Service Price

As important as the quality and capacity issues, the cost of the goods which the franchisor purchases through system suppliers must be favorable to the system and its individual franchisees. Ultimately, the franchisor must select the supplier who meets quality, supply and capacity needs at the lowest price of goods. The franchisor should take the availability of volume discounts into account. Volume discounts may be achieved through committed volumes from the franchise network. Alternatively, discounts may be achieved by establishing thresholds in relation to time of purchases either to reduce pricing as the system meets the thresholds or to establish the basis for rebates.

The franchisor must analyze what services the supplier will commit to provide along with the goods that it supplies and must determine how delivery costs will be allocated. If the burden of paying delivery costs is borne by the buyer, and such delivery costs are not factored into the pricing of goods or services, the effective unit pricing of the supplier's products may increase to the point that it is not competitive in the marketplace. While there are many factors that may cause discontent within a franchise system, one of the most challenging (and avoidable) is a

widespread perception among franchises that the costs imposed by exclusive or designated suppliers exceed those for comparable goods or services that may independently be acquired in the open market place. If purchases from a particular supplier for a particular product are mandatory purchases, it will be important for the franchise network to achieve pricing levels that meet, or are lower than, prices charged by the supplier's competitors for similar products. Even if the franchisee's purchases from a particular supplier are optional, the franchisor will want to achieve optimum pricing levels to make it attractive for the franchisees to purchase from that supplier, which will make it easier for the franchisor to negotiate volume discounts.

B. Contract Issues

It is not uncommon for franchisors to enter into master supply agreements with suppliers. The master agreement may provide the mechanism for system purchases, or it may require that the franchisees execute an agreement directly with the supplier. A number of important issues must be addressed in connection with the negotiation of master agreements, some even before the negotiations begin.

1. Contract Structures

The manner of franchisee participation in the master supply agreements may vary considerably. To the extent that the franchisor seeks to control the supply chain within the franchise system, the franchisor will incur administrative costs. On the one hand, the simplest form of relationship is one in which each franchisee may order directly from the supplier under the supply agreement and the supplier ships directly to the franchisee. The franchisor's involvement in the system's commercial activity under such an arrangement will typically be limited to purchases that it makes for its company-owned operations. Under this structure, notwithstanding the franchisor's limited involvement with the supply chain, if the supplier is unable to meet the franchisee's delivery expectations, the franchisor nonetheless will be subject to franchisee complaints. To ensure smooth functioning of the system, the franchisor should reserve in the master agreement the right to monitor the supplier's activities.

Some master agreements permit each franchisee to enter into a direct contract with the supplier for the supply of goods. Such contracts typically will be appended as an exhibit to the master agreement. In such arrangements, the franchisee typically is given the "option" to contract with the supplier. Such contracts should be structured to make the supply arrangement economically attractive to the franchisee so that it will want to deal with the particular supplier. The master agreement in such circumstances may provide for discounts and/or contributions to the marketing fund and/or rebates based on the volume of system wide purchases. Franchisors in such situations normally retain the right to audit the supplier to verify sales volumes.

A master supply structure that places an increased cost burden on the franchisor will be one in which the franchisor maintains an inventory of the supplier's product, and ships directly to its franchisees from one or more centrally located warehouses. The franchisor orders in bulk from the supplier and resells to the franchisees, who order directly from the franchisor. The costs associated with such an operation include not only warehousing, inventory and administrative processing costs, but also the cost of dealing with aged inventory, if aged inventory is a factor. Nonetheless, such a structure gives the franchisor significant control over purchase volumes and permits the franchisor more easily to monitor the volume of franchisee purchases (which, in turn, enables the franchisor to compare franchisee product purchases with revenue and royalty reports).

2. Term

Initially the franchisor and supplier will need to determine the length of the contractual supply relationship. To a certain extent, the length of the relationship will depend on the resolution of other issues to be negotiated such as volume commitments and pricing. From the franchisor's perspective, the desirable length of a relationship may turn on a number of factors. First, the franchisor will need to determine whether the supplier has the capability to grow with the system. If not, the franchisor may seek a shorter term contract or a contract that is terminable on relatively short notice. At a minimum, although not necessarily a "term" issue, such a contract should be nonexclusive. Alternatively, if the supplier does have the capacity to grow with the system, a longer term contract may provide the franchisor with greater opportunities for lower pricing based on higher volumes; potentially, price reductions based on the supplier's economies of scale; and, potential cost reductions as volume increases. In these circumstances, the franchisor may seek a longer term commitment from the supplier, particularly if the pricing structure is determined at the time the contract is entered into. The supplier, on the other hand, may seek a longer term commitment from the franchisor if the supplier will be required to make an investment in its infrastructure to meet the demands of the franchise system as it grows. Alternatively, if the supplier's products are fungible and supplier anticipates the availability of ample markets for its products for the indefinite future, the supplier may seek a shorter term contract or a contract with price escalators which will enable it to maximize its margins and return on investment over time.

3. Volume Commitments/Incentives

Another key element of a master agreement will be the treatment of committed purchase volumes of products. Often, the franchisor and its suppliers establish contractual mechanisms that encourage increased purchase volumes over the term of the contract by creating percentage discounts as volume increases or by having the supplier commit increased amounts of money to marketing activities related to sale of the supplier's products by the system as the volume of purchases reach milestones during the course of the contract. In some larger systems suppliers will supply funds for multiple purposes, including contributing to the franchise system advertising fund, providing grand opening funds, and providing funding for marketing and promotions. As noted above, these incentives may also serve to reduce overall product pricing.

To the extent that a particular product is critical to the system, and especially if the supplier is the sole source of the product, the franchisor may seek to enter into a "requirements" contract with the supplier whereby the supplier commits to supply all of the requirements of the system during the life of the contract. Alternatively, the franchisor may seek priority from the supplier, with the franchise network having first priority in the event supplier's capacity to produce a product lags behind its demand from all customers for the product. To ensure that it will have adequate supply to meet the network orders, the supplier may require the franchise network to provide forecasts of purchases as much as 12 months ahead of the committed delivery date. Such forecasts typically are revised monthly, and normally permit the buyer to vary the forecast from its previous forecast. Such variances become increasingly limited on a percentage basis as the delivery date draws near.

4. Rebates

Although rebates may be used to incentivize purchases, reduce overall prices, or both, misallocation of rebates may eliminate the benefit and may create one of the most sensitive

issues in supply arrangements. The first concern is whether the arrangement will be structured to provide rebates and, if so, who will receive them. If the rebates are paid to the franchisor, the franchisor must determine if it will retain or expend the rebates, and if it expends them, how they will be allocated. For example, if the franchisor uses the rebate for some system-wide benefit, such as contributing the rebates to the advertising fund, some franchisees may feel that they are not receiving a *pro rata* benefit from the rebates based on their volume of purchases. If the rebates are paid to the franchisees, the franchisor and supplier must determine how they will be quantified. If the potential volume of purchases throughout the system is somewhat uncertain, a fixed rebate may impair the economic viability of the arrangement for one party or the other. Alternatively, rebates based on individual purchase volumes for each unit in the system creates an administrative overlay that is both expensive and difficult to administer. In more complex structures, where the franchisor purchases from a supplier and resells to its franchisees, essentially as a distributor, the franchisor may cover its overhead by charging a price to its franchisees that is slightly higher than what it pays the supplier. Here again, it will be critical for the franchisor to ensure that notwithstanding this price spread, the price ultimately paid by the franchisees is at or below market.

5. Warranties

In commercial contracts, suppliers most often provide certain warranties for the goods or services they provide. It is also not uncommon for commercial contracts to limit such warranties and to exclude Uniform Commercial Code warranties that otherwise would apply. Key issues in establishing appropriate warranties are the scope of warranty coverage, the time period of the warranty, and the kinds of defects, patent or latent, that they will cover. In addition, in a complex arrangement, the supplier may want all warranty claims to be processed through the franchisor, which tends to reduce the supplier's administrative costs. If the supplier enters into individual contracts with each of the franchisees, warranty claims usually will be made by the franchisee directly to the supplier. For manufactured goods, an issue that arises in connection with return of warranted merchandise is who will bear the expense of shipping returned goods and their replacements.

6. Indemnities/Limitations on Liability

Two areas of concern in the negotiation of supplier contracts are indemnities and limitations of liability. The franchisor should ensure that the supplier fully indemnifies system members for harms arising out of or related to the use and/or sale of the supplier's products. The franchise network should also ensure that the supplier has adequate insurance to satisfy indemnity claims should they arise. Should a problem occur with a supplier's product, the impact on a franchise system may be substantial. The system will need to be fully indemnified by the supplier for customer claims arising out of or related to defective or harmful products.

Most suppliers limit their liability to the purchaser. Suppliers routinely disclaim special, consequential and punitive damages. If a supplier creates an adverse situation in a franchise system through the supply of defective products, however, damages other than direct damages may be considerable. Among other things, the franchisor may bear considerable expense to recall products and to develop marketing to repair its image. Accordingly, either the franchisor should not agree to such limitations of liability, or the limitation of liability should expressly not apply to the supplier's indemnification obligation under the agreement.

C. Private Labeling

In many cases, franchisors will enter into relationships with suppliers to provide private-labeled merchandise both to the franchisor and to the franchise system. In some cases, franchisors and their franchisees may resell private label merchandise to the public either through the franchise network and/or through secondary channels of distribution. Such relationships typically require the franchisor to grant a license to the supplier to use the franchisor's trademark on products that the supplier manufactures. Such licenses usually restrict the channels of distribution and the particular purchasers of the products so that the franchisor/licensor may maximize its revenues from the sale of the products. They also typically will feature a full panoply of protections for the franchisor with respect to quality control procedures both for the use of the mark and also for the products that are sold under the mark. Licensors also reserve significant, if not overly broad, audit rights with respect to the business aspects of the relationship, particularly when the license is royalty bearing.

Suppliers who manufacture goods on a private label basis will usually be the sole source of supply for the system. In such cases, franchisors must ensure that the supplier's pricing is not excessive. Suppliers will resist engaging in cost based pricing, because that will give the franchisor the opportunity to review the supplier's entire overhead structure. Accordingly, the franchisor should evaluate the market for branded products similar to those that it seeks to provide to the system and ensure that the pricing is in line with the market.

III. LEGAL ISSUES

A franchisor generally has two overriding concerns when it comes to implementing supplier arrangements for its system. First, the franchisor wants to ensure that the products and services offered by its franchisees are of consistent quality. Second, the franchisor wants to implement its supplier program in a way that protects the distinctiveness of its system from potential competitors. To accomplish this, franchisors usually approve or designate suppliers for specific products and services. For some franchisors, there is a third overriding goal — to profit from franchisee purchases from approved or designated suppliers.

Each of these goals raise potential legal issues relating to franchisees, suppliers or both. Some of these issues are discussed below.

A. Franchise Regulatory Issues

As a starting point for analyzing the legal issues relating to franchise sourcing, it is helpful to review the laws that have been specifically adopted to address franchise supply arrangements. Generally, these laws fall into two categories — disclosure obligations and franchise relationship prohibitions.

The disclosure obligations relating to franchise supply arrangement can be found in the Federal Trade Commission's recently revised Trade Regulation Rule on Franchising (the "FTC Franchise Rule").² The FTC Franchise Rule replaces its antiquated and little-used predecessor and largely adopts the format and substance of the UFOC Guidelines³ and the commentary

² 16 C.F.R. 436 (2007).

³ GUIDELINES FOR PREPARATION OF THE UNIFORM FRANCHISE OFFERING CIRCULAR, as revised and adopted by the North American Securities Administrators Association on April 25, 1993, BUS. FRAN. GUIDE ¶¶ 5751-5775. Fifteen

adopted by the North American Securities Administrators Association (NASAA) relating to it.⁴ The revised FTC Franchise Rule became effective on July 1, 2007 and on that date franchisors were permitted to begin using the new FTC Franchise Rule format. All franchisors must begin using the FTC Franchise Rule format no later than July 1, 2008. With regard to Item 8 sourcing requirements, the new FTC Franchise Rule uses the UFOC Guidelines format and terminology and the FTC Franchise Rule's Statement of Basis and Purpose specifically references the expectation that the FTC will adopt the commentary issued by NASAA.⁵ Therefore, unless the FTC Franchise Rule differs explicitly from the UFOC Guidelines on a particular point, a franchisor's disclosure obligations will be identical under the newly revised FTC Franchise Rule as they would have been under the UFOC Guidelines. In this paper, we refer to the FTC Franchise Rule and the UFOC Guidelines collectively as the "Disclosure Obligations," unless the FTC Franchise Rule's requirement differs explicitly from that of the UFOC Guidelines.

Several states also have adopted franchise relationship laws which, among other things, limit a franchisor's ability to impose sourcing restrictions on their franchisees. These restrictions may increase the availability of alternative sources of supply for franchisees, limit the ability of the franchisor to collect rebates from suppliers or restrict the ability of franchisors to increase the prices of products.

1. **FTC and State Disclosure Obligations**

Sourcing requirements and abuse of the franchisor's control over the supply chain are frequent areas of complaints by franchisees. To address this, fifteen states and the FTC have required a franchisor to provide pre-sale disclosures to prospective franchisees. The Disclosure Obligations requires a franchisor to disclose three types of information about each source restriction — the item subject to the restriction, the criteria and manner of the franchisor's approval of suppliers, and the extent to which the franchisor will derive revenue from franchisee purchases.

a. **Approved/Designated Suppliers**

As noted above, in creating a supply chain, a franchisor is usually primarily concerned with ensuring the uniformity and quality of the products and services offered by franchisees. Accordingly, most franchisors identify specific items that are important to the system and which, therefore, are subject to some sort of source restriction. As a threshold matter, Item 8 of the Disclosure Obligations requires franchisors to disclose those "goods, services, supplies,

states have adopted the UFOC format by statute or regulation, including: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Additionally, states may, in effect, require compliance with the FTC Franchise Rule by application of that state's Deceptive Trade Practices Act (commonly referred to as "Little FTC Acts"). See *generally* Angela M. Fifelski and John G. Parker, *Claims Under Little FTC Acts*, American Bar Association 28th Annual Forum on Franchising (2005).

⁴ COMMENTARY DATED APRIL 18, 1999 ON THE UNIFORM FRANCHISE OFFERING CIRCULAR, BUS. FRAN. GUIDE ¶¶ 5790.

⁵ 16 C.F.R. 436, BUS. FRAN. GUIDE ¶¶ 6011-6026; see also 72 Federal Register 15,444 (March 30, 2007), § I.E. (stating "the Commission anticipates that Compliance Guides will likely incorporate, in large measure, the UFOC Guidelines' existing sample answers and NASAA's previously issued commentaries on the UFOC Guidelines, to the extent such sample answers and commentaries do not deviate from the final amended Rule" (footnote omitted)).

fixtures, equipment, inventory, computer hardware and software, real estate or other items” that are subject to the franchisor’s source limitations.⁶

The Disclosure Obligations generally require disclosure concerning two types of supplier restrictions that a franchisor may impose on franchisees -- designated suppliers and approved suppliers. Designated suppliers are suppliers from whom the franchisee must purchase a particular product or service. Approved suppliers are those suppliers from whom franchisees are permitted to purchase certain products or services. Usually, a franchisor will maintain a list of approved suppliers from whom franchisees may elect to purchase and criteria by which new suppliers may become approved. As a practical matter, Item 8 requires the same information about designated suppliers as it does for approved suppliers.

Franchisees and franchisee advocates periodically argue that approved supplier programs are — in essence — a sham, and that their franchisor does not, in practice, approve additional suppliers (they may additionally or alternatively contend that the approval criteria for new suppliers is so ambiguous that new suppliers cannot meet the approval requirements). In addition, franchisees and their representatives sometimes argue that franchisors simply do not review or respond to franchisee requests for approval of alternative suppliers. To address these concerns, Item 8 requires that a franchisor disclose all “obligations to purchase or lease . . . from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor’s specifications.”⁷ The franchisor must disclose “[t]he manner in which the franchisor issues and modifies specifications or grants or revokes approval to suppliers.”⁸ Finally, if the franchisor or its affiliates supply any products to franchisees, the franchisor must disclose that fact and whether they are the only approved suppliers for those items.⁹

One area in which the FTC Franchise Rule differs from the UFOC Guidelines is its requirement that franchisors disclose any suppliers in which any officer of the franchisor owns an interest.¹⁰ This requirement, if strictly interpreted, could create onerous disclosure obligations for some franchisors. For example, in systems which have numerous suppliers, this requirement seems to suggest that a franchisor must obtain information from its officers about all of their stock holdings and disclose any holdings in companies that provide any product or service to franchisees.

b. Franchisor Revenues from Franchisee Purchases

One of the most significant provisions of Item 8 of the Disclosure Obligations is the requirement that franchisors disclose the “precise basis by which the franchisor or its affiliates will or may derive” revenue or other material consideration as a result of required purchases or leases.¹¹ A

⁶ 16 C.F.R. 436(h), *see also* GUIDELINES, Item 8.

⁷ 16 C.F.R. 436(h), *see also* GUIDELINES, Item 8.

⁸ 16 C.F.R. 436(h)(5), *see also* GUIDELINES, Item 8.

⁹ 16 C.F.R. 436(h)(2), *see also* GUIDELINES, Item 8.

¹⁰ 16 C.F.R. 436(h)(3).

¹¹ 16 C.F.R. 436(h)(6), *see also* GUIDELINES, Item 8.

“precise basis,” includes disclosing the revenues the franchisor receives from franchisee purchases and the proportion of the franchisor’s total revenues represented by such franchisee purchases.¹² Interestingly, the Item 8 requirement to disclose “[w]hether the franchisor ... *will or may derive revenue*” (emphasis added) appears to contemplate disclosure of prospective information, rather than historic data.¹³ But, the “precise basis” under the Item 8 disclosures appear to require historical information only.¹⁴ So, questions have been posed about whether the franchisor has any obligation to predict the extent to which it will receive revenues from suppliers over the term of the franchise.

Another area of confusion regarding whether a franchisor has any obligation to predict its receipt of compensation from suppliers in consideration of franchisee purchases is the franchisor’s obligation to disclose rebates paid by suppliers. The instructions to Item 8 appear to contemplate forward-looking disclosures in that they require that a franchisor must disclose the basis for payments made by suppliers to the franchisor “[i]f the designated supplier *will* make payments to the franchisor” (emphasis added).¹⁵ This language is the source of some uncertainty for franchisors and a potential source of contention for franchisees. If this language is interpreted to mean that a franchisor must disclose every future rebate which it will collect on purchases made by a particular franchisee, franchisors will either have no ability to accept new rebates on products or services or they will be forced to track permissible rebates on a franchisee-by-franchisee basis (which may raise some Robinson-Patman issues, as discussed below). As a practical matter, franchisors generally state in Item 8 that they retain the contractual right to change or modify their supply programs, including accepting new or different rebates from suppliers. This disclosure is intended to directly refute any claim that a yet-to-be-determined rebate will make the Item 8 disclosure false or misleading.

c. Identity of Suppliers

Franchisors clearly must identify the extent to which they or their affiliates are the “only” approved suppliers for franchisee purchases and whether any franchisee purchases from the franchisor and its affiliates are “source-restricted.”¹⁶ Some confusion arose under the language of the Item 8 Guidelines based on the fact that neither the Guidelines nor the instructions to the Guidelines required the franchisor to identify, by name, specific suppliers, but the sample answer to Item 8 did specifically reference an identified supplier. NASAA addressed this issue in its 1994 commentary by stating that “[f]ranchisors are not required to identify by name any

¹² 16 C.F.R. 436(h)(6), *see also* GUIDELINES, Item 8. (A footnote to the FTC Franchise Rule and Instruction iii to Item 8 of the Guidelines also note that the amounts should be taken from the franchisor’s most recent audited financial statement. If the franchisor’s affiliate receives revenue from franchisee purchases, similar information must be provided about the affiliate’s revenues and the source of the data must be disclosed. *See* 16 C.F.R. 436(h)(6) (iv).)

¹³ 16 C.F.R. 436(h)(6), *see also* GUIDELINES, Item 8.

¹⁴ *See* 16 C.F.R. 436(h)(6)(i), note 5 *and* GUIDELINES, Item 8, Instruction iii (each stating that figures should be taken from the franchisor’s most recent annual audited financial statement).

¹⁵ 16 C.F.R. 436(h)(8), *see also* GUIDELINES, Item 8, Instruction vii. Note that although the language of the Guidelines’ instruction on this point refers only to “designated” suppliers, the 1994 commentary to the Guidelines states that this instruction “requires the disclosure of all rebates paid by ... approved suppliers whose goods and services meet specifications.” COMMENTARY, BUS. FRAN. GUIDE ¶ 5790.

¹⁶ 16 C.F.R. 436(h)(2), *see also* GUIDELINES *and* COMMENTARY.

suppliers who pay rebates.” The wording of this answer could be read to suggest that although franchisors are not required to state whether a particular supplier pays a rebate to the franchisor and that the identity of the suppliers may still be required, the FTC Franchise Rule does not address this issue directly and no state agency has taken the position that the identity of all suppliers are required and franchisors do not, as a general matter, provide this information.

2. State Restrictions

In response to franchisee concerns over franchisors’ ability to unilaterally determine the source and terms of franchisees’ sources of supply, some states have limited franchisors’ rights by statute. Typically, these limitations fall into two categories: (1) availability of alternative sources of supply and (2) restrictions on supplier rebates. State law also may place restrictions on the franchisor’s ability to set prices to franchisees.

a. Alternative Sources

Hawaii, Indiana, Iowa and Washington each have statutes that limit a franchisor’s right to dictate the sources of supply for products and services used in or sold by the franchised business. Generally, each statute makes it either (a) unlawful¹⁷ or (b) an unfair or deceptive trade practice or an unfair method of competition¹⁸ to require that a franchisee purchase or lease goods or services from designated sources, except under limited circumstances.

Hawaii

Hawaii provides that limitations on sources are permitted if they are “reasonably necessary for a lawful purpose justified on business grounds.”¹⁹

Indiana

Indiana prohibits the designation of sources by the franchisor “where such goods, supplies, inventories, or services of comparable quality are available from sources other than those designated by the franchisor” but notes that the approval of suppliers based on the suppliers compliance with the franchisor’s specifications does not constitute “designation” of sources under the statute.²⁰ Indiana’s statute further notes that it does not apply to “the principal goods, supplies, inventories, or services manufactured or trademarked by the franchisor.”²¹

¹⁷ See, e.g., IND. CODE ANN. § 23-2-2.7-1; IOWA CODE § 523H.12; and IOWA CODE § 537A.10.

¹⁸ See, e.g., HAW. REV. STAT. § 482E-6(2); and WASH. REV. CODE § 19.100.180(2) (2005).

¹⁹ HAW. REV. STAT. § 482E-6(2)(B).

²⁰ IND. CODE ANN. § 23-2-2.7-1(1).

²¹ *Id.*

Iowa

Iowa has two statutes that address source restrictions, one of which applies to agreements entered into before July 1, 2000 and one that applies to agreements entered into on or after July 1, 2000.²² For pre-July 1, 2000 agreements, franchisors must allow franchisees to use other sources of supply “provided that such goods and services meet standards as to their nature and quality promulgated by the franchisor.”²³ Reasonable quantities of inventory may be required to be purchased from the franchisor or its affiliate if they are “central to the franchised business and are either manufactured or produced by the franchisor or its affiliate, or incorporate a trade secret owned by the franchisor or its affiliate.”²⁴ The Iowa statute applicable to agreements entered into after July 1, 2000 gives a franchisor more leeway in that it allows a franchisor to approve or disapprove suppliers based upon specifications and standards prescribed by the franchisor.²⁵

Washington

Washington places the burden of proof on the franchisor to show that the source restriction is “reasonably necessary for a lawful purpose justified on business grounds, and do[es] not substantially affect competition.”²⁶ The statute further provides that courts should look to United States antitrust laws to determine whether the restriction is unfair or deceptive.²⁷

b. Rebates

If a franchisor will receive a rebate from a supplier on account of franchisee purchases, Hawaii and Washington require that the franchisor disclose the rebate to the franchisee in advance²⁸ It is interesting to note that neither of these statutes specifies that the disclosure must be made at or before the signing of the franchise agreement (as, for example, in Item 8 of the offering circular). So, it appears that each law imposes an ongoing obligation to disclose the rebate to the franchisee in advance, throughout the term of the relationship. Indiana’s law is more substantive -- rebates, if any, must be “promptly accounted for, and transmitted to the franchisee.”²⁹

²² See IOWA CODE § 523H.2A and IOWA CODE § 537A.10.

²³ IOWA CODE § 523H.12.

²⁴ *Id.*

²⁵ IOWA CODE § 537A.10.

²⁶ WASH. REV. CODE § 19.100.180(2)(b).

²⁷ *Id.*

²⁸ See HAW. REV. STAT. § 482E-6(2)(D) and WASH. REV. CODE § 19.100.180(2)(e).

²⁹ IND. CODE ANN. § 23-2-2.7-1(4).

c. Pricing

Indiana and Washington have each adopted relationship laws that address the prices paid by franchisees to franchisors. Indiana's law provides that it is unlawful to increase the price of goods provided by the franchisor which the franchisee has ordered for a customer.³⁰ Washington's statute states that selling or renting products or services to franchisees at more than fair and reasonable prices is an unfair method of competition.³¹

B. UNIFORM COMMERCIAL CODE

As noted above, franchise supply arrangements generally involve the sale of goods. Therefore, these transactions are normally covered by the applicable state's version of the Uniform Commercial Code ("UCC").

The purpose of the UCC is to "simplify, clarify and modernize" commercial law, as well as to make the law uniform among the states.³² At the same time, most (but not all) of the provisions of the UCC can be varied by the parties in their contracts.³³ Thus, the UCC should be thought of as providing default terms or acting as a "gap filler" in case a contract does not address a specific term. The UCC should not be relied on too heavily for this purpose, however, as the UCC does not address every term important to the contracting parties. This discussion will focus on some of the obligations that Article 2 of the UCC does address, *i.e.*, warranties, risk of loss, passage of title, and remedies for breach of contract.

1. Warranties

Warranties are risk allocation devices. Under the UCC, generally speaking, risk is allocated to the party that is best able to avoid or insure against the risk. In the case of warranties, the risk is allocated largely to the seller, because, in most cases, the seller has superior knowledge about the product. This is especially true, according to the UCC, when the seller is a "merchant."³⁴ Thus, warranties allocate risk based on comparative advantage, not culpability. Even so, the buyer must demonstrate a causal connection between the breach and the injury suffered. The UCC provides two types of warranties: warranty of quality and warranty of title

³⁰ IND. CODE ANN. § 23-2-2.7-1(6).

³¹ WASH. REV. CODE § 19.100.180(2)(d).

³² UCC § 1-102. The Uniform Commercial Code has been adopted in all states except Louisiana, plus the District of Columbia and the U.S. Virgin Islands, and is, for the most part, uniform among the states. Article 2 of the UCC, which is discussed here, governs sales of goods, but not services. Contracts for services are governed by state contract law.

³³ The "obligations of good faith, diligence, reasonableness and care" cannot be disclaimed by agreement. UCC § 1-102 (3). The parties can, however, decide the standards by which their obligations are to be measured. *Id.*

³⁴ The rules in Article 2 often distinguish between merchants and non-merchants. Article 2 defines a "merchant" as a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the goods in the transaction. To be a merchant, however, the person need not actually have the skills or knowledge; it is sufficient that these skills and knowledge can be attributed to him by his occupation or employment. § 2-104. When viewed in this light, the UCC's rationale behind allocating much of the risk on the seller becomes clear.

and infringement. Quality warranties are subdivided into two types: express warranties and implied warranties. Each is discussed in turn below.

a. Warranties of Quality

i. Express Warranties

Express warranties can be created either by the words or the conduct of the seller.³⁵ They are created either by the seller making an affirmation of fact or promise about the goods, by giving a description of the goods, or by providing a sample or model of the goods.³⁶ The substance of the warranty in each case is that the goods will conform to the affirmation, promise, description, sample or model. The seller need not use the words “guarantee” or “warranty” to create the warranty.³⁷ In fact, the seller need not even have a specific intention to make a warranty in order to create one.³⁸ In addition, express warranties can be created and become part of the bargain even after the sale is complete; for example, when a buyer takes delivery of a car and asks for additional assurances about the car, those additional assurances would be deemed express warranties.³⁹ Also, any seller can make an express warranty; the seller need not be a merchant.⁴⁰

Express warranties must be distinguished from sales talk or “puffing,” which are not warranties. To qualify as an express warranty, the statement must be more than the seller’s opinion. For example, a claim that “this is the best car on the market” would be deemed puffing and not a warranty. Whether a statement is an express warranty or merely sales talk depends on whether the statement reveals the type of information that would reasonably be thought of to be within the seller’s knowledge. Put another way, since the seller has superior knowledge about the product, if the seller makes a statement about the goods and does not qualify the statement as his opinion, the statement will be treated as a statement of fact and therefore an express warranty.⁴¹ For example, if a jeweler described diamonds as being of “v.v.s” quality, this description would be an express warranty.⁴²

In franchise supply relationships, suppliers will generally be deemed to have made an express warranty by virtue of the fact that they are supplying their goods to meet specifications and standards set by the franchisor.

³⁵ Examples of conduct would include providing a sample or model of the goods, or providing technical specifications or blueprints. UCC § 2-313, Official Comment 5.

³⁶ UCC § 2.313(1).

³⁷ UCC § 2-313(2).

³⁸ *Id.*

³⁹ UCC § 2-313, Official Comment 7.

⁴⁰ See note 30, *supra* for the definition of “merchant”.

⁴¹ *Daughtrey v. Ashe*, 243 Va. 73, 413 S.E.2d 336 (1992).

⁴² *Id.*

ii. Implied Warranty of Merchantability

The warranty of merchantability arises automatically (unless excluded, as discussed below) in every contract where the seller is a merchant with respect to the type of goods sold.⁴³ To be “merchantable,” the goods must pass without objection in the trade as being the goods described.⁴⁴ But, the goods only have to be of “fair average quality” within that description to be merchantable. This warranty only arises if the seller is a merchant with respect to the type of goods being sold. Thus, this warranty would not arise in a sale of a used car by a consumer seller, but would arise if the car was sold by a used car dealer.

iii. Implied Warranty of Fitness for a Particular Purpose

The implied warranty of fitness for a particular purpose arises when, at the time of the sale, the seller knows about the specific purpose for which the buyer wants the goods, the seller selects specific goods for this purpose, and the buyer relies on the seller’s expertise to supply the correct goods.⁴⁵ Thus, the buyer must have a specific purpose for the goods (as opposed to an ordinary purpose, which is covered by the warranty of merchantability), the seller must know about the purpose, the seller must choose the goods based on this purpose, and the buyer must rely on the seller’s skill or judgment to choose the correct goods. In this situation, the seller need not be a merchant, because the rationale is that the seller has lulled the buyer into stopping any additional search for the goods. This warranty can only arise at the time of the sale, however, and not afterwards. In addition, the warranty only applies if the goods are being used in the manner intended.⁴⁶

b. Warranty of Title and Infringement

There are two parts to this warranty. First, the seller promises that the seller has good title to the product and has the right to transfer the title free of any security interests, liens and encumbrances.⁴⁷ This warranty protects the buyer in case the seller sells stolen goods. If the goods are stolen, the buyer must return them but will have a breach of warranty claim against the seller. Similarly, if the goods are sold subject to a lien and the lien holder forecloses on the goods, the buyer will be able to recover damages from the seller.

Second, if the seller is a merchant, the seller also promises that the goods are free of infringement or similar claims.⁴⁸ A patent infringement claim is a good example. An actual claim need not be asserted against the buyer in order for the buyer to recover damages for breach of this warranty. If the buyer learns that an infringement claim has been brought against the seller, the buyer can rescind the contract and recover damages from the seller. If, however,

⁴³ UCC § 2-314 (1).

⁴⁴ UCC § 2-314(2).

⁴⁵ UCC § 2-315.

⁴⁶ *Layne-Atlantic Co. v. Koppers, Co.*, 214 Va. 467, 201 S.E.2d 609 (1974).

⁴⁷ UCC § 2-312(1).

⁴⁸ UCC § 2-312(3).

the seller obtains a license which allows the buyer to continue to use the goods, then the buyer may not be able to rescind the contract.⁴⁹ On the other hand, if the buyer provides the product specifications to the seller, then the buyer must indemnify the seller against infringement claims that arise out of the seller's compliance with the buyer's specifications.⁵⁰

c. Warranty Claims Against a "Remote Seller"

In most instances, the manufacturer is not the seller to the ultimate consumer. The goods are sold through a distributor or resaler (in some cases, the franchisor). Thus, the ultimate consumer does not have a direct contractual relationship with the manufacturer. The absence of a contractual relationship (called "privity") between the seller and the party seeking damages for breach of warranty is no longer a defense to a claim of breach of warranty.⁵¹ Indeed, the person seeking damages for breach of warranty need not be the purchaser at all. The UCC provides three alternatives to the states for deciding who can be the beneficiary of a warranty.⁵² Alternative A, which is the most restrictive, limits warranty coverage to natural persons (as opposed to a company), who live with or are guests of the buyer, and limits coverage to personal injury only. Alternative B also limits coverage to natural persons and personal injury, but extends coverage to anyone who may reasonably be expected to use, consume or be affected by the goods". Coverage under alternative C is not limited to natural persons or to personal injury, but extends to any person whom the manufacturer or seller might reasonably have expected to use, consume, or be affected by the goods. In spite of the words "personal injury" in alternatives A and B, some states have extended coverage to claims for property damage.⁵³ To recover economic damages, such as lost profits, however, some states (but not all) have held that the buyer and seller must have a direct contractual relationship.⁵⁴

d. Excluding Warranties

Typically in supply agreements, sellers exclude some or all of the UCC warranties and replace them with their own warranties, or provide none at all. Express warranties can be disclaimed, but the seller must be careful in how it is done because the courts typically disfavor such disclaimers.⁵⁵ For example, some sales agreements will give express warranties and then include a blanket disclaimer of all warranties. The disclaimer probably would be construed as

⁴⁹ See, e.g., *Yttro Corp. v. X-Ray Marketing Assn.*, 540 N.W.2d 172 (S.D. 1995).

⁵⁰ UCC § 2-312(3).

⁵¹ See, e.g., *Williams v. Gradall*, 990 F. Supp. 442 (E.D. Va. 1998); *Beard Plumbing & Heating, Inc. v. Thompson Plastics, Inc.*, 254 Va. 240, 491 S.E. 2d 731 (1997) (privity of contract required to recover economic damages for breach of implied warranty of merchantability).

⁵² UCC § 2-318.

⁵³ See, e.g., *Kassab v. Central Soya*, 246 A.2d 848 (Pa. 1968).

⁵⁴ See, e.g., *Westchester County v. General Motors Corp*, 555 F. Supp. 290 (S.D.N.Y. 1983); *Beard Plumbing & Heating, Inc. v. Thompson Plastics, Inc.*, 254 Va. 240, 491 S.E. 2d 731 (1997) (privity of contract required to recover economic damages for breach of implied warranty of merchantability).

⁵⁵ UCC § 2-316.

disclaiming all warranties except those expressly stated in the agreement. In other words, the seller cannot give a warranty with one hand and then take it away with the other.

An express warranty given by the description of the goods cannot be disclaimed.⁵⁶ For example, if a product was described as a boat and the seller delivered a toy airplane, the seller would have breached the express warranty given by the description of the product.

To exclude the implied warranty of merchantability effectively, the exclusion must specifically mention the word “merchantability.”⁵⁷ If the exclusion is in writing (which suggests the exclusion need not be in writing), then it must be conspicuous.⁵⁸ An exclusion of the warranty of fitness for a particular purpose, on the other hand, must be in writing and must be conspicuous.⁵⁹ Both implied warranties can be excluded by saying “there are no warranties which extend beyond the description on the face hereof,” or by using the words “as is,” or “with all faults,” or similar language.⁶⁰ Implied warranties can also be excluded by course of dealing, course of performance, or usage of trade.⁶¹

The warranty of title can be disclaimed only by specific language, or by circumstances that give the buyer reason to know that the seller does not claim to have title or is only selling such rights or title that the seller has.⁶² Examples of these circumstances would be sheriff’s sales and estate sales.⁶³

In negotiating the terms of supply arrangements with suppliers, franchisors should be attentive to the types of warranties the supplier/manufacturer intends to exclude and make an informed decision of whether the elimination of a particular warranty may jeopardize its certainty that franchisees will be receiving products that meet the franchisor’s expectations for quality and uniformity. Likewise, where the franchisor takes on the role of middleman, it should be aware which warranties it may be making to its franchisees with regard to each sale of goods.

⁵⁶ According to the official comment to the UCC, a contract “clause generally disclaiming ‘all warranties, express or implied’ cannot reduce the seller’s obligation” with respect to an express warranty given by a description of the goods, and therefore “cannot be given literal effect.” The rationale is that the buyer is agreeing to buy something that is describable; if the description is disclaimed, then the buyer isn’t really getting anything for the price and, “the probability is small that a real price is intended to be exchanged for a pseudo-obligations.” What this means in practice is that even if a seller attempted to exclude all “express warranties”, this would really mean that the seller excludes all express warranties other than the description of the goods.

⁵⁷ UCC § 2-316(2).

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² UCC § 2-312(2).

⁶³ *Id.*, Comment 5.

Exclusions of warranties should not be confused with limitations on the remedies for breach of warranty, which are discussed below.⁶⁴

2. Risk of Loss and Insurance

If the goods are lost, damaged or stolen between the time the contract is formed and the buyer receives and accepts the goods, which party bears the risk? The UCC places the risk on the party most likely to insure the goods. Usually, but not always, this is the party who possesses or controls the goods. As a general statement, risk of loss passes from the seller to the buyer upon seller's "tender of delivery."⁶⁵ When tender of delivery occurs depends, however, on the shipping terms in the contract. In addition, this rule only applies in the absence of a breach of contract.⁶⁶

There are four scenarios in which the risk of loss will be an issue. First is if the goods are lost or damaged while they are still in the seller's possession. If the seller is a merchant, then the risk of loss will be placed on the seller.⁶⁷ If the seller is not a merchant, however, then if the seller has made the goods available to the buyer to pick up ("tender of delivery"), the risk of loss will be placed on the buyer.⁶⁸

The second scenario is where the goods are in the hands of a bailee, such as a warehouse, when the goods are damaged or lost. Allocation of risk of loss between the buyer and the seller will depend on which party has the *right* of possession of the goods, (not actual possession, obviously, since the bailee has actual possession). For example, risk of loss will be placed on the buyer if the buyer has received a negotiable document of title covering the goods.⁶⁹ The buyer will also bear the risk of loss if the bailee has acknowledged to the buyer that the buyer has the right of possession.⁷⁰ Third, the buyer will bear the risk of loss if the bailee has received a non-negotiable document of title or other direction to deliver the goods to the buyer before the goods are lost, stolen or damaged.⁷¹

⁶⁴ UCC § 2-316(4).

⁶⁵ UCC § 2-509.

⁶⁶ *Id.*

⁶⁷ UCC § 2-509(3).

⁶⁸ *Id.*

⁶⁹ UCC § 2-509(2)(a).

⁷⁰ UCC § 2-509(2)(b).

⁷¹ UCC § 2-509(2)(c). The buyer may have a cause of action against the bailee for the loss. If the bailee is a warehouseman, then the warehouseman is liable for damages for the loss or injury to the goods "caused by his failure to exercise such care in regard to them as a reasonably careful man would exercise under like circumstances," in other words, caused by the warehouseman's negligence. § 7-204. Warehousemen cannot deny liability for their negligence, but they can limit the amount of damages for which they are responsible. *Id.*

In the third scenario, the loss occurs during transit. This is where the shipping terms used in the contract become important. Many supply contracts use the FOB shipping term and state that the FOB point is either the seller's place of business or the buyer's place of business. The parties usually intend that the risk of loss will pass at the FOB point. In other words, if the contract states the FOB point is the place of shipment, the seller has the risk of loss until it places the goods into the possession of the carrier.⁷² If the FOB point is the place of destination, then the seller has the risk of loss until the goods reach the place of destination.⁷³ The parties are free to change this allocation of risk of loss by contract, and thus, special attention should be placed on the shipping term.⁷⁴

Finally, the loss could occur after the goods have reached the buyer, but before the buyer has accepted the goods. Since at the very latest, risk of loss passes to buyer upon receipt of the goods, the risk of loss would be on the buyer if the buyer had received the goods, even if the buyer had not yet accepted them. In this situation, however, the buyer would be able to revoke its acceptance and seek remedies for breach of contract, because the delivery of the goods would have failed to conform to terms of the contract.⁷⁵

The UCC does not address insurance obligations *per se*, but they would follow the risk of loss. As long as the seller retains the risk of loss, the seller should insure the goods. The buyer should insure the goods from the point that the risk of loss passes to the buyer.

Note that these UCC risk of loss rules are default rules only; the parties can alter these rules in the contract.⁷⁶ But, the parties must use specific language that clearly indicates when the risk of loss passes in order to avoid the default rules. If the contract language is not clear, the default rules will apply.⁷⁷

The UCC rules are different, however, if the contract has been breached before the time of loss. If the seller has breached the contract by delivering defective goods, then the risk of loss remains on the seller until the seller cures the defect or the buyer accepts the goods.⁷⁸ But this shifting back to seller only applies to the extent the buyer's insurance does not cover the loss.⁷⁹ Similarly, if the buyer has breached or repudiated the contract before the risk of loss has passed to the buyer, the seller can nevertheless treat the risk of loss as resting on the buyer for a commercially reasonable time, but again, only to the extent that seller's insurance does not

⁷² UCC § 2-319(1)(a).

⁷³ UCC § 2-319(1)(b).

⁷⁴ *Id.*

⁷⁵ UCC § 2-503; UCC § 2-601. This is known as the "perfect tender rule." In other words, if the goods are damaged, then they are not "conforming" goods and the buyer has the right to reject them.

⁷⁶ UCC § 2-509(4).

⁷⁷ See, e.g., *Lynch Imports v. Frey*, 558 N.E. 2d 484 (Ill. Spp. Ct. 1990).

⁷⁸ UCC § 2-510(1).

⁷⁹ *Id.*

cover the loss.⁸⁰ What is considered to be a “commercially reasonable time” will depend on the circumstances.

3. Passage of Title

Title passes “in any manner and on any conditions explicitly agreed on by the parties.”⁸¹ In the absence of an express agreement, title passes when the seller has completed the physical delivery of the goods.⁸² If the contract requires the seller to deliver the goods to the buyer’s destination, title passes when the goods get there.⁸³ If the contract doesn’t require delivery to a particular destination (as under a shipment contract), title passes when the seller has given the goods to the carrier.⁸⁴ If delivery takes place without moving the goods, then title passes when the seller delivers the documents of title to the buyer.⁸⁵ Note that under these default rules, the payment arrangement does not affect the passage of title. As a matter of practice, however, sellers often delay the passage of title until they receive payment, and the UCC allows them to do so.

4. Remedies

a. Purpose and Scope of UCC Default Remedies

The purpose of remedies under the UCC (as in contract law in general) is to put the non-breaching party in as good a position as if the other party had fully performed.⁸⁶ This is called the “expectation measure of damages.” Again, the UCC sets the default terms; the parties are free to decide which remedies will apply.

If the buyer breaches, the UCC provides a menu of remedies from which the seller can choose. For example, if the buyer refuses to accept and pay for the goods, and the seller re-sells the goods at a price lower than the contract price, the seller can recover the difference between the contract price and the resale price.⁸⁷ If the seller is unable to re-sell the goods, then the seller

⁸⁰ UCC § 2-510(3).

⁸¹ UCC § 2-401(1). This provision is subject to Article 8 of the UCC, which governs secured transactions. Also, title cannot pass to the buyer until the goods are existing and identified. What this means is that the goods must be set aside and designated as the buyer’s goods. As long as they are not designated for the buyer, title cannot pass to the buyer. UCC § 2-501.

⁸² UCC § 2-401(2).

⁸³ UCC § 2-401(2)(b).

⁸⁴ UCC § 2-401(2)(a).

⁸⁵ UCC § 2-401(3). Or, if the goods are identified at the time of contracting, then title passes at the time and place of contracting. *Id.*

⁸⁶ UCC § 1-106.

⁸⁷ UCC § 2-706.

can recover the difference between the contract price and the then-current market price.⁸⁸ The seller is also entitled to lost profits and incidental expenses.⁸⁹ Or, the seller can seek an action for the price,⁹⁰ withhold delivery,⁹¹ stop delivery,⁹² reclaim the goods,⁹³ or cancel the contract.⁹⁴ Some remedies are mutually exclusive; others are not. The bottom line is that the seller can seek a combination of remedies that will make the seller whole but not give the seller a windfall.

If the seller breaches, the buyer likewise can choose from a menu of remedies. If, for example, the seller fails to deliver the promised goods and the buyer has to buy them at a higher price (called “cover”), then the buyer can recover the difference between the cover price and the contract price.⁹⁵ Or, if the seller delivers defective goods, the buyer can accept the goods and seek a reduction in price⁹⁶ or the difference in value between conforming goods and the defective goods.⁹⁷ In some situations, the buyer can seek specific performance (force the seller to perform).⁹⁸ The buyer can also seek incidental and consequential damages,⁹⁹ claim the goods on payment,¹⁰⁰ or cancel the contract.¹⁰¹ As with the seller’s remedies, some of the buyer’s remedies are mutually exclusive. For example, if the buyer accepts non-conforming goods, the buyer cannot cancel the contract or obtain cover damages. Instead, the buyer’s damages would be measured by the difference between the value of the goods accepted by the buyer and the value of the goods had they been conforming.¹⁰²

⁸⁸ UCC § 2-708(1).

⁸⁹ UCC § 2-708(2) (lost profits); UCC § 2-710 (incidental expenses).

⁹⁰ UCC § 2-709.

⁹¹ UCC § 2-702.

⁹² UCC § 2-705(1).

⁹³ UCC §§ 2-507, 2-703.

⁹⁴ UCC § 2-703.

⁹⁵ UCC § 2-712. The buyer also has the option of seeking the difference in value between the market price and the contract price.

⁹⁶ UCC § 2-717.

⁹⁷ UCC § 2-714. This is called the “value differential.”

⁹⁸ UCC § 2-716.

⁹⁹ UCC § 2-715.

¹⁰⁰ UCC § 2-502(1).

¹⁰¹ UCC § 2-711.

¹⁰² UCC § 2-714.

b. Contractual Limits on Remedies and Damages

Remedy limitations fix the breaching party's liability. For example, the seller's remedy may be limited to repairing or replacing defective goods. Damage exclusions, on the other hand, allocate the risk of certain types of damages between the seller and buyer. For example, a damage exclusion clause may exclude the seller's liability for lost profits. A third type of limitation is a cap on the total amount of the seller's liability. From the seller's point of view, such limitations, exclusions and caps are essential elements in the seller's bargain. A contract without such limitations may not be worth the risk to the seller.

A common limitation of remedies gives the seller the exclusive right to repair or replace nonconforming goods. Thus, the buyer cannot cancel the contract or recover damages for the nonconformity.

With respect to damages, contracts commonly exclude consequential, incidental, and indirect damages, such as lost profits and production down time. These are usually bundled together in one long phrase in all caps, e.g., :

IN NO EVENT WILL SELLER BE LIABLE FOR CONSEQUENTIAL,
INCIDENTAL OR INDIRECT DAMAGES, INCLUDING BUT NOT LIMITED TO
LOST PROFITS.¹⁰³

The proper characterization of damages as direct or indirect, consequential, etc., is essential to understanding the scope and impact of this type of exclusion. Unfortunately, this will be a question of fact that must be decided on a case-by-case basis.¹⁰⁴ In *Metric Constructors, Inc. v. Hawker Siddeley Power Eng'g, Inc.*, 468 S.E.2d 435 (1996) the court characterized overtime costs, loss of productivity, and extended overhead as "direct" damages, although they are typically considered "consequential damages." The court cited the sophistication of the defendant, a corporation well-versed in the nature and terms of the project and the industry, as the primary reason why it believed the defendant had contemplated that delays on its part would result in the damages claimed by the plaintiff. Thus, for the seller, it is important that the exclusion be written as broadly as possible.

Generally speaking, "direct" damages are foreseeable damages that a reasonable person, in the ordinary course of events, would expect as a result of a breach.¹⁰⁵ Direct damages are always recoverable, unless expressly excluded in the contract, if the plaintiff can prove that the

¹⁰³ Interestingly, the UCC requires warranty exclusion language to be "conspicuous", thus the exclusion is printed in all capital letters, but does not require limitations of liability or remedies to be conspicuous. UCC § 2-316(2)(warranty exclusions); UCC § 2-719. *Flintkote Co. v. W.W. Wilkinson, Inc.*, 220 Va. 564, 260 S.E. 2d 229 (1979). Nevertheless, as a matter of drafting practice, they usually are.

¹⁰⁴ The proper characterization of a damages claim is an issue of fact to be decided by the jury. See 2 U.C.C. Reporter Digest § 2-102. Many determinations rely heavily on the specific facts of the case instead of on a bright-line, steadfast rule. Even seemingly simple determinations, such as whether the damages are direct or not, are less clear-cut and predictable than one would anticipate.

¹⁰⁵ See, e.g. *Philbrick v. Kendall*, 88 A. 540, Me. (1913) (holding a seller liable for the direct damages resulting from failure to furnish fertilizer that complied with the requirements of the brand ordered. The buyer recovered the difference in value between the crop actually raised and the crop that might have been raised if there had been compliance).

injury occurred as a result of the breach. As shown above, however, in some situations, lost profits might be a direct damage, but if the contract specifically excludes lost profits (which they often do), then this remedy would not be available. As a result, remedy exclusions should be examined carefully.

“Indirect” or “remote” damages is a term often used synonymously with special, incidental or consequential damages. “Incidental” damages, in contrast to direct damages, do not flow in ordinary course from the seller’s breach. Rather, incidental damages are the “costs that the aggrieved party incurs in unwinding the transaction after the breaching party has breached the ... contract.”¹⁰⁶ In other words, they are the damages incurred by the non-breaching party while effecting “cover.” Instead of defining incidental damages, the UCC lists examples of incidental damages, including any reasonable expenses incurred in the inspection, storage, transportation, or reselling of goods that have been rightfully rejected.¹⁰⁷ All of these damages would be excluded under a limitation of liability clause.

“Consequential” damages, like incidental damages, do not flow directly and immediately from a breach; instead “they result indirectly from the act.” Whereas incidental damages arise within the scope of the immediate buyer-seller transaction, consequential damages arise from losses incurred by the non-breaching party, often in dealings with third parties.¹⁰⁸ Examples of consequential damages include lost opportunity costs, loss of goodwill, losses resulting from interruption of buyer’s production process, and lost interest. In addition, under the UCC, consequential damages also include injury to person or property proximately resulting from a breach or defective performance, *i.e.*, third party claims, including product liability claims.¹⁰⁹

Consequential damages can be limited or excluded unless the limitation or exclusion is “unconscionable.”¹¹⁰ Under the UCC, a limitation of consequential damages for personal injury in the case of consumer goods is “prima facie unconscionable,” but a limitation of damages where the loss is commercial (e.g., lost profits) is not.¹¹¹

In some contracts, the parties agree to fix their damages ahead of time, which is known as “liquidated damages.” The UCC allows liquidated damages, but they are subject to scrutiny. To be enforceable, liquidated damages must “be reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or

¹⁰⁶ Paul S. Turner, *Consequential Damages: Hadley v. Baxendale Under the Uniform Commercial Code*, 54 S.M.U. L. Rev. 655, 622 (2001).

¹⁰⁷ UCC § 2-715(1) (Comment 1 of Section 2-715 explains that the list is meant to be illustrative, not exhaustive). To recover incidental damages, the buyer must prove the damages were (1) incurred because of the breach and (2) reasonable. White & Summers, U.C.C. § 6-5 (4th ed. 2006).

¹⁰⁸ White & Summers, U.C.C. § 6-5 (4th ed. 2006).

¹⁰⁹ UCC § 2-715.

¹¹⁰ UCC § 2-719(2).

¹¹¹ *Id.* See, also, *Matthews v. Ford Motor Co.*, 479 F.2d 399 (4th Cir. 1973); *Blevins v. New Holland N. Am., Inc.*, 97 F. Supp. 2d 7471 (W.D. Va. 2000).

nonfeasibility of otherwise obtaining an adequate remedy.”¹¹² A contract term that fixes “unreasonably large liquidated damages is void as a penalty.”¹¹³ In one respect, this provision presents a catch-22 to the parties. Liquidated damages are only allowed if the damages are difficult to prove in the event of a loss, and therefore the parties have to guess in order to set the amount of liquidated damages. At the same time, the guess has to be “reasonable”; if the parties guess too high, the liquidated damages will be void as a penalty.

Finally, often sellers will put a cap on the amount of damages for which they will be responsible. Typically the cap will be set at the amount of compensation payable under the contract. This means, for example, that the seller will only repair or replace defective product until the cap is reached. After that point, the buyer bears the risk. These provisions are especially onerous in the case of specially manufactured goods or specialty goods that could require multiple attempts to fix.

As with the exclusion of warranties, franchisors should closely examine what remedies they or their franchisees may have against a supplier, paying particular attention to the particular role they have decided to play in the transaction.

C. Antitrust

Although many antitrust theories have been offered over the years to attack the validity of various restrictions placed on franchisees by franchisors, in recent years, the most fertile areas of franchise antitrust law as it relates to the franchise supply chain are in tying and price discrimination.

1. Tying

A franchisor may use a tying arrangement to require a franchisee to purchase supplies from a particular source, as a condition of maintaining the franchise or of obtaining other necessary products. The Supreme Court has defined a tying arrangement as “an agreement by a party to sell one product but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier.”¹¹⁴ Tying arrangements can, though they do not always, violate § 1 of the Sherman Act, 15 U.S.C. § 1. A plaintiff seeking to demonstrate such a violation generally is required to show four elements: (1) a tying and a tied product; (2) evidence of actual coercion by the seller that forced the buyer to purchase the tied product; (3) that the seller had sufficient market power in the tying product market to force the buyer to accept the tied product; and (4) involvement of a “not insubstantial” amount of interstate commerce in the tied product market.¹¹⁵ The franchise

¹¹² UCC § 2-718(1).

¹¹³ *Id.*

¹¹⁴ *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 461 (1992) (quoting *Northern Pac. Ry. Co. v. United States*, 356 U.S. 1, 5-6 (1958)).

¹¹⁵ See *Fortner Enters. v. United States Steel Corp.*, 394 U.S. 495, 497-99 (1969). Some courts also require demonstration of an anticompetitive effect on the market. See, e.g., *Subsolutions, Inc. v. Doctor's Assocs., Inc.*, 62 F. Supp. 2d 616, 622 (D. Conn. 1999); *Collins v. Int'l Dairy Queen, Inc.*, 939 F. Supp. 875, 877 (M.D. Ga. 1996).

relationship has given rise to substantial case law both with respect to the existence of a tying and tied produce and with respect to the market power of the seller.

a. Separate Products

To advance a successful tying claim, a plaintiff must offer evidence that two distinct products are involved, and that the defendant has tied the sale of the two products.¹¹⁶ In *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992), the Supreme Court evaluated a tying claim against Kodak raised by independent service organizations (ISOs) who serviced Kodak copying and micrographic equipment.¹¹⁷ Kodak had adopted a policy pursuant to which it would sell replacement parts for micrographic and copying machines only to buyers of Kodak equipment who also used Kodak service or serviced their own machines (in other words, buyers who did not use ISOs). As a result of this policy, ISOs had a difficult time obtaining parts, and accordingly lost business or were driven out of business entirely.¹¹⁸ The ISOs filed suit against Kodak, alleging, *inter alia*, that Kodak had unlawfully tied the sale of service for its machines to the sale of parts.¹¹⁹

The court noted that in order for service and parts to be two distinct products, “there must be sufficient consumer demand so that it is efficient for a firm to provide service separately from parts.”¹²⁰ Kodak contended that service and parts could not be separate products because there is no demand for parts separate from service.¹²¹ The court rejected this conclusion, based both on its factual conclusion that some consumers purchased service without parts and parts without service, and on its legal conclusion that “arrangements involving functionally linked products at least one of which is useless without the others [can constitute] prohibited tying devices.”¹²²

Franchisee-plaintiffs alleging unlawful tying claims against franchisors often contend that the franchisor requires them to purchase particular supplies (the tied product) as a condition of maintaining the franchise relationship.¹²³ Several courts have recognized that the franchisor’s trademark can constitute a separate product in evaluating a tying arrangement.¹²⁴ However, the tied product must still be separate and distinct from the franchise itself.¹²⁵

¹¹⁶ *Eastman Kodak Co.*, 504 U.S. at 462.

¹¹⁷ *Id.* at 454.

¹¹⁸ *Id.* at 458.

¹¹⁹ *Id.* at 459.

¹²⁰ *Id.* at 462 (citing *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 21-22 (1984)).

¹²¹ *Id.*

¹²² *Id.* at 463 (quoting *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 19, n.30 (1984)).

¹²³ See, e.g., *Subsolutions, Inc.*, 62 F. Supp. 2d at 622 (alleging that the Subway trademark was the tying product); *Queen City Pizza, Inc. v. Domino’s Pizza, Inc.*, 124 F.3d 430, 443 (3rd Cir. 1997) (alleging tying arrangement where plaintiffs were required to buy ingredients and supplies as a condition of their continued right to operate a franchise); *Collins*, 939 F. Supp. at 877 (alleging that the right to buy a Dairy Queen franchise was conditioned on the requirement that franchisees purchase other products).

¹²⁴ *Subsolutions, Inc.*, 62 F. Supp. 2d at 622 (citing *Susser v. Carvel Corp.*, 332 F.2d 505, 519 (2nd Cir. 1964)); *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 49 (9th Cir. 1971). *But see Queen City Pizza*, 124 F.3d at 443 (holding that an allegation that the franchisor required franchisees to buy ingredients and supplies as a condition of

In *Subsolutions, Inc. v. Doctor's Assocs., Inc.*, 62 F. Supp. 2d 616 (D. Conn. 1999), the plaintiffs developed, serviced, marketed, and sold point of sales systems ("POS systems"), a computerized alternative to conventional cash registers. The defendant, which sold and serviced "Subway" sandwich shop franchises, had implemented a policy requiring that all Subway franchisees employ a POS system supplied by a particular company, effectively foreclosing plaintiffs from the market.¹²⁶ Plaintiffs alleged this policy was an unlawful tying arrangement. The defendants argued that there was no market for the Subway POS system distinct from the Subway franchise market, and accordingly that only a single product market existed.¹²⁷ The court rejected this argument, instead concluding that the proper test was whether it would be "efficient for a firm to provide [the allegedly tied product] separate from the ... franchise."¹²⁸ Because multiple firms competed for sales in the Subway POS system market before adoption of the requirement that such systems be purchased from a single firm, the court concluded that the Subway franchise market was distinct from the POS system market. As a result, the court held that the plaintiff could survive a motion to dismiss on the first element of their tying claim, i.e., that a tying product and a tied product existed.¹²⁹

b. Economic Power/Tying Product

The other commonly contentious issue in tying cases arising out of franchise relationships is whether the franchisor has market power in the tying product market. Again, the starting point for analysis of such claims is *Eastman Kodak Co.*

The court in *Eastman Kodak Co.* defined market power as "the power 'to force a purchaser to do something that he would not do in a competitive market.'"¹³⁰ The plaintiffs offered evidence that certain parts were available exclusively through Kodak, and that it had control over the availability of parts that it did not manufacture.¹³¹ They further offered evidence that Kodak's tying arrangement had led to consumers switching to Kodak service even though they preferred ISO service, and that ISOs were driven out of business by the arrangement.¹³² The court held that this evidence was sufficient to survive summary judgment on the issue of market power.

Kodak, however, contended that, notwithstanding its dominant share in the parts market, it was unable to exercise market power because competition existed in the equipment market.

the right to operate a franchise is insufficient as an allegation of "any particular tying product or service over which Domino's Pizza, Inc. has market power.").

¹²⁵ See *Principe v. McDonald's Corp.*, 631 F.2d 303, 309 (4th Cir. 1980) ("Where the challenged aggregation is an essential ingredient of the franchised system's formula for success, there is but a single product and no tie in exists as a matter of law."). Mr. Maslyn's firm, Hunton & Williams, represented the defendant in this case.

¹²⁶ *Subsolutions, Inc.*, 62 F. Supp. 2d at 619-20.

¹²⁷ *Id.* at 622.

¹²⁸ *Id.* at 623 (quoting *Little Caesar Enter. v. Smith*, 34 F. Supp. 2d 459, 469 (E.D. Mich. 1998)).

¹²⁹ *Id.* at 623; *Little Caesar Enter.*, 34 F. Supp. 2d at 470.

¹³⁰ *Eastman Kodak Co.*, 504 U.S. at 464 (quoting *Jefferson Parish*, 466 U.S. at 14).

¹³¹ *Id.* at 464.

¹³² *Id.* at 465.

Accordingly, Kodak argued, it could not raise the prices of service and parts above competitive levels because consumers would begin purchasing equipment that was cheaper to service.¹³³ The court rejected this argument. It concluded that “significant information and switching costs” prevented consumers from being as responsive to increases in the cost of service and parts as Kodak alleged. Consumers would be unable to acquire the information necessary to make an informed decision with respect to the future costs that would be required by the purchase of any particular piece of equipment.¹³⁴ Additionally, the court concluded that consumers who had already purchased the equipment would be “locked in,” and thus would “tolerate some level of service-price increases before changing equipment brands.”¹³⁵ The court accordingly held that the plaintiffs could survive summary judgment on the question of Kodak’s market power.

Application of *Eastman Kodak Co.* to the franchise context requires a conclusion that franchisees, like consumers purchasing from Kodak, are “locked-in” to their current franchises, and accordingly cannot change in response to an undesired tying arrangement. Many courts have been resistant to this idea.¹³⁶ For example, in *Subsolutions*, the court adopted the theory of the district court in *Little Caesar Enter. v. Smith*, 34 F. Supp. 2d 459, 490 (D. Conn. 1999), that a plaintiff who, as a buyer, knew of “an announced or generally understood restrictive policy,” or could have reasonably anticipated the risk of such a future policy, could have compared that policy or prospective policy with the policies of competing franchisors.¹³⁷ Accordingly, the *Subsolutions* court, like the *Little Caesar Enter.* court, held that “a plaintiff may pursue a ‘lock-in’ theory in the franchise context only if he demonstrates that a reasonable person could not ‘reasonably anticipate later exploitation when they bought the . . . franchise and that they could not reasonably protect themselves in the marketplace by obtaining . . . contract guarantees or warranties from the defendant or his rivals.’”¹³⁸ Under this theory, disclosure by a franchisor of the requirements accompanying the agreement before the agreement was entered — as franchisors are generally required to do in Item 8 of their offering circulars¹³⁹ — would defeat a lock-in theory. Notably, in *Subsolutions*, the court concluded that the plaintiffs had alleged facts sufficient to satisfy this test, as there was no POS system requirement in effect when many of the franchisees entered into their franchise agreements.¹⁴⁰ The court’s decision in *Subsolutions* should encourage franchisors to look closely at their Item 8

¹³³ *Id.* at 465-66.

¹³⁴ *Id.* at 473.

¹³⁵ *Id.* at 476.

¹³⁶ *Queen City Pizza*, 124 F.3d at 440; *George Lussier Enters., Inc. v. Subaru of New England, Inc.*, 286 F. Supp. 2d 86, 100 (D.N.H. 2003) (“Although not all courts and commentators agree, the prevailing view is that a contractual lock-in ordinarily does not give rise to concerns that the antitrust laws were enacted to address.”) (citing cases). *But see Collins*, 939 F. Supp. at 883 (“Because of the excessive costs and potential losses associated with purchasing another franchise, a Dairy Queen franchise wishing to obtain products and supplies from alternative sources at lower costs may be locked in to the existing arrangement enjoyed by IDQ/ADQ.”).

¹³⁷ *Subsolutions, Inc.*, 62 F. Supp. 2d at 626 (quoting *Little Caesar Enter.*, 34 F. Supp. 2d at 490).

¹³⁸ *Id.* (quoting *Little Caesar Enters.*, 34 F. Supp. 2d at 490). See also Alan H. Silberman, 65 Antitrust L.J. 181 (1996) (“For market power to exist there must be something that shows that, pre-contract, the seller had the power to force a potential franchisee to purchase something that would not have occurred in a competitive market -- a requirement drawn directly from *Jefferson Parish.*”).

¹³⁹ See III.A.1, *infra*.

¹⁴⁰ *Id.*

disclosures to determine whether more specific disclosures about their current or future intent to require purchases of specific goods are sufficient to permit franchisees to “reasonably protect themselves in the marketplace.” Franchisors are also well-advised to disclose, in detail, any rights the franchisor has reserved to direct franchisee purchases, whether or not there is any plan in place to exercise those rights.

Similarly, the court in *Queen City Pizza* refused to find that Domino’s franchisees were “locked-in” to purchasing dough only from Domino’s, observing that *Eastman Kodak Co.* “does not hold that the existence of information and switching costs alone . . . renders an otherwise invalid relevant market valid.”¹⁴¹ However, in *Collins*, Dairy Queen franchisees were able to survive summary judgment based on the court’s determination that an “approved source requirement can constitute an illegal tie if a franchisee is coerced into buying products from a company in which a franchisor has a financial interest.”¹⁴²

2. Robinson-Patman Act

Franchisors can face potential liability under the Robinson-Patman Act either for discriminating in sales to its franchisees or receiving unlawful rebates from a supplier. Under Section 2(a) of the Robinson-Patman Act, 15 U.S.C. § 13(a), it is unlawful for a person

to discriminate in price between different purchasers of commodities of like grade and quality . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them

The Supreme Court has recognized three categories of competitive injury that give rise to a Robinson-Patman Act claim. Primary-line cases involve conduct, such as predatory pricing, that injures competition at the level of the discriminating seller and its direct competitors; secondary-line cases involve price discrimination that injures competition among the discriminating seller’s customers; and tertiary-line cases involve injury to competition at the level of the purchaser’s customers.¹⁴³ In franchise situations, secondary-line cases receive most of the attention.¹⁴⁴

To establish a secondary-line injury, a plaintiff must demonstrate that the relevant sales were made in interstate commerce; the sales were of commodities of like grade and quality; the defendant discriminated in price between the plaintiff and another purchaser; and the effect of the discrimination may be “to injure, destroy, or prevent competition” to the advantage of a favored purchaser.¹⁴⁵ In a typical franchise supply case, the primary issue would be the effect of the discrimination. A competitive injury requires “diversion of sales or profits from a

¹⁴¹ *Queen City Pizza*, 124 F.3d at 439.

¹⁴² *Collins*, 939 F. Supp. at 881.

¹⁴³ *Volvo Trucks N.A., Inc. v. Reeder-Simco GMC, Inc.*, 546 U.S. 164, 176 (2006).

¹⁴⁴ See Stuart Hershman, *Revisiting the Robinson-Patman Act in the Franchise Supply Setting*, 16 Franchise L.J. 57, 79 (1996) (recognizing that primary-line cases are uncommon in franchising).

¹⁴⁵ See *Volvo Trucks N.A., Inc.*, 546 U.S. at 176-77.

disfavored purchaser to a favored purchaser.”¹⁴⁶ No competitive injury can result when, as is often the case in franchise arrangements, the favored and disfavored customers operate in different geographic markets or otherwise do not directly compete.¹⁴⁷

In addition to liability for selling at differing rates, parties can also be liable under the Robinson-Patman Act for inducing other parties to violate the Robinson-Patman Act. Section 2(f) of the Act provides that “It shall be unlawful for any person engaged in commerce, in the course of such commerce, knowingly to induce or receive a discrimination in price which is prohibited by this section.” Accordingly, when a franchisor negotiates with a seller to purchase supplies, it must be aware of the possibility of inducement liability as well as of liability for direct price discrimination.

a. Functional Discounts/Cost Justification

Not all price differentials necessarily give rise to liability. Relevant to the franchise context, section 2(a) allows for price differentials that “make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities” in which the goods are “sold or delivered.”¹⁴⁸ Proof of this cost justification defense, however, “has proven difficult, expensive, and often unsuccessful.”¹⁴⁹

Defendants can also evade liability if a discount is given to a wholesaler and qualifies as a “functional discount,” i.e., “one given to a purchaser based on its role in the supplier’s distributive system, reflecting, at least in a generalized sense, the services performed by the purchaser for the supplier.”¹⁵⁰ The Supreme Court has explained that “[o]nly to the extent that a buyer actually performs certain functions, assuming all the risk, investment, and costs involved, should he legally qualify for a functional discount.”¹⁵¹

b. Rebates

To determine whether a difference in price exists, the net price is the relevant price.¹⁵² Accordingly, rebates that reduce the effective price can give rise to a claim for price discrimination.

Franchisors can also theoretically get into trouble for receiving rebates from a supplier in return for franchisee purchases, but such liability is unlikely.¹⁵³ Franchisees have often received such rebates or other payments from suppliers, but these payments have generally been found

¹⁴⁶ *Id.* at 177.

¹⁴⁷ Hershman, *supra* note 144, at 79; *Best Brands Beverage, Inc. v. Falstaff Brewing Corp.*, 842 F. 2d 578, 585-86 (2nd Cir. 1987).

¹⁴⁸ 15 U.S.C. § 13(a).

¹⁴⁹ *Texaco, Inc. v. Hasbrouck*, 496 U.S. 543, 561 n.18 (1990) (citing 3 E. Kintner & J. Bauer, *Federal Antitrust Law*, § 23.19, pp. 366-67 (1983)).

¹⁵⁰ *Id.* at 554 n.11.

¹⁵¹ *Id.* at 560-61.

¹⁵² See ABA Section of Antitrust Law, *Antitrust Law Developments* (5th) 463 n.50 (gathering cases).

¹⁵³ See Steven B. Feirman, *The Legality of Rebates from Suppliers*, 23 *Franchise L.J.* 71, 75 (2003).

lawful.¹⁵⁴ In recent years, franchisees have attempted to bring such suits under Section 2(c) of the Act, which bars payment of

anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods, wares, or merchandise, either to the other party to such transaction, or to any agent, representative, or other intermediary therein where such intermediary is acting in fact for or in behalf, or is subject to the direct or indirect control, of any party to such transaction other than the person by whom such compensation is so granted or paid.

Some courts have construed this provision to bar commercial bribery.¹⁵⁵ In order for commercial bribery to violate § 2(c), however, most courts hold that the third party receiving the commission -- in the franchise context, the franchisor -- must be the agent of the party paying the fees from which the commission is drawn.¹⁵⁶ In franchising, this test should generally not be met, as the franchisor is not the agent of the buyer.¹⁵⁷ Notably, however, at least one court has misread the requirement of an agency relationship as a simple requirement that the intermediary (the franchisor) be able to compel the buyer to act, and thus has found § 2(c) liability possible.¹⁵⁸ This court, like many courts, however, treated disclosure as a relevant factor; accordingly, disclosure of any supplier rebate arrangements should assist in avoiding § 2(c) liability.¹⁵⁹

3. State Law Claims

Anti-competitive behavior can give rise to state law liability as well.¹⁶⁰ Such liability is, in some cases, broader than the liability under federal law. For example, many states provide protection to indirect purchasers, while federal law does not.¹⁶¹ Accordingly, franchisors must be available of the prospect of such claims, which are not as obvious a risk.

¹⁵⁴ *Id.* at 71.

¹⁵⁵ *United Magazine Co. v. Murdoch Magazines Distrib.*, 146 F. Supp. 2d 385, 396 (S.D.N.Y. 2001).

¹⁵⁶ See *Bridges v. MacLean-Stevens Studios, Inc.*, 201 F.3d 6, 12-13 (1st Cir. 2000); *Philip Morris, Inc. v. Grinnell Litho. Co.*, 67 F. Supp. 2d 126, 130-31 (E.D.N.Y. 1999); *Watkins & Son Pet Supplies v. Iams Co.*, 107 F. Supp. 2d 883, 899 (S.D. Ohio 1999).

¹⁵⁷ Feirman, *supra* note 153, at 75-76.

¹⁵⁸ *Substantial Invs., Inc. v. D'Angelo Franchising Corp.*, Civil Action No. 03-11202-RWZ, 2004 U.S. Dist. LEXIS 17300, at *7-8 (D. Mass. Aug. 30, 2004).

¹⁵⁹ *Id.* at *8-9; Feirman, *supra* note 153, at 77 ("To the extent that disclosure is relevant to section 2(c), franchisors that disclose their revenue arrangements with suppliers in Item 8 of their Uniform Franchise Offering Circular (UFOC) ought to be able to defeat a Section 2(c) claim on this basis, among others.").

¹⁶⁰ See generally, James L. Petersen and Angela Fifelski, *State Tying Claims: Do You Know What May Be Lurking*, 21 Franchise L.J. 118 (2002).

¹⁶¹ *Illinois Brick Co. v. Illinois*, 431 U.S. 720, 746-47 (1977); *California v. ARC Am. Corp.*, 490 U.S. 93, 105-06 (1989) (holding that state indirect purchaser statutes are not preempted by federal law).

Some state statutes also permit the recovery of “full consideration damages,” in addition to having a treble damages provision.¹⁶² Such provisions permit persons injured by contracts in restraint of trade to “sue for and recover . . . the full consideration or sum paid by such person for any goods, wares, merchandise and articles included in or advanced or controlled in price by such combination, or the full amount of money borrowed.”¹⁶³

D. Intellectual Property

Anytime a franchisor outsources the manufacture of products for use in the franchise system they face a number of issues relating to the protection and ownership of the intellectual property related to those products or services. The responsibilities allocated to the franchisor and the supplier in these outsourcing arrangements can vary dramatically. The simplest form of outsourcing arrangement is one in which the franchisor contracts with a supplier to affix the franchisor’s trademark on a product that is completely or substantially a generic product manufactured by the supplier. On the other end of the spectrum, a franchisor may contract with a supplier to produce a unique product, meeting the franchisor’s detailed specifications and using a recipe or process prescribed by the franchisor.¹⁶⁴ For each of these relationships — and all of those in between — the parties should take care to identify and clarify the ownership and ensure the proper licensing of all of the intellectual property rights related to the outsourcing arrangement, potentially including trade secrets, trade dress, and copyrights.¹⁶⁵

1. Trade Secrets

A trade secret is defined by the Uniform Trade Secrets Act (“UTSA”)¹⁶⁶ as:

information, including a formula, pattern, compilation, program, device, method, technique, or process, that:

- (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by, other persons who can obtain economic value from its disclosure or use, and

¹⁶² See, e.g., *Four B Corp. v. Daicel Chem. Indus.*, 253 F. Supp. 2d 1147, 1153 (D. Kan. 2003) (extending such damages to indirect purchasers under Kansas law); *In re Methionine Antitrust Litig. v. Rhone-Poulenc*, No. 99-3491 CRB, MDL 00-1311, 2001 U.S. Dist. LEXIS 13402, at *6-8 (Aug. 29, 2001).

¹⁶³ *Four B. Corp.*, 253 F. Supp. 2d at 1150.

¹⁶⁴ Many practitioners refer to *any* arrangement in which a supplier affixes the franchisor’s mark to a product manufactured by the supplier as a “private label” arrangement, while others reserve that term for only those relationships where the supplier *only* affixes the franchisor’s trademark to a product manufactured by the supplier. Regardless of the terminology used, the legal issues raised by a particular outsourcing arrangement will depend on the obligations of the parties to the contract.

¹⁶⁵ Outsourcing arrangements usually also involve the license of the franchisor’s trademark and may involve patents owned by the franchisor, the supplier or a third party.

¹⁶⁶ National Conference of Commissioners on Uniform State Laws, Section of Patent, Trademark, and Copyright Law, 1973 Committee Reports 179-182 (1973). Prior to the adoption of the UTSA, trade secrets were defined by the *Restatement of Torts* §757, comment b (1939), which continues to hold influence with courts in determining whether a trade secret exists. See generally *Milgrim on Trade Secrets* § 1.01.

(ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.¹⁶⁷

To the extent that a franchisor can validly claim that they have a trade secret in the products produced by third parties for use in or sale from the franchisees' business, the franchisor can claim to add value to their franchise offering by maintaining a barrier to entry to the franchisees' potential competitors. If a third party will be producing the products in which the franchisor wishes to claim "trade secret" rights, the franchisor must — as the UTSA definition requires — take reasonable steps to keep the information secret. At a minimum, that likely will mean that the franchisor must obtain the supplier's commitment to not disclose any trade secrets. However, even the best non-disclosure agreements may not be sufficient to protect the trade secret information from accidental (or intentional) disclosure and once the trade secret has been divulged, it may be impossible to prevent its use by a non-contracting party. Consequently, the best protection for a trade secret is — above all — to keep it secret. In addition contractual protections, some methods of keeping a trade secret include compartmentalization and coding.

In the case of franchise supplier relationships, "compartmentalization" may mean ensuring that no single supplier possesses the entire trade secret. For example, if a franchisor claims a trade secret in a food recipe¹⁶⁸ that consists of 12 herbs and spices, the franchisor could arrange for three suppliers to prepare four herbs and spices each which would then be shipped to a fourth supplier (or the franchisor) to be combined into a final product. In this scenario, if any one supplier discloses the portion of the recipe to which it has been entrusted the trade secret will remain secret. Adding additional levels to the production process may increase the cost of production, so franchisors should carefully weigh the significance of the trade secret it seeks to protect and the marginal benefit of each additional level of compartmentalization.

Similarly, franchisors can effectively prevent disclosure of their trade secrets by coding critical information so that only a limited number of trusted people possess the critical information needed to reproduce that trade secret.

Typically, a franchisor chooses a supplier in part because the supplier has experience in producing the kinds of products the franchisor seeks for its franchise system. Such a supplier may also claim to have its own intellectual property in the products it is providing to the franchise system. In negotiating a master supply agreement with such a supplier, the franchisor and the supplier should clearly delineate which portions of the product are intellectual property of the supplier and which portions are the intellectual property of the franchisor.

2. Trade Dress

In addition to identifying private label products by using the franchisor's trademark, many private label products are designed to have a look and feel that identifies the product as the franchisor's proprietary product. This sort of "trade dress" is protected by Section 43(a) of the Lanham Act.¹⁶⁹ If the product being produced by the supplier is a unique product for the franchisor's

¹⁶⁷ *Id* at §1(4).

¹⁶⁸ Other types of trade secrets that may exist in the franchise supply context include the franchisor's detailed specifications and standards for specific products, methods of preparation or manufacturer, materials and chemical compositions of products.

¹⁶⁹ 15 U.S.C. §1125(a).

system, the ownership of the look and feel of the product may not be in question. However, in many cases, the supplier will only partially adapt their existing product design and packaging while at the same time incorporating the franchisor's design elements. In these cases, the franchisor should come to an agreement with the supplier regarding which elements belong to the supplier and which elements belong to the franchisor.

3. **Copyrights**

Although there are a number of items related to supply relationship in which a franchisor may claim copyrights, the most significant — in the private label context — is the designs, drawings or specifications used by the supplier in making the products for the franchise system. Typically, a supplier takes the franchisor's designs, drawings or specifications and adapts its manufacturing processes to fit the franchisor's needs. In doing so, the supplier may revise or improve upon the franchisor's original concept. Franchisors and suppliers should ensure that their master agreements reflect an acknowledgement that this may occur and should identify to whom the intellectual property rights for those revisions or improvements will accrue.

E. **Common Law**

As with any contractual relationship, supply arrangements may create opportunities for a host of contractual or common law claims. Typically, these claims come from franchisees who feel that their franchisor has unfairly profited from the supply arrangements at the franchisee's expense. In these situations, franchisees may raise a variety of the claims discussed above, such as failure to disclose or improper disclosure under a state disclosure law, illegal tying, or price discrimination (for example, based on the franchisor's receipt of rebates). But, they are also likely to offer an assortment of other claims. The approach a franchisee-plaintiff may take is perhaps best illustrated by reviewing two recent cases in which franchisees accused their franchisor of using their contractual ability to designate supply sources to improperly profit from the franchisees' purchases.

1. **Team Tires Plus, Ltd. v. Heartlein**¹⁷⁰

Team Tires sued to terminate the Heartleins' Tires Plus franchises for various financial defaults under their franchise agreements, including unpaid royalties, advertising fees and invoices. Heartlein counterclaimed alleging, among other things, that Team Tires had entered into agreements with vendors under which vendors would inflate the price of goods sold to Team Tires' franchisees and that those vendors would pay a rebate to Team Tires between five and ten percent of the total purchases by franchisees. Heartlein argued that this alleged arrangement amounted to fraud and negligent misrepresentation. To support these claims, Heartlein argued that Team Tires had an obligation to disclose the rebates in the UFOC provided to Heartlein in Item 6 (as a fee) and Item 8 (as revenue from a third party supplier). Importantly, the court seemed to focus less on a technical reading of the disclosure obligations of the UFOC and instead noted that the UFOC stated that franchisees could purchase products from other suppliers. The court granted Team Tires motion for summary judgment on each of these claims because Heartlein failed to show that Team Tires had made any false statements in its UFOC relating to the rebates.¹⁷¹

¹⁷⁰ BUS. FRAN. GUIDE ¶ 12,821 (D. Minn. Apr. 19, 2004).

¹⁷¹ See also *Team Tires Plus, Ltd. v. Heartlein*, BUS. FRAN. GUIDE ¶ 12,820 (D. Minn. Mar. 17, 2004) (holding that Heartlein failed to present a *prima facie* case for fraud or negligent misrepresentation because there was

2. *Tubby's #14 Ltd. v. Tubby's Sub Shops, Inc.*¹⁷²

In this case, Tubby's, a franchisor of a submarine sandwich franchise, established a distribution system in which a subsidiary (SDS) acted as an intermediary between vendors and franchisees. The plaintiffs alleged, among other things, that SDS would mark up the prices to be paid by the franchisees and that SDS would receive a "kickback" (or rebate) from the manufacturers. The Tubby's franchisees claimed that this scheme, and the fact that it was not fully disclosed in the offering circulars provided to the franchisees, amounted to fraud under the Federal Trade Commission Act ("FTCA"), common law fraud, breach of contract, and a breach of the implied covenant of good faith and fair dealing.

It is generally recognized that the disclosure obligations under the FTC Franchise Rule do not create a private right of action.¹⁷³ However, the franchisee-plaintiffs' argument on the FTCA claim was that Tubby's failure to make the proper disclosures in Item 8 regarding suppliers and rebates was not simply a violation of the FTC Franchise Rule, but rather was independently actionable as fraud. Surprisingly, the court agreed with the franchisees without reference to any precedent to support the position and refused to dismiss the franchisees' fraud claims under the FTCA.

The court also refused to grant summary judgment to Tubby's on the franchisees' common law fraud claims. These claims were based on comments made by the defendants to the plaintiffs at a franchise meeting to the effect that if they purchased all of their products from SDS, their costs would be reduced by twenty percent. Plaintiffs claimed that this statement was false, that the defendants knew it was false when it was made and that they actively tried to conceal the truth from the franchisees.

The franchise agreements used by Tubby's contained a provision stating that Tubby's may receive up to a two percent rebate from suppliers. The franchisee-plaintiffs claimed that Tubby's violated this provision by substituting SDS to accomplish what the clear language of the franchise agreement would not allow Tubby's to do directly. The court also refused to dismiss these claims.

Finally, the franchisee-plaintiffs claimed that by only negotiating with suppliers that would pay rebates to Tubby's, resulting in higher prices to the franchisees. Absent any evidence that the prices the franchisees paid were in excessive, the court dismissed this claim.

IV. CONCLUSION

The products and services offered by franchisees are at the core of every franchise system. A franchisor's ability to maintain the uniqueness and consistency of the products and services offered by the franchisees depends, in large part, on the contracts it enters into with third parties

no evidence of any false statements by Team Tires and no evidence of detrimental reliance or damage to Heartlein because there was no indication that the rebate scheme resulted in higher prices to Heartlein).

¹⁷² BUS. FRAN. GUIDE ¶ 13,460 (E.D. Mich. Sept. 27, 2006).

¹⁷³ See, e.g., *Mon-Shore Mgmt., Inc. v. Family Media*, BUS. FRAN. GUIDE (CCH), ¶8494 (S.D.N.Y. Dec. 23, 1985).

to provide these products and services. If a franchisor is successful in maintaining the uniqueness and consistency of those products and services, its franchisees may enjoy a competitive advantage over its competitors. Similarly, the business terms of the supply arrangements employed by the system will have a direct bearing on franchisees' — and the systems' — success. Of course, these relationships also present risks in the form of potential claims franchisees. To a large degree, the success or failure of a franchise system will depend on counsel's ability to intelligently navigate these issues.

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Patrick Maslyn is Counsel in the Richmond, Virginia office of Hunton & Williams, LLP where he is a member of the firm's Franchising & Distribution Practice Group and its Global Competition Team. Mr. Maslyn provides counseling to franchisors in all facets of structuring and operating their franchise systems. In particular, he assists franchisors with the negotiation and memorialization of vendor supply agreements, and drafts franchise and development agreements and offering circulars. Mr. Maslyn also represents franchisors in connection with system compliance issues and the enforcement of franchisee obligations. In 2007, Mr. Maslyn successfully lobbied the Virginia legislature, and served as lead legislation draftsman, for an amendment to the Virginia Retail Franchising Act which provided for exemptions from franchise registration and the escrow and deferral of franchise fees for "insolvent" franchisors.

Mr. Maslyn also represents manufacturers in configuring and managing their national distribution systems, which includes the drafting of dealer and distributor agreements, structuring and negotiation of supplier relationships and counseling with regard to the application of generally applicable and industry-specific state franchise, distributor and dealer laws.

Mr. Maslyn and Hunton & Williams' Franchising & Distribution Practice Group are each listed in *Chambers USA (2007)* for national Franchising. Mr. Maslyn currently serves as Vice Chair of the Virginia State Bar's Antitrust, Franchise and Trade Regulation Section. He served on the International Franchise Association's (IFA) Legal Symposium Task Force in 2005 and 2006. He was a speaker and moderator on the *Best Practices for Handling Default and Termination for Established Franchisors* at the IFA's 2007 Annual Convention. Mr. Maslyn co-presented a paper on *Franchise Agreement Drafting* at the 2005 IFA Legal Symposium. He has also served as a faculty member for a joint CLE program of the Maryland, Virginia and District of Columbia bar associations entitled *Understanding and Negotiating a Franchise Agreement*. Mr. Maslyn has published articles on franchising in *Franchising World* magazine and the *New York Law Journal*.

Mr. Maslyn received his law degree in 1997 from The George Washington University Law School and he received a Bachelor of Arts degree from Miami University in 1992 with a double major in Diplomacy & Foreign Affairs and Economics. He is a member of the Virginia and Washington, D.C. bars.

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Mr. Scott primarily represents technology companies, software developers, product manufacturers and distributors, and franchisors. In the past several years he has served as lead counsel for domestic U.S. companies on transactions in England, Italy, Thailand, Spain, Portugal, Argentina, Hong Kong, Malaysia and Mexico, involving large commercial transactions, asset acquisitions, joint ventures and master franchises, and has been involved in establishing licensing and distribution arrangements in Mexico, South Korea and France. He has spoken on numerous occasions at the American Bar Association Forum on Franchising, the International Franchise Association Legal Symposium and before the International Franchising Committee of the International Bar Association.

Mr. Scott is a co-author of the three volume work entitled *Franchising Law: Practice and Forms* (Specialty Technical Publishers, Inc.; ed. 2006), and has published articles relating to International Franchising in the *Journal of International Franchise and Distribution Law and the International Business Lawyer*. ("Extra-territorial Application of U.S. Franchise Registration and Disclosure Laws in International Franchise Transactions" and "Technology Transfer Laws and International Franchising").

Mr. Scott has been a member of the Forum on Franchising since 1990 and currently chairs its Publications Committee. He was an editor of the *Franchise Law Journal* from 1999-2001, and from 2002 to 2004. He was also an editor of *The Franchise Lawyer* from 2001 to 2002. He has conducted workshops at the Annual Forum on Co-Branding (1997) and Personal Exposure: Risk Management in the Franchise Relationship (1999). In 2001 he presented the Judicial Update. He has authored several pieces for the *Franchise Law Journal: A Review of Franchising Bookshelf-International Franchising* (2d ed.), 18 *Franchise L.J.* 19 (Summer 1998); an article entitled: "Meineke Revisited: The Specter of Individual Liability" (co-author). In 2006 he co-chaired the Annual Forum on Franchising in Boston, Massachusetts.

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