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Supply "Chain Links" and its Implications on the Franchise Systems

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1. Introduction

Consumers expect trusted household brands to provide high quality, safe products. When a business that operates under a household brand is operated by an independent third party franchisee, a franchise system’s decisions about supply chain management can make or break both consumers’ experiences with the brand and the franchise system’s success. The “link” between the strength of the franchise system’s supply chain and its success is a crucial one, and requires the same careful consideration and resources as any other aspect of a well-franchised concept.

This paper first provides an overview of the components that may be present within a franchise system’s supply chain and identifies strategic considerations for franchise systems that are establishing a supply chain for the first time or are undertaking critical supply chain change initiatives. This paper then discusses how mature, established, and large franchise systems can implement efficient supply chain management practices and supply chain changes, and whether, when, and how franchise systems may establish and interact with purchasing cooperatives or other types of group buying organizations. Finally, this paper briefly summarizes some of the myriad of global trade and corporate social responsibility issues that are attendant to modern supply chain management.

<u>A note before we begin</u>: Parts of this paper use “franchise system” to describe the party that will undertake the activities that result in the establishment, management, or reinvigoration of a strong supply chain for a brand or related brands of franchised businesses. The authors recognize that very often, the nature of the work involved goes to the heart and essence of the creation and expansion of the brand itself, and therefore, the franchisor will perform the activities that this paper addresses. However, since franchisees may own or be very engaged in various supply chain functions, we adopt the use of “franchise system” in parts of this paper. “Franchise system” reflects that franchisors and franchisees are united in their desire for a strong supply chain. “Franchise system” also reflects that with respect to many functions, the same considerations apply regardless of whether the franchisor, a group of franchisees, a combination thereof, or a franchisee-owned entity performs various parts of building, equipping, and managing a franchise system’s supply chain.

2. Supply Chain Overview

In its simplest form, a supply chain consists of the components and processes that a company utilizes to source, produce, distribute, and market products. There are many structuring options available for franchise system supply chains, and the appropriate structure depends on many factors, such as the types of products and services offered, the degree of control the franchisor chooses to retain, the size of the system, and the location of the franchised units.[1] For some companies, a "captive" affiliated or owned supply chain is possible and provides significant strategic benefit. For most companies, and most franchise systems, the supply chain involves the selection and management of multiple vendors that provide goods and services. This section provides an overview of the components that a franchise system's supply chain may include, including the relationships with third parties that may be present at each stage, and identifies newer supply chain components, such as block chain, that may impact franchise system supply chains moving forward.

Because supply chains are typically global and complex, this overview of supply chain components also touches upon various strategies for supply chain management that involve "multiple firms, multiple business activities, and the coordination of those activities across functions and across firms in the supply chain."[2] It also addresses the ultimate goals of supply chain management, which are generally to lower costs, increase customer value and satisfaction, create a competitive advantage, and ensure franchisee satisfaction.[3]

a. Research and Development

Great supply chains begin with great products and great products begin with creativity. During the research and development stage, companies conceive of new ideas and begin to give those ideas life through research and application. For a restaurant chain, research and development may involve the development and formulation of new menu items and further works on existing products or product lines, which could require the creation of template documents or new software. Proper research and development requires the allocation of significant resources at the outset, as some ideas may work, and others, particularly in a franchise system where feasibility is more critical, may not.

Though the ideas that feed a research and development team and help build and sustain a brand (and therefore a franchise system) are typically the work of a company's research and development team and executives, much of the legwork of research and development can be completed by third parties that specialize in developing, formulating, engineering, and refining various products and concepts. Many well-qualified consultants and companies specialize in furthering other companies' ideas and routinely vet and help companies realize new product concepts. This is beneficial for franchise systems, as it allows the flexibility to push multiple concepts toward testing or completion at once, even if the primary focus of the business remains the management of the franchise system.

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[1] Suzie Trigg and Emma Ricaurte Harker, *Seizing an Opportunity: Supplier Contracts and System Health* (available at: https://www.franchising.com/articles/seizing_an_opportunity_supplier_contracts_and_system_health.html) (last visited February 16, 2018).

[2] Peter Yeoh, *Risk Issues in Global Supply Chain Management*, 38 Bus. Law Rev. 80 (2017) (citation omitted).

[3] *Id.*

If a franchise system elects to involve third parties in research and development, it is critical for the franchise system to carefully vet such third parties. The company must ensure that a third party that is entrusted with research and development responsibility (*e.g.*, product formulation) can be trusted with the company's intellectual property and that appropriate safeguards are in place, which include, but are not limited to comprehensive contracts that address intellectual property ownership, confidentiality, and exclusivity. For example, if a third party develops a variety of products from which the franchise system will choose, the franchise system may consider requiring that all developed products remain exclusive, at least for some period of time; or, the franchise system may opt to only obtain exclusivity and intellectual property ownership with respect to those products that it opts to purchase. At the outset, the company should also ensure that such vendors will either be limited to research and development work, or are suitable supply chain vendors for the franchise system on a long term basis. Throughout this paper, we discuss some of the characteristics of a suitable long-term supply chain vendor.

b. Manufacturing and Supplier Sourcing and Management

i. Manufacturing

A strong brand depends, in large part, upon a franchise system's ability to consistently and continually distribute safe, high quality products. Manufacturing involves the transformation of raw materials or ingredients into finished products via one or more mechanical, physical, or chemical processes, and the packaging of such products for further distribution. In order to manufacture safe, high quality products on a consistent and continual basis, the franchise system must understand how to manufacture such products itself, or how to engage third parties that are strong manufacturers and who make good, long-term supply chain vendors.

ii. Supplier or Manufacturer Sourcing

The franchise system should take care to construct properly planned, strong, and reliable manufacturing relationships that provide flexibility and provide strong protection for intellectual property rights. Manufacturers should understand their importance to and relationship with the franchise system, and their overall place in the supply chain. There are several strategies that a franchise system can utilize when sourcing suppliers to help ensure that the supplier is a good fit for the work intended, and to ensure that the supplier is likely to be able to be a reliable long-term manufacturer of the products that the franchisor and franchisees need.

Optimal supplier sourcing begins with the careful development of standards that each supplier, or manufacturer, must meet. Such standards may include:

- Financial strength and viability;
- Industry-specific certifications (*e.g.*, International Organization for Standardization, or ISO);
- Available production capacity and suitability of production facilities;
- Efficiency;
- Competitive concerns (for many reasons, the selection of the "top" supplier in an industry may not be suitable);
- The supplier's quality assurance program;
- The supplier's *own* sourcing standards for raw materials or ingredients;
- Reputation and client references; and
- Innovation.

Once a franchise system determines the standards that it expects that all manufacturers of goods must meet, the franchise system must determine how to document such standards so that moving forward, the franchise system can compare potential manufacturers on an apples to apples basis. Often, the franchise system will carefully develop a set of supplier approval standards or a supplier approval program. The supplier approval standards or program often includes:

- An explanation of the objectives of the program;
- An overview of the specific standards that suppliers must meet to be selected as vendors to the franchise system;
- Applications, checklists, and other documentation that a franchise system may require a prospective supplier to submit to be considered for further evaluation or to submit a response to a request for proposal ("RFP").

Unless a product is very unique, or an industry crowded with many entrants and few private label or contract manufacturers, in most instances, a company will find that there are multiple suppliers that meet the company's standards and could be suitable vendors and the company may then opt to conduct an RFP process to select one or a few vendors.

Franchise systems that distribute products regulated by the U.S. Food and Drug Administration ("FDA") must also ensure that any supplier sourcing (and supplier management) practices that the franchise system adopts account for the requirements of the FDA's regulations.[4] Since the FDA regulates products that account for 20 cents of

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[4] *See, e.g.,* 21 C.F.R. Part 117, subpart G; *see also* Suzie Trigg, *Throwing the First Tomato - What Will 2017's Food Fights Look Like?*, available at: http://www.haynesboone.com/alerts/throwing-the-first-tomato ("[T]he FDA's [Food Safety Modernization Act] rules require active oversight of food supply chains.") (last visited February 16, 2018); *see also* Suzie Trigg and Kenya Woodruff, *Inside the Minds: Recent Developments in Food and Drug Law* (2016 ed., Aspatore Books), at 9 ("[A]s the FDA continues to evolve and adapt regulatory policies to address new products and innovative spaces in food and drugs, supply chain quality and safety also continue to be important trends.").

every dollar spent in America, including consumer products such as cosmetics, tobacco, food, and over-the-counter medicines, many companies find their business and/or product lines subject to the FDA's regulations.[5] For example, if a franchised system of dental offices determines that a private label line of oral care products would be an added boost to the brand and an additional stream of income, but lacks the capabilities to formulate and manufacture its own oral care products, the franchise system is likely to engage a contract manufacturer to formulate and manufacture the products. In selecting a contract manufacturer of toothpaste (for example), the franchised system entity responsible for the manufacture of the product would need to consider the regulatory requirements applicable to over-the-counter drug manufacturers, and develop an appropriate quality system in accordance with the FDA's regulations applicable to over-the-counter drug manufacturers.[6]

iii. Supplier and Manufacturer Monitoring and Management

A company's work with a manufacturer or other supply chain vendor has only just begun when the ink on the contract manufacturing agreement or supply agreement has dried. Ensuring the continual and consistent production and distribution of safe, high-quality products requires that the franchise system be knowledgeable of and diligent in best practices pertaining to supplier management. Supplier management pertains to all vendors of goods and services. However, supplier management is particularly relevant with respect to manufacturing, since a lapse in supplier management with respect to manufacturing can create product safety concerns that lead to significant liability and the expense and bad publicity of a product recall, in addition to delays and other costly and detrimental effects.

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[5] Sheri Walker, PhD and Clark Nardinelli, *Consumer expenditure on FDA regulated products: 20 cents of every dollar*, available at: https://blogs.fda.gov/fdavoice/index.php/2016/11/consumer-expenditure-on-fda-regulated-products-20-cents-of-every-dollar/ (last visited February 16, 2018). Though outside of the scope of this paper, franchise systems should also be aware that franchise system websites that promote FDA regulated products may provide notification to the agency that the franchise system is marketing FDA regulated products. Such websites are a frequent source of liability. *See* Suzie Trigg and Kenya Woodruff, *Inside the Minds: Recent Developments in Food and Drug Law* (2016 ed., Aspatore Books), at 10 ("Enforcement Trends – The FDA's Continued Focus on Websites").

[6] "Each party engaged in the manufacture of a drug is responsible for ensuring compliance with CGMP for the manufacturing activities it performs. For both owners and contract facilities that conduct manufacturing operations, CGMP 'includes the implementation and oversight and controls over the manufacture of drugs to ensure quality….Drugs not manufactured in compliance with CGMP are adulterated. The FD&C Act also prohibits any person from introducing or delivering for introduction an adulterated or misbranded drug into interstate commerce….FDA's regulations recognize that owners commonly use contract facilities to perform some drug manufacturing activities. When an owner uses a contract facility, the owner's quality unit is legally responsible for approving or rejecting drug products manufactured by the contract facility, including for final release. The regulations require that the quality unit's responsibilities and procedures be in writing and that they be followed." Contract Manufacturing Arrangements for Drugs: Quality Agreements, Guidance for Industry, November 2016, at 3-4 (internal citations omitted), available at: https://www.fda.gov/downloads/drugs/guidances/ucm353925.pdf (last visited February 16, 2018).

Supplier management can broadly mean all aspects of selecting suppliers, procurement, and managing the relationship post-procurement. Here, "supplier management" is utilized to refer to post-contract execution activities that continually reinforce the alignment of a franchise system and its manufacturers and other suppliers. Supplier management also refers to practices that enable a franchise system to identify, monitor, and address potential threats to the supply chain, and help address whether, or when, a franchise system should terminate or refuse to renew a supplier's contract.

Many franchise systems require that supply chain vendors meet key performance indicators ("KPIs") as part of ongoing supplier management, and such franchise systems may also implement pay for performance ("PFP") metrics to encourage ongoing alignment and satisfactory performance by supply chain vendors. While KPIs and PFP are helpful, and in particular, provide strong incentives and disincentives to supply chain vendors, such metrics are typically focused on on-time delivery, fill rates, and the like, which are not sufficient, on their own, to accomplish all of the objectives of a strong supplier management program. Therefore, a supplier management program will ideally encompass more than KPIs.

A robust supplier management program encompasses monitoring of vendor performance and practices, consistent standards for vendor best practices, and the ability to quickly adapt to changing market conditions or address supply chain disruptions. A supplier management program may also consist of written policies to which a vendor's contract requires adherence, such as written policies that are necessary to document compliance with regulatory requirements.[7] A supplier management program also serves to impose clear minimum standards in jurisdictions where a standard of compliance with applicable laws (sometimes referred to by auditors and others as a standard of "regulatory compliance") may not sufficiently protect a brand's reputation.[8] Typically, vendors' adherence to the standards set forth in a supplier management program is measured during regular audits.[9] The supplier

[7] *See, e.g.,* 81 Fed. Reg. 20092, 20093 ("The shipper may rely on contractual agreements to assign some of these responsibilities to other parties…if they agree to accept the responsibility."). "The FDA, as part of the final [Food Safety Modernization Act ("FSMA")] Transportation Rule, acknowledged that industry practice is to alter, by contract, the tasks assigned by the Rule, and that such contractual assignment of duties is acceptable. Companies should note, however, that the Rule also subjects such contracts to the records requirements of the Rule. Therefore, it may be prudent for companies to plan ahead to protect sensitive information by including the allocation of responsibilities related to the FSMA Transportation Rule in a separate exhibit, short form of agreement, or policy or procedure." Suzie Trigg, *Equipping Your Supply Chain for FSMA: Allocating Responsibilities under the FSMA Transportation Rule*, at 6, Apr. 29, 2016 (available at: http://www.haynesboone.com/~/media/files/alert% 20pdfs/2016/ equipping_your_supply _chain_ for_fsma.ashx) (last visited February 16, 2018).

[8] *See generally,* Andrew Herman, Reassessing the Role of Supplier Codes of Conduct: Closing the Gap Between Aspirations and Reality, 52 Virginia J. of Int'l Law 446 (2012).

[9] "To ensure that licensees are complying with these codes [of conduct], licensors often use independent supplier monitoring programs, in which factory condition auditors are sent to specific factories by the licensor to report on its present conditions, ensuring that the licensee is complying with the licensor's code of conduct and all applicable laws." Marc J. Monte, *Corporate Factory/Supplier Monitoring Programs*

management program documents should include language outlining how the standards will be enforced and the consequences of noncompliance.[10] The supplier management program documents may be incorporated by reference into vendor agreements or separately acknowledged by vendors; however, if a vendor has not expressly signed off on such program documents, monitoring and enforcement are difficult.[11]

c. Warehousing, Distribution, Transportation and Other Logistics

Once a franchise system has ensured that it has the strongest arrangements in place to create and manufacture products, whether itself, or through a combination of third party vendors, the franchise system must ensure that it has in place warehousing, distribution, transportation, and other logistics operations or vendor arrangements. Such operations or vendor arrangements are a critical component of a supply chain since a failure at any point may cause disruption, delays, and lost sales.[12] Where a franchisor operates warehouses, or otherwise engages in or arranges for logistics, it is particularly important that the franchisor ensure supply chain continuity to foster positive franchisor-franchisee relationships and avoid potential legal claims by franchisees. Because many warehousing, transportation, and logistics functions related to franchise system supply chains are handled by third parties, franchise systems establishing or modifying contracts related to such relationships should become familiar with legal standards applicable to logistics providers' operations. Franchise systems will often find that the legal standard that applies absent a well-drafted contract is a lesser standard than the franchise system may believe adequately serves to protect its interests in its products and supply chain.

Many states have adopted Article 7 of the Uniform Commercial Code, which contains standards applicable to warehouseman. Specifically, Section 7-204 of the Uniform Commercial Code ("U.C.C.") provides that "[a] warehouse is liable for damages for loss of or injury to the goods caused by its failure to exercise care with regard to the goods that a *reasonably careful person* would exercise under similar circumstances. However, *unless otherwise agreed*, the warehouse is *not liable for damages* that could not have been avoided by the exercise of that care."[13] Article 7 of the U.C.C. further provides

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and the Failure of International Law in Regulating Indian Factory Conditions, 26 Brook. J. of Int'l. Law 3 (2001), p. 1139 (citation omitted).

[10] Gina Romo, R. James Straus, and Suzie Trigg, *Building an Effective Supply Chain and Distribution System*, pp. 67-69 (Part VI, Vendor Code of Conduct) (ABA Forum on Franchising 2012).

[11] *Id.* at 68.

[12] For example, in 2017, Hurricane Harvey caused significant supply chain disruption and delays and contractual and other claims as a consequence, such as assertions of force majeure. *See* Suzie Trigg, *Managing Legal Aspects of the Implications of a Hurricane on the Supply Chain*, Material Handling & Logistics (Sept. 13, 2017) (available at: http://www.mhlnews.com/global-supply-chain/managing-legal-aspects-implications-hurricane-supply-chain) (last visited February 16, 2018).

[13] U.C.C. § 7-204(a) (available at: https://www.law.cornell.edu/ucc/7/7-204) (last visited February 16, 2018).

that a warehouse may further limited its damages by use of a warehouse receipt or storage agreement.[14] In addition, a warehouse may set reasonable limits on the time for and manner of presenting claims,[15] leaving those that entrust their goods to a warehouse with an onerous burden of complying with such claims processes.

The "vendor paper" (*i.e.*, form of contract) in use by most companies that provide warehouse services will echo the limited liability standards contained within Article 7 of the U.C.C. Therefore, franchise systems that utilize such services should carefully analyze and revise such contracts or insist upon the use of their own form of service agreement that specifically disclaims the applicability of such standards and the warehouse's internal claims policies and provides a clear delineation of risk of loss, liability, and responsibility for the submission and processing of claims. The contract should also contain robust standards for the types and amounts of insurance coverage that the warehouse must maintain.[16] However, franchise systems should also recognize that a warehouse is not in a position to be an insurer for the value of the goods stored for losses well outside of its control, and thus, the franchise system must be prepared to align its own insurance coverage where the warehouse contract and insurance coverage leaves off.

The transportation of goods is also subject to laws and regulations that, on the whole, tend to favor the carrier, or provider of transportation services. The "Carmack Amendment", which prescribes the rights, duties, and liabilities of shippers and carriers with respect to interstate cargo loss and damage claims, was first enacted as to interstate rail transportation in 1096.[17] Congress extended the Carmack Amendment to motor carriers by the Motor Carrier Act of 1935.[18] "The Carmack Amendment codified the common law rule making a carrier liable, without proof of negligence, for all damage to the goods it transports, unless it affirmatively shows that the damage was occasioned by an act or omission of the shipper, an act of God, the public enemy, public authority, or the inherent vice or nature of the goods transported."[19]

Even though the Carmack Amendment established strict liability for carriers, a shipper of goods may still be challenged and disappointed by the outcome of the application of the Carmack Amendment and attendant regulations. First, given the complex nature of

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[14] *Id.* at § 7-204(b).

[15] *Id.* at § 7-204(c).

[16] Kevin M. Phillips, *Warehouse Law*, at pp. 6-7 (available at: http://www.imua.org/Files/reports/999122.pdf) (last visited February 16, 2018).

[17] Wesley S. Chused, *The Evolution of Motor Carrier Liability Under the Carmack Amendment Into the 21st Century*, 36 Transportation L. J. 177, 178 (2009) (citations omitted).

[18] *Id.*

[19] *Id.* at 179 (citation omitted).

modern supply chains, which often have the involvement of brokers and logistics providers that are not carriers, establishing carrier liability can be difficult.[20] Such liability may be better apportioned to the other third party providers, who are also the subject of various laws and regulations.[21] Even if carrier liability is established, shippers are likely to find themselves tied up in the carrier's claims process or a claims process established by federal regulations.[22] Finally, the carrier may limit recovery to amounts required by law, which are generally insufficient to cover the shipper's losses. Therefore, a franchise system that is considering contracting for the transportation of goods should consider engaging legal counsel with specialization in transportation matters.[23]

In modern supply chains, the lines between warehousing, distribution, transportation, and other logistics services are often blurred and many providers offer holistic logistics solutions that address more than one "link" of the supply chain. Therefore, a franchise system must ensure that it understands the particular components of each service that a logistics provider offers. The franchise system should then consider the specific legal framework applicable to each component of the services and the extent to which the franchise system desires to seek a different standard from that which is otherwise applicable by law or by the vendor's contract. Then, the franchise system should ensure the careful documentation of services, the standard of care and liability applicable to each component of the services (with sufficient documentation of waivers of or departures from applicable laws, as needed), and the insurance coverage that each party should maintain to adequately protect the franchise system's interests.

d. Outsourcing and Technology Solutions

Modern supply chains are built upon sophisticated technology solutions that enable real-time transmission of and access to information, as further described below in Section 4. Such solutions may be custom-built and owned by a franchise system, or outsourced to or licensed from a third party. These solutions may also include warehouse management systems, real-time information sharing, and other solutions that allow a company to plan, execute, and control supply chain activities.

Unless a franchise system opts to develop its own software solutions, the franchise system will contract with one or more third party vendors for outsourced solutions. In

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[20] *Id.*

[21] *See, e.g.*, 49 C.F.R. Part 371, Brokers of Property.

[22] 49 C.F.R. Part 370, Principles and Practices for the Investigation and Voluntary Disposition of Loss and Damage Claims and Processing Salvage.

[23] Chambers and Partners provides annual rankings and other information in the category of "Transportation: Road (Carriage/Commercial) – USA – Nationwide." *See e.g.*, https://www.chambersandpartners.com /12788/727/ editorial/5/1 (last visited February 16, 2018).

negotiating such contracts, the franchise system should carefully consider a variety of issues, including:

- Financial liability of the vendor for downtime, data breach, and other events that adversely impact the franchise system;
- Applicable warranties on performance of the solution and uptime;
- Rights to the franchise system's information upon expiration or termination of the contract (and the format of such information and whether it will be portable);
- Training, maintenance, and support services; and
- Intellectual property rights and indemnification.

3. Strategic Considerations for Franchise System Supply Chains

A well-operated supply chain is an essential part of building any franchise system that has one or more flagship products or that relies upon marketing safe, high quality products. Given the wide range of options available when structuring or restructuring franchise system supply chains, franchise systems should carefully consider their needs and strategy when making significant decisions about or changes to the supply chain. Such advance planning can lead to further growth and success and avoid significant claims by franchisees, consumers, and others. Strategic considerations when structuring or restructuring a franchise system's supply chain should include:

- The amount of control needed to maintain and grow the brand;
- The ownership of the supply chain functions (franchisor, franchisees, or a third party);
- Supply chain stability and contingency planning;
- Current political and similar considerations, such as the renegotiation of the North American Free Trade Agreement ("NAFTA");
- Available resources for procurement processes and supplier management;
- The franchisor's and/or franchisees' potential receipt of income and other benefits from supply chain vendors or as a result of the purchase of goods and services; and
- What consumers (*i.e.*, the customers of the franchised units) want.

a. Control and Ownership of the Supply Chain

It is entirely possible for a third party to run much of a franchise system's supply chain while the franchisor retains enough control to establish and maintain brand standards. Still, achieving such a dynamic can be difficult and takes time. Therefore, the degree to which control is necessary or advisable should be one of the first strategic considerations for franchise system supply chain planning. If the franchisor chooses to maintain a significant degree of control over various supply chain functions, such as manufacturing, or required sources of supply, the franchisor should become familiar with potential antitrust constraints, such as restrictions on tying arrangements.[24]

Franchise systems that allow and encourage franchisee participation in supply chain functions can experience greater franchisee satisfaction, franchisee understanding of challenges, and lower cost of goods. Where feasible, franchisee participation opportunities in supply chain functions may be a strong selling point for helping to acquire new franchisees. Still, franchisee participation is not possible or practical in all situations and may take many different forms.

As discussed in Part 5 below, a purchasing cooperative is one option to provide franchisees with both ownership and control of key supply chain functions. In addition to a purchasing cooperative, many franchise systems engage a franchisee committee or association to participate in supply chain decisions and/or operations. The franchise system may choose to have the franchisees participate in an advisory capacity only, may permit them to share "voting rights" with members of a committee that represents both the franchisor and franchisees, or may permit the franchisees greater latitude over certain decisions.

b. Supply Chain Stability

When making decisions about supply chain structuring or restructuring, strategies to achieve overall supply chain stability should be central to planning and decisions. For example, even though franchise system owned and controlled manufacturing may seem an ideal way to control quality and cost of goods, relying upon a single factory could severely disable an entire franchise system in the event of a fire, flood, or other shutdown. Often, opting for multiple sources of supply provides much more stability. By the same token, franchise systems should be wary of suppliers that commit to develop a product *if* the franchise system agrees that such supplier will be the franchise system's sole source of supply of the product. In such situations, the franchise system should carefully negotiate for access to information, intellectual property rights, and other mechanisms that would be needed to engage an alternate source of supply in the event that the supplier were unable to meet its commitments to the franchise system.

c. Impact of Political Conditions and NAFTA Renegotiation

In considering supply chain strategy and overall stability, franchise systems should also be mindful of current political conditions. For example, the renegotiation of NAFTA may have a significant impact on supply chains. The potential changes to and possible repeal of NAFTA would have broad reaching effects on supply chains and effective supply chain management. Companies with operations in the U.S., Canada, Mexico (collectively, "NAFTA Countries"), and any other countries that have trade agreements with the U.S. must consider these potential changes and adopt a flexible plan to adapt

[24] *See generally* Robert T. Joseph, *Antitrust Law, Franchising, and Vertical Restraints*, 31 Franchise L. J. 1 (2011).

to such changes. NAFTA has a direct impact on the import and export of goods between NAFTA Countries. Specifically, NAFTA:

- Eliminates or reduces tariffs on a wide range of products;
- Removes other non-tariff barriers to trade;
- Provides for uniform country of origin provisions;
- Eliminates custom charges; and
- Allows for easier travel by shipping vehicles across borders.

As a preliminary issue, it is unclear exactly how, or if, NAFTA will change and whether it will be repealed entirely. However, several changes are under consideration that could significantly impact franchise systems operating in the U.S.

One potential change is to the NAFTA country of origin requirements. The country of origin requirements require that a certain percentage of a product be sourced from NAFTA Countries to qualify for treaty benefits. For example, a steering wheel produced in Mexico might contain parts from China. The rules of origin state how many of those parts can come from China while still qualifying as a product that was manufactured in Mexico. The U.S. seeks a stricter content requirement, specifically that a greater percentage of a product be sourced from a NAFTA Country and the possible addition of a U.S. origin requirement, that is, that a certain percentage of a product must be sourced from within the U.S. Additionally, the U.S. proposes more comprehensive origin certification and verification systems, such as tracking of steel and electronic origin parts.[25] If country of origin requirements are tightened, this will make fewer products eligible for the tariff benefits available under NAFTA, and would increase the cost of products that would no longer be eligible.

The U.S. has also proposed new rules for seasonal and perishable products, such as fruits and vegetables, which would make it easier for U.S. producers to initiate trade remedy cases (such as anti-dumping and countervailing duties proceedings) against exports to the U.S.[26] These rules are aimed mostly at Mexican producers who some U.S. farmers have initiated complaints against for flooding the U.S. market with certain produce items. Mexico is currently the largest foreign supplier of U.S. imports of vegetables and fruits (excluding bananas).[27] The availability of produce from Mexico is largely attributable to large-scale greenhouses and other technologies that allow Mexico to grow seasonal fruits and vegetables year-round. An increase in the use of trade remedies would limit the import of certain products from Mexico and may make it more

[25] *See* in general, Office of the United States Trade Representative, Summary of Objectives for the NAFTA Renegotiation (July 17, 2017 and November 2017).

[26] Congressional Research Service, "Efforts to Address Seasonal Agricultural Import Competition in the NAFTA Renegotiation," Renee Johnson, December 7, 2017.

[27] *Id*. (citing L. Calvin and S. Zahniser, "Mexico-US Agricultural Trade," https://migration.ucdavis.edu/farm-labor/, presentation at "Farm Labor and Mexico's Export Produce Industry," Wilson Center, November 15, 2017.)

difficult and more expensive for suppliers to obtain fresh fruits and vegetables year-round, particularly tomatoes, avocados, peppers and berries.[28] It is easy to see how such changes could adversely impact limited time only (LTO) promotions and menus of franchised restaurant systems.

There have also been proposals for NAFTA to include more stringent labor standards, aimed at improving the condition of workers in Mexico and imposing a higher minimum wage in Mexico. A higher minimum wage would impact the price of products exported from Mexico and would protect U.S. and Canadian producers who are currently paying more for labor.

Additionally, if NAFTA is repealed, this would result in the repeal of tariff benefits and is expected to restore World Trade Organization (WTO) most favored nation rates for tariffs. Such a repeal would potentially reduce the net income margin of companies in industries that rely heavily on imported parts such as automotive, agricultural and textile industries.[29] Less affected industries are expected to be aerospace, metals, mining, pharmaceutical and oil and gas, which rely less on imports from NAFTA countries.[30] Companies should begin the process now of assessing what changes, if any, need to be made to prepare for changes to NAFTA.

d. Available Resources

In making determining supply chain strategy, the franchise system should also carefully consider the resources that the franchise system has available to dedicate to procurement processes and supplier management. For example, while switching from broadline distribution to a series of regional distributors, or to a system by which locally sourced produce is delivered to a commissary, processed, and then distributed to restaurants, may seem like an improvement, the RFP process, contract negotiation, and subsequent supplier management involved in each such alternative may be draining for many franchise systems. Franchise systems experiencing explosive growth should be particularly careful to consider the resources necessary to manage the chosen supply chain.

e. Rebates and Other Income

"Supplier income", or the receipt of rebates, advertising, or other benefits from vendors to the franchise system, is a hotly debated topic that can spark not only significant ill will within a franchise system, but also litigation. Whether, or to what degree, various supply chain participants (such as the franchisor) may benefit from supplier income may depend upon what rights were reserved in applicable franchise agreements or in pre-

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[28] *Id.*

[29] Bain & Company, "Is Your Supply Chain Ready for a NAFTA Overhaul?," Rodrigo Rubio, Thomas Huber, Joe Terino and Gabriela Lozada, August 3, 2017.

[30] *Id.*

sale disclosures made in the franchisor's Franchise Disclosure Document ("FDD"). Even where the franchisor has liberally reserved the right to accept supplier income, it may still be advisable to dedicate such income exclusively to the support of the supply chain or to advertising and other activities that support the franchise system as a whole, to avoid disputes and increase franchisee satisfaction.

f. Customer First

Finally, when considering any supply chain decision, the franchise system must be careful to ensure that it considers consumer expectations. Supplier certifications must be sufficient to support advertising and claims made about products. For example, if a restaurant advertises "Non-GMO" salad, it must ensure that it can substantiate this claim in order to avoid and defend itself in a potential class action for false and deceptive advertising. Similarly, claims that a supply chain is "green" or "sustainable" require careful planning and contractual provisions that support such claims.[31]

4. Implementing Efficient Supply Chain Management Practices in a Mature System

The considerations outlined in this paper thus far lay the foundation for strategic decision-making when establishing a supply chain that functions efficiently and effectively for the franchise system. However, like most franchise systems themselves, a franchise system's supply chain often evolves organically, beginning with handshake arrangements with certain suppliers and little more than the terms of a purchase order or floor stocking agreement to govern the relationship with other suppliers. For example, recall procedures are broadly crafted and largely unknown to anyone outside of the franchisor's purchasing department until a crisis management event arises that impacts the franchise system and the logistics of ensuring the correct products reach franchisees. The idea of implementing supply chain management practices often is overwhelming to growing brands, many of whom defer implementing such practices until the franchise system reaches a certain size, geographical footprint or maturity level because the franchise system is "too small" or "lacks bargaining leverage" to establish supply chain management practices in its current state. However, the reasons underlying deferral of improving supply chain management within a franchise system are misplaced. Efficiencies may be gained through smart supply chain management practices in franchise systems of any size, to the benefit of the franchisees and strength of the franchise system as a whole.

a. Evaluating Existing Supplier Relationships

The initial step in identifying opportunities to improve a franchise system's supply chain is an evaluation of existing relationships with all suppliers in the supply chain described in Part 2(b) above, from formulation service providers through suppliers and

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[31] *See* Stephen C. Ellis, *"Green" Supply Chain Contractual Provisions*, The Practical Lawyer, p. 19 (June 2013).

manufacturers, to logistics providers and distributors of the products. A survey of the existing obligations of each respective supplier[32] to the franchise system, any obligations of the franchise system to meet binding forecasts and minimum purchase requirements (and whether such forecasts and minimum purchase requirements historically have been met by the franchise system), and franchisee complaints with respect to suppliers and demonstrated performance of each supplier, offer valuable information to a franchisor in identifying immediate opportunities to implement change as well as shape the overall strategic direction of implementing more efficient supply chain management practices.[33]

b. Identifying New Suppliers and Reshaping Existing Supplier Relationships

Armed with the information gained in an evaluation of the franchise system's existing supply chain, a franchisor may begin to make improvements by selecting suppliers that will increase the performance of the supply chain as a whole while minimizing risk. In connection with evaluating responses to a franchisor's requests for information ("RFI")[34], requests for quote ("RFQ")[35] and RFP,[36] the franchisor should conduct a due diligence investigation that encompasses not only the supplier but key subcontractors upon which the supplier will rely to perform material obligations on its behalf, including ownership and organizational structure, financial condition, insurance and maintenance of required licenses, litigation history and criminal background, corporate social responsibilities

[32] The term "supplier" is used to refer to all providers in the supply chain, including suppliers of products as well as service providers (e.g. formulation and development service providers), logistics providers, distributors, freight forwarders, transportation service providers and supply chain management technology systems providers.

[33] Relationships with suppliers and distributors that are not governed by binding forecasts or commitments to purchase minimum quantities of products and that allow for the franchisor to exit the relationship without cause or penalty are the "low hanging fruit" in the initial evaluation and should be targeted for the first phase of requests for proposal described in Part 4b. Arrangements with suppliers and distributors that require the franchise system to satisfy forecasts or minimum purchase requirements (or, for which pricing has been established based upon the franchise system meeting certain minimum purchase requirements) or, as is common with products that are proprietary to the franchise system, arrangements for which quantities of inventory have already been produced, may be addressed in subsequent (and more strategic) phases of supply chain management.

[34] Requests for information focus on gathering information about a product or supplier in connection with narrowing the strategy for sourcing such product (e.g. whether sourcing a product from several regional suppliers is preferable to sourcing from a national supplier due to supplier capabilities or in evaluating the feasibility of a contemplated limited time offering).

[35] Requests for quote are utilized where the terms the franchisor seeks to determine are primarily economic in nature.

[36] Requests for proposal are the most detailed forms of request and commonly include the scope of services to be provided and expected deliverables (including the timeline associated with the same), ownership of intellectual property, allocation of risk, pricing and performance expectations, and information demonstrating the respondent's ability to achieve the expected results.

policies and instances of administrative actions for regulatory non-compliance.[37] A franchisor should be mindful of crafting RFIs, RFQs and RFPs that will not be construed as an offer under applicable law,[38] including, for example, reserving the right to reject any responses to such RFIs, RFQs and RFPs, and modify any terms of the RFIs, RFQs and RFPs.[39]

c. Maximizing Supply Chain Efficiency Using Key Terms of Agreements

Once a franchisor has identified those suppliers with whom it will engage to provide products and services to the franchise system, the franchisor should ensure the terms and conditions governing the parties' relationship include certain key terms, as outlined below.[40]

i. **Forecasts and Inventory Requirements.** A franchisor should consider the economic benefits and stability to the supply of products that including product forecasts and minimum inventory requirements in agreements could provide.[41] In establishing forecasts and minimum inventory requirements (and determining whether such forecasts and inventory requirements will be binding), a franchisor should evaluate the lead time for the product (including the lead time and potential sourcing issues of any components, raw

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[37] Franchisors may consider engaging third party providers to facilitate supplier due diligence, particularly where international supplier and subcontractor relationships are contemplated, to ensure FCPA compliance, verification of corporate registration, identification of business and political relationships to uncover unfavorable affiliations (e.g. links to organized crime or terrorist groups, improper payment arrangements) and analysis of press resources. *See Kreller Due Diligence: Investigations Levels & Estimates – Subject Company*, KRELLER GRP.; LexisNexis, *9 Steps to Effective Third Party Due Diligence* (2015), http://www.lexisnexis.com/pdf/Lexis-Diligence/ctr/Lexis-Diligence-9-steps-to-effective-3rd-party-due-diligence.pdf; WORLD ECONOMIC FORUM, GOOD PRACTICE GUIDELINES ON CONDUCTING THIRD-PARTY DUE DILIGENCE 8-15 (2013), http://www3.weforum.org/docs/WEF_PACI_ConductingThirdPartyDueDiligence_Guidelines_2013.pdf.

[38] Duckworth Pathology Grp, Inc. vs Reg'l Med. Ctr. at Memphis, No. W2012-02607-COA-R3-CV, 2014 WL 1514602, at *3 (Tenn. Ct. App. Apr. 17, 2014), *aff'd in part, rev'd in part on other grounds;* Modern Office Methods, Inc. v. Ohio State Univ., 975 N.E.2d 523, 528 (Ohio Ct. App. 2012); Delta Testing & Inspections, Inc. v. Ernest N. Morial New Orleans Exhibition Hall Auth., 699 So. 2d 122, 124 (La. Ct. App. 1997).

[39] Five Star Airport Alliance, Inc. v. Milwaukee Cty., 939 F. Supp. 2d, 936, 941 (E.D. Wis. 2013) (issuer of RFP has the right to reject all bids and issue a new RFP).

[40] This list of key terms is not exhaustive and does not address all of the considerations and issues that arise with respect to each of the terms described in this Section 4.c. For a more extensive discussion of key terms, see J. Mazero and L. MacPhee, Setting the Stage for "Best in Class" Supply Chain, 36(2) FRANCHISE L. J. 219 (2016).

[41] Forecasts and inventory requirements often require a franchisor to commit to purchasing minimum quantities of products absent breach by the supplier, so such commitments should be established with careful consideration as to purchase history, availability of the same or similar product from other sources and whether the franchisor anticipates modification or substitution of the product in the near future.

materials or ingredients, particularly if any such components, raw materials or ingredients are sourced internationally, and whether such supply relationships are made by the franchisor directly or through the manufacturer). Establishing performance criteria (i.e. key performance indicators, as further described below) to ensure component suppliers comply with prescribed lead times and forecasts can prevent the domino effect that may occur when such component suppliers are unable to meet delivery deadlines to product manufacturers, who in turn are unable to meet delivery deadlines for finished products, ultimately resulting in product shortages at the franchisees' units.

A franchisor should consider any potential sourcing issues before making commitments that the franchise system will purchase certain quantities of products. On the other hand, there are certain economic benefits that can be achieved by entering into binding commitments that the franchise system will purchase a specified quantity of products (e.g. fixed pricing and secure supply of commodity products that are subject to volatility in cost and availability).[42] However, entering into binding forecasts and minimum inventory requirements should be balanced with purchasing behaviors of franchisees and the franchisor's methods of enforcing compliance with purchasing requirements within the system. If there is an established pattern of non-compliance with requirements to purchase from approved suppliers among franchisees, and the franchisor has not developed a strategy to gain franchisee buy-in to change purchasing behavior or otherwise enforce its standards with respect to purchasing requirements, then the franchisor should proceed cautiously before entering into binding forecasts or minimum inventory requirements.

ii. **Product Warranties and Recalls.** Agreements with suppliers also should include robust product warranties that extend beyond product specifications to include all aspects of how the products are packaged, labeled, stored, maintained (e.g. cold chain management), transported and delivered, to ensure the integrity and quality of the product when it arrives at each franchisee's unit. Franchisors should consider the impact of the U.C.C. on the terms of its agreements with suppliers.[43] In addition to the implied

[42] *See* "Demystifying commodity hedging," Bloomberg Professional (Sept. 1, 2016) *available at:* https://www.bloomberg.com/professional/blog/demystifying-commodity-hedging/ (explaining factors in assessing volatility in commodity markets and determining hedging strategy).

[43] Article 2 of the U.C.C. governs the sale of goods over $500 between merchants (as defined in the U.C.C.) and, in the absence of a disclaimer or specific terms regarding the warranties, applies to most supply transactions. Article 2 has been adopted by all states except Louisiana and while codified by the states in a mostly uniform manner, some modifications at the state level have been made. *See generally*

warranties provided for under the U.C.C. (e.g. merchantability, fitness for a particular purpose, non-infringement, title and freedom from encumbrances),[44] franchisors should include express warranties that the products and services will comply with franchisor's specifications and standards and will be provided in accordance with applicable law (including compliance with regulatory requirements with respect to packaging and labeling), and that products will not be adulterated or misbranded.

Where franchisors have historically been required to manage supplier compliance with such product warranties on a supplier-by-supplier basis, the emergence of sophisticated supply chain technology utilized by disruptors in the e-commerce industry (e.g. Amazon, Alibaba) have made it possible for franchisors to demand uniformity and continuity across suppliers from manufacturer to final-mile delivery. The increasing role of technology in managing supply chains has opened the door to a myriad of opportunities for franchisors to capture efficiencies not only in its direct relationships with each supplier but also across its supply chain. The benefits of block chain technology have infiltrated recent discussions of supply chain management, with companies utilizing block chain technology to establish continuity of performance metrics across the suppliers in the chain. Blockchain is a type of database technology that maintains, records and authenticates data, and in the supply chain context, it allows for products to be identified by unique markers to allows for transparency across the history of the product as it moves to the end customer, including information regarding whether anyone has attempted to alter any record.[45] For example, Starbucks recently announced a pilot program to implement blockchain technology to track its coffee beans from supplier to customer.[46] DHL has identified that a potential benefit of the use of blockchain technology in its performance of logistics services is the ability to determine when counterfeit products have been

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Martin Carrara, *The Basics of U.C.C. Article 2-Sales*, ASS'N OF CORP. COUNSEL (June 2013), http://news.acca.com/accnj/issues/2013-06-07/3.html. Links to the commercial code as adopted by various states may be accessed at the Cornell University Law School Legal Information Institute website at http://www.law.cornell.edu/uniform/uss/html.

[44] U.C.C. §§2-312(1)(a), 2-312(1)(b), 2-312(3), 2-314 and 2-315.

[45] "Blockchain Powerful Tool for Transparency in Complex Supply Chains," MATERIAL HANDLING & LOGISTICS (Mar. 13, 2018), *available at: http://www.mhlnews.com/technology-automation/blockchain-powerful-tool-transparency-complex-supply-chains*.

[46] T. Soper, "Starbucks explores potential use of blockchain technology for 'bean to cup' pilot program," GEEKWIRE (Mar. 21, 2018), *available at: https://www.geekwire.com/2018/starbucks-explores-potential-use-blockchain-tech-bean-cup-pilot-program/*.

introduced into the supply chain.[47] The use of block chain technology coupled with the emergence of smart contracts[48] make it possible for companies to determine real-time where a supplier has failed to meet performance metrics. The implications of this technology for franchisors, particularly those in the food and beverage industry, are tremendous, as it increases significantly the likelihood that a franchisor will be aware that products that have not been maintained in accordance with product specifications (for example, with respect to temperature control requirements), prior to the products being served to customers.

Although this technology is increasingly becoming accessible for growing companies, it may still be out of reach for smaller franchisors. Regardless of the role technology systems currently play in a franchisor's supply chain management, the importance of established recall procedures that are consistent across the supply chain cannot be understated. While many suppliers maintain product recall policies, a franchisor should ensure that those product recall policies are aligned across the system and include the appropriate protections for the brand. The ramifications of a delay in responding to a food safety issue due to confusion or inconsistency in product recall policies at the manufacturer and distributor levels can be devastating for a franchise system.[49] A franchisor should ensure that compliance with its product recall policies as well as crisis management policies are incorporated into agreements with all suppliers to ensure the message to customers with respect to any product recall is consistent with franchisor's position with respect to such recall and to minimize impact to the brand.

iii. **Indemnity Obligations and Contingency Planning.** Franchisors should ensure that indemnity obligations of its suppliers to the franchise system expressly provide for indemnification in the event of claims by franchisees in the event the supplier fails to perform. The failure of a supplier designated by a franchisor to perform that results in the inability of the franchisees to operate their businesses

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[47] *Supra* at n. 46.

[48] *Id. See also* J. Gelski, "The Buzz on blockhain," Food Business News (Feb. 13, 2018), *available at*: https://www.foodbusinessnews.net/articles/11281-the-buzz-on-blockchain.

[49] In the past two decades, numerous restaurant chains have been plagued with food safety issues related to contaminated products, including Chipotle, Jimmy John's, Taco Bell, Wendy's, Sizzler, Burger King, KFC, Jack in the Box, McDonald's, Chi-Chi's and Frederico's Mexican Food. M. Hill, "10 notable E. coli outbreaks at U.S. fast-food restaurants," United Press International (Dec. 31, 2015), *available at*: https://www.upi.com/Health_News/2015/12/31/10-notable-E-coli-outbreaks-at-US-fast-food-restaurants/5781451489618/.

can be catastrophic to a brand as well as the franchisor/franchisee relationship.[50] For example, in February 2018, technology issues crippled KFC's distribution of chicken to its 900 restaurants in the United Kingdom, causing approximately two-thirds of the restaurants to experience a shortage in their core menu which resulted in temporary closures.[51] Although KFC attempted to mitigate the negative impact these closures had on their stores and franchisees, the impacts on its franchise system in the United Kingdom are still beginning to unfold.[52] Franchisors also should be prepared to have contingency plans in the event of a failure of their supply chains to minimize the impact to their franchise systems and include in their agreements with suppliers that such contingency plans will be at the breaching supplier's cost. In the KFC example above, KFC reacted quickly to enlist the support of an on-demand warehousing provider (think AirBNB for warehousing) that was operational within three days to facilitate getting product to its franchisees.[53]

iv. **Inspections and Audits.** Supply agreements commonly provide for inspection and audit rights of a franchisor with respect to the supplier's records and facilities. However, many franchisors do not regularly exercise those audit and inspection rights. When establishing the terms under which a franchisor may audit a supplier's records and inspect its operations, a franchisor should include rights that it has the ability to exercise and establish internal processes to ensure regular audits and inspections are completed. In addition, because the franchisor is rarely the recipient of the products or services provided by suppliers, franchisors should make sure that franchisees are aware of any obligations in the agreement with respect to inspection of products upon delivery and deadlines by which a supplier must be notified of order inaccuracies or product defects.

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[50] *See Ponderosa Systems, Inc. v. Brandt*, 767 F.2d 668, 670 (10th Cir. 1995) (franchisee prevailed on counterclaims against the franchisor for Steak & Ale restaurants related to the franchisee's failed restaurants resulting from franchisor's refusal to allow franchisee to use alternative suppliers of proteins despite numerous complaints from defendant franchisee and other franchisees regarding the poor quality of proteins delivered by franchisor's designated supplier.)

[51] G. Drakes and T. Rickard, "Clucking Mad – what can franchise businesses learn from KFC's supply chain issues?" FieldFisher (Mar. 12, 2018), *available at: http://www.fieldfisher.com/publications/2018/03/clucking-mad-what-can-franchise-businesses-learn-from-kfcs-supply-chain-issues#sthash.T3rgFUVA.dpbs.*

[52] *Id.*

[53] *Id.*

v. **Insurance; Title Issues.** As products move from supplier to freight forwarder to logistics providers and ultimately to distributors (and in some cases, last-mile providers), a franchisor should ensure that each supplier in the chain maintains the appropriate insurance to minimize risk to the franchise system in the event of a loss. In addition, a franchisor should ensure that its agreements with various suppliers across the chain do not inadvertently result in a break in chain of title. This issue may arise where a franchisor contracts with a raw materials supplier for delivery of components to supplier's designated manufacturer, and the raw materials are stored at the manufacturer's facility until they are incorporated into a finished product. While this issue is unlikely to arise in the context of food supply to franchised restaurants, it is foreseeable in the context of equipment and technology systems manufactured on behalf of a franchisor for use in its franchised system where raw materials are sourced by the franchisor and franchisor retains title to such raw materials stored at its manufacturer's facility. The terms of a franchisor's agreement with the manufacturer should expressly provide that franchisor retains title to such raw materials while stored at the manufacturer's facility and include appropriate insurance requirements for the manufacturer to minimize loss as well as prohibit any encumbrances of the franchisor's raw materials while at the facility.

d. Establishing and Using Key Performance Indicators to Manage Supply Chain

A key component to managing supplier relationships is the implementation and use of KPIs to measure supplier performance. In discussing approaches to establishing KPIs that drive supplier performance, it may be helpful to begin with a discussion of what KPIs are not. A KPI should not be defined as the expected result (e.g. a sales goal); rather, KPIs should be comprised of metrics that, if met, will ensure sales goals are achieved.[54] Maximizing efficiencies in a supply chain means suppliers continually strive to exceed expectations and not merely satisfy their obligations under the agreement.

An example of the benefits of using KPIs can be seen using a potential scenario that may occur within a franchise system when a franchisor enters into a supply agreement with a beef supplier and franchisees then place orders with the franchisor's designated broadline distributor who is purchasing the beef from the beef supplier. On multiple occasions, franchisees do not receive their orders for beef when scheduled and when products do arrive, quality is poor, and dissatisfaction among franchisees with the franchisor's designated suppliers grows. When this occurs, the franchisor looks to the distributor that failed to deliver products on time, and the distributor points to the supplier for failing to fulfill the distributor's purchase orders for beef – except the terms

[54] D. Parmenter, KEY PERFORMANCE INDICTORS: DEVELOPING AND USING WINNING KPIS 4 (2010).

of the supply agreement with the beef supplier provide only that the supplier fulfill purchase orders for beef at the specified rate. Because of these supply chain issues, franchisees demand change in the franchisor's beef supplier, the franchisor commences another request for bid, and looks for ways to exit the relationship with the existing beef supplier and find a new beef supplier. Consider how the timeline changes if KPIs are made part of the agreement with the beef supplier.

Effective KPIs generally include nonfinancial or financial measures, measured periodically on a consistent basis, normally beginning with a supplier's self-report scorecard, that are reviewed and determined by a franchisor who communicates the performance measurements with the supplier. Any corrective and preventative measures that result from failure to achieve KPIs should be easily understood.[55] For example, in the case of the beef supplier, KPIs may include the following: inventory availability at 95%, on-time delivery at 98%, order accuracy at 99% and product quality at 99%. KPIs are weighted based upon their impact to performance and the brand, and a scorecard is used to determine the overall performance of a supplier based on the weighted score of each KPI. KPIs are measured at regular intervals (e.g. quarterly). Following a failing KPI score, the beef supplier would be required to submit a corrective and preventative action plan ("CAPA") to resolve performance issues and a penalty for non-performance is assessed in the form of a credit that is passed down to franchisees on their next beef purchase. The beef supplier would then be eligible to receive incentive payments from the franchisor for demonstrating continuous process improvement and a pattern of exceeding KPIs.

Mismanagement of supply chain within franchise systems is a widely litigated issue among franchisors and franchisees. Franchisees, frustrated with the contractual obligation in the franchise agreement to use suppliers designated by the franchisor that consistently fail to perform, look to the franchisor as the party responsible for the franchisees' inability to maximize profits in the operation of its business due to inventory issues.[56] Implementing a process for ongoing assessment of supplier performance provides the opportunity for the franchisor to identify supplier issues, ensure accountability of the supplier and maximize benefits to the franchise system of the supplier relationship. Where the potential economic loss is significant, the use of KPIs may be made more efficient by implementing a pain-share/gain-share program to drive supplier performance. As illustrated in the example above, the monetary consequences to the supplier for failing to satisfy KPIs (or, alternatively, the monetary incentive exceeding KPIs) are made part of the agreement with the franchisor. Utilizing KPIs in managing supplier relationships strengthens the stability of a franchise system's supply chain by providing a mechanism by which supplier issues may be resolved before the relationship deteriorates such that the only viable option is default and termination, which requires the franchisor to expend time and resources identifying a new supplier,

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[55] *Id.* at 6.

[56] *Supra*, n.50.

and the franchisees to adjust to ongoing inconsistency in the products sold from or used in connection with the operation of their business.

In addition to the benefits of implementing KPIs described above, there are legal considerations in support of a more focused approach to a franchisor's management of its supply chain. Some states require that a franchisor satisfy certain conditions in connection with any restriction imposed on franchisees with respect to sourcing and supplier selection.[57] Accordingly, a prudent franchisor would be wise to have an established process of managing supplier performance (through the use of KPIs) to support its requirement that franchisees purchase products and services from the franchisor's designated suppliers.

5. The Role of Purchasing Cooperatives, Group Buying Organizations and Other Buying Arrangements in Strategic Supply Chain Management

Amazon and Alibaba are continually raising the customer perception of what constitutes a good customer experience – purchasing decisions are increasingly personalized, products are available immediately and delivered to the customer's doorstep within hours at prices equal to or below prices at retail locations. Franchisees in all industries are scrambling to adjust to the shifting customer expectation of faster, better and cheaper access to products while interacting with the retailer in a way that feels personalized to the customer, and many franchisees are looking toward their supply chain to gain efficiencies in how they deliver products to customers and how their businesses are operated. Leveraging group purchasing can produce efficiencies not only in procurement of products and services but also can allow franchisees to achieve efficiencies in services and products used in the operation of their businesses, including advertising, insurance programs, technology systems and data analytics, logistics and distribution. The approach that a franchise system may take to leverage group purchasing can take many forms, including, for example, establishing a purchasing cooperative as a separate legal entity to oversee supply chain management of an entire franchise system, forming regional buying groups to maximize efficiencies in locally sourced products, and entering into buying arrangements across franchise systems to take advantage of volume purchases of certain products utilized by each of the franchise systems. Purchasing cooperatives often originate from underlying tension between the franchisees and franchisors due to issues related to performance of the franchisor's designated suppliers and a desire for franchisees to have transparency into the supply chain upon which they rely to operate their businesses. This demand for transparency is not unique to franchise systems and is underlying the emergence of blockchain technology as an integral component of supply chain management. In addition to increasing trust among franchisees in the franchisor's supply chain, greater

[57] For example, a Washington statute permits a franchisor to restrict the suppliers from which its franchisees must purchase provided such restrictions are necessary for business purposes. WASH. REV. CODE ANN.§19.100.180(2)(e). A Hawaii statute allows franchisors to designate suppliers if the purchasing required is "justified on business grounds." HAW. REV. STAT. §482E-6(2)-(2)(B). And, an Indiana statute makes it unlawful for a franchisor to require franchisees to purchase products or services exclusively from franchisor's designated suppliers when products are services are comparable in quality and available from other sources. IND. CODE §23-2-2.7-1(1).

transparency benefits the "trading partners" (e.g. suppliers, manufacturers, distributors, logistics providers) by providing access to information regarding anticipated or actual disruption in the supply chain to allow such trading partners to make adjustments to minimize the disruption. Another benefit to franchise systems, both at the franchisor and franchisee level, of implementing purchasing cooperatives or leveraging other group buying arrangements is the cost savings and improved stability to the supply chain, as further discussed below.

a. Purchasing Cooperatives.

Purchasing cooperatives often are established as a separate legal entity, with franchisee members receiving benefits in the form of cost savings on products and services and dividends paid to members. Cooperatives may be managed by its members or the members may elect to retain the services of a consultant. In some cases, the franchisor will have a role in the cooperative (e.g. as a board member). Among the most widely recognized purchase cooperative is Restaurant Services, Inc. ("RSI"), the independent supply chain management and distribution cooperative for the Burger King system owned by Burger King Corporation and Burger King franchisees. RSI provides numerous support functions to the Burger King system, including business analysis, promotion planning, commodity analysis, integration of technology and analytics systems to improve system performance, and supplier selection.[58] Similarly the Wendy's Quality Supply Chain Co-Op, Inc. ("Wendy's Co-Op"), owned by Wendy's and its franchisees, is responsible for negotiating the purchase terms of numerous food and packaging used in the operation of Wendy's restaurants (including strategic reduction of the impact of commodity price fluctuation and pricing stability related to food and fuel), managing distribution and logistics, and procurement of equipment and services (including energy, water, cleaning services, office supplies and restaurant equipment).[59] Restaurant Supply Chain Solutions ("RSCS") is the purchasing cooperative established to services Yum! Brands, Inc.'s portfolio of brands and oversees the operations of the brand-specific purchasing cooperatives established for A&W, KFC, Pizza Hut and Taco Bell.[60] RSCS supports Yum! Brands globally in strategic purchasing of food, packaging and equipment, provides commodity risk management services, oversees management of programs at the brand level and manages distribution and logistics across the Yum! Brands system.[61]

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[58] "RSI Support Functions," Restaurant Services, Inc., *available at*: https://www.rsiweb.com/Net/public/GeneralInformation/AboutRSI.aspx#support.

[59] Wendy's Quality Supply Chain Co-Op, *available at*: https://www.wqscc.com/what-we-do.

[60] Restaurant Supply Chain Solutions, *available at*: http://www.rscs.com/.

[61] *Id.*

b. Independent Franchisee Associations.

Another approach to incorporating franchisees in strategic decisions related to supply chain management of a franchise system includes soliciting input from an independent franchisee association. For example, the Denny's Franchisee Association established a Supply Chain Oversight Committee with Denny's, Inc. to address franchisee concerns regarding rising costs of products and equipment, and to involve the franchisees in purchasing decisions affecting the operation of their restaurants.[62] Other franchise systems may solicit input from franchisees with respect to performance of the system's supply chain through the use of advisory councils. This approach to incorporating franchisee feedback in the supplier selection and supply chain management processes facilitates the flow of information from franchisees while reserving with the franchisor complete control over its supply chain because it may (but is not obligated to) consider and act on the information received from franchisees.

c. Regional Cooperatives and Buying Arrangements.

For certain types of products (e.g. produce, dairy, eggs), leveraging group purchasing among franchisees can provide both improvements in product quality, and efficiencies in delivery of products to franchisees, as well as deliver economic benefits of volume purchases. This type of buying arrangement can fill gaps in a franchise system's capabilities with its broadline distributor where supply chain issues are related to challenges in servicing certain franchise units due to the distance of those units from the broadline distributor's nearest distribution center, the integrity of the product transported during long-haul deliveries, or to address regionally-focused demands of customers.

d. Gaining Franchisee Buy-In.

The evolution of an efficient supply chain within a franchise system is often as organic as the evolution of the franchise system itself. Purchasing cooperatives owned and operated by franchisees (or, a combination of franchisees and representatives of the franchisor) provide a pathway for franchisees to enact changes in the supply chain that may have significant impact in operations at the unit level, and the ability to have such an impact may be a powerful motivator to franchisees. For franchise systems without established cooperatives, transparency and objective data regarding supply chain performance and efforts undertaken by the franchisor to increase such performance and enforce performance standards against suppliers may be a pivotal factor in strengthening franchisee trust and confidence in the franchise system's supply chain.

[62] How Denny's Franchisees Manage Purchasing Through Their Supply Chain Oversight Committee, Food Logistics (Jan. 27, 2016), *available at: https://www.foodlogistics.com/sustainability/news/12162731/how-dennys-franchisees-manage-purchasing-through-their-supply-chain-oversight-committee.*

6. Establishing Corporate Social Responsibility Policies in Supply Chain Management.

There are significant corporate social responsibility issues that should be considered with respect to global supply chains that service franchise systems. While a complete discussion of these issues is beyond the scope of this paper, some key considerations for franchisors in selecting suppliers and establishing corporate social responsibility policies with which suppliers must comply when providing products and services to the franchise system include certain "green" initiatives and causes (e.g., free range poultry products, conflict-free minerals, and Fairtrade), the carbon footprint of manufacturing activities, transportation, and distribution and procurement activities, as well as adhering to diverse and inclusive hiring practices.[63] Additionally, franchisors should require suppliers to comply with anti-corruption,[64] anti-boycott[65] and anti-terrorism laws[66] in addition to certifying that neither supplier nor its principals, executives or subcontractors is listed as a "Specially Designated National" or "Blocked Persons" by the U.S. Treasury Department's Office of Foreign Control Assets.[67] Corporate social responsibility policies should also focus on identifying and eliminating risks of forced labor, slavery and human trafficking and child labor within a franchisor's supply chain.[68] Franchisors should require in their agreements with each supplier that the supplier certify its compliance and the compliance of its subcontractors with the franchisor's corporate social responsibility policy. In addition to certification, a franchisor's corporate social responsibility policy should include audit procedures that provide for a franchisor to audit its suppliers to verify compliance with such policies. Corporate social responsibility policies can have a positive impact on a franchise system's overall reputation and lead to greater consumer satisfaction and positive brand publicity.

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[63] Corporate Social Responsibility in the Supply Chain (May 14, 2012), http://www.industryweek.com/environment/corporate-social-responsibility-supply-chain.

[64] The Foreign Corrupt Practices Act of 1977 (FCPA), Pub. L. 95-213, 91 Stat. 1494 (1977), 15 U.S.C. §§78dd-1, et seq.

[65] *See e.g.*, Export Administration Regulations ('EAR'), 15 C.F.R. Part 760; Ribicoff Amendment to the 1976 Tax Reform Act, 26 U.S.C.A. § 999.

[66] *See e.g.*, U.S. Patriot Act, Pub.L. 107–56, Oct. 26, 2001, 115 Stat. 272, 18 U.S.C. §1 et seq.; Bank Secrecy Act, 12 U.S.C. §1951 et seq; International Money Laundering Abatement and Financial Anti-Terrorism Act, 31 U.S.C. §5301 et seq.; International Investment and Trade in Services Survey Act, 22 U.S.C. §3101 et seq.; Trading with the Enemy Act, 50 App. U.S.C. §1 et seq.; Foreign Narcotics Kingpin Designation Act, 21 U.S.C. §1901 et seq.; International Emergency Economic Powers Act, 50 U.S.C. §1701 et seq.

[67] *See* https://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx.

[68] Corporate social responsibility policies should also incorporate requirements that a supplier comply with applicable environmental and labor and employment laws with respect to employee working environments and human rights.

7. Conclusion

Proper supply chain management is essential to the success of a franchise system and requires that all “links” in a supply chain work together to create an effective and efficient supply chain. These management practices include implementing an effective method of selecting the members of a supply chain team, and managing members through metrics such as KPIs. Additionally, franchisors should continue to modify their supply chain management practices to adapt to the changing social and political climate, through initiatives such as social corporate responsibility programs, and planning for the impact of political changes on supply chain operations, such as the renegotiation of NAFTA. By continuing to monitor and advance supply chain management practices, franchisors will benefit from the success that effective supply chain management brings to a franchise system.