

# PUBLICATION

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## Quiznos Settlement Sparks Franchisee Focus on Supply Chain Issues

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Last November, when an Illinois federal court preliminarily approved a \$100 million settlement resolving four class action lawsuits filed by certain Quiznos franchisees against the Quiznos organization, the franchisees involved, as well as all existing and potential Quiznos franchisees, reaped the financial benefits of the settlement and the benefits of an agreement by Quiznos to be more transparent with respect to its supply chain. Specifically, Quiznos agreed to submit to an annual review of its supply and food prices by a third-party auditor and to revise its Franchise Disclosure Document (FDD) to clarify the supply chain disclosure and the involvement of Quiznos-owned entities.

The Quiznos class actions included claims of fraud, antitrust, racketeering and violations of applicable state franchise, business opportunity and consumer protection laws. The plaintiffs alleged that Quiznos required franchisees to purchase food and supplies from Quiznos or its affiliates and then improperly inflated prices on food and supplies to amounts much higher than franchisees would pay comparable suppliers, with Quiznos receiving significant rebates from these affiliates on franchisee food and supply purchases. The plaintiffs also alleged that the rebates and Quiznos' supplier relationships were not properly disclosed in Item 8 of the Quiznos FDD.

Supply chain issues and allegations of inflated food prices by franchisees had plagued Quiznos for years, and such issues are frequently the focus of franchisee ire in other franchise systems, particularly in the restaurant industry. With the Quiznos settlement, however, the franchisees finally saw results, which likely will prompt and, in at least one case, already has prompted franchisees in other systems to bring similar claims against their franchisors.

As the Quiznos settlement was wrapping up last year, an area developer of Incredible Pizza family entertainment centers, FEC Holdings, LP, and its related franchisee entities sued Incredible Pizza Company Franchise Group, LLC for fraud, negligent misrepresentation, violation of the Robinson-Patman Act regarding price discrimination, violation of relevant state consumer protection and business opportunity laws, and breach of contract and the implied covenant of good faith and fair dealing. See *FEC Holdings, LP v. Incredible Pizza Franchise Group, LLC*, 2009-cv-03289, S.D. Tex. (October 9, 2009), transferred to 2010-cv-03042, W.D. Mo. (February 4, 2010).

Incredible Pizza requires its franchisees to purchase food and supplies from particular vendors and has entered into national and regional contracts with vendors for food, supplies and merchandise. The plaintiffs allege that Incredible Pizza “solicited and accepted payments by third-party vendors” which were “in fact, kickbacks which have not been paid for services rendered in connection with the sale or purchase of goods, wares, and/ or merchandise.” As a result of the “kickbacks,” the plaintiffs argue that they were “restricted in their choice of and access to independent vendors and consequently have paid prices for goods, wares, and/or merchandise, and other products that were higher than they would have paid in the absence of [Incredible Pizza]’s kickback scheme.”

The plaintiffs also allege that Incredible Pizza had agreed in the Area Development Agreement and disclosed in its Item 8 that “it would not accept any vendor rebates, commissions, and kickbacks as a result of franchisee purchases from required suppliers, other than a 10% markup on proprietary items and [a] Coca-Cola rebate.”

The rebates were more extensive than the 10% markup and the Coca-Cola rebate, according to the FEC plaintiffs, resulting in a breach of the Area Development Agreement and rendering the Item 8 disclosures false.

The Incredible Pizza case was recently transferred from the Southern District of Texas to the Western District of Missouri, and Incredible Pizza filed an amended Answer in mid-March. It will be worth watching how the case progresses. Because of the settlement, the Quiznos cases did not set any formal legal precedent on which franchisees can rely. However, the franchisee-friendly results of the Quiznos settlement should make franchisors cognizant of the risks of inflated prices and rebates and any perception that improper “kickbacks” are being received.

During this FDD renewal season, as franchisors update their supply chain disclosures in Item 8, the recent experience of some franchisors argues for close attention to their Item 8 disclosures, both in their current FDD and historically. Management will then be well informed about the history, the promises made and issues that were addressed, or not, in the brand's earlier generations of franchise agreement and franchise disclosure document. The review of these materials against the franchisor's current practices should assure that disclosures are historically consistent, complete and accurate and that the brand's supply chains and rebate arrangements comply with all laws and agreements with franchisees.

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