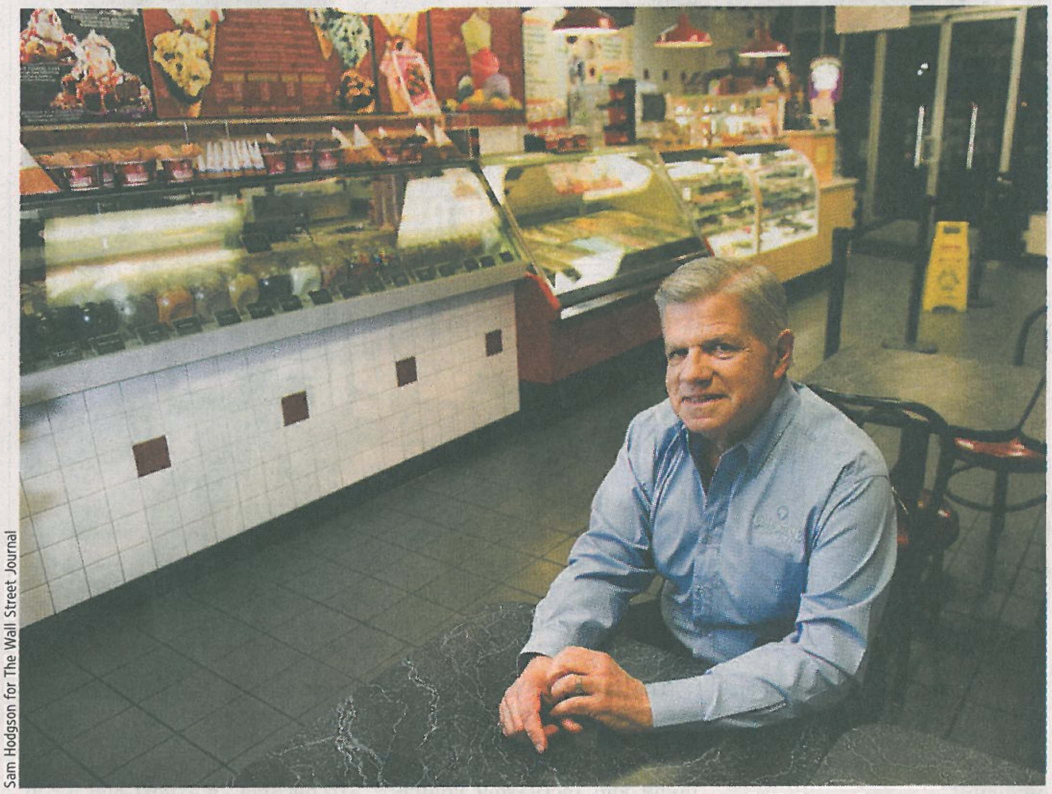
Tough Times for Franchising

As Business Disputes Spark Tensions, Some Franchisees Take Franchisers to Court

By SARAH E. NEEDLEMAN



Sam Hodgson for The Wall Street Journal

Frank Caperino is part of a franchisee association that filed a lawsuit against Cold Stone Creamery.

Two closely watched disputes now playing out in the courts are shining a spotlight on tensions between franchise owners and management.

The growing rift between franchisees and franchisers—businesses that collectively employ roughly eight million people in the U.S.—follows three consecutive years of declines in the number of U.S. franchises, and as economic pressures prompt people to limit discretionary spending.

Late last month, an association made up of roughly 185 U.S. franchise owners filed a lawsuit against Cold Stone Creamery Inc., a subsidiary of **Kahala** Corp., accusing the ice-cream chain of refusing to provide detailed information about funds that the franchisees believe should be set aside for their benefit in a marketing fund.

The lawsuit, which seeks declaratory relief, is asking the court to force Cold Stone to provide the franchisees with information on how much of the rebate money it receives from its approved vendors is actually used for marketing purposes. The franchisee association is also demanding insight into what the company does with revenue and interest generated from sales of unused gift cards.

"We're paying too much for our products and we're making less profit every year," said Frank Caperino, who is part of the association that filed the lawsuit in Miami-Dade County, Fla., state court. Mr. Caperino currently owns two Cold Stone Creamery stores, both in San Diego.

A spokeswoman for Kahala said in an emailed statement that company policy prevented her from commenting on "pending legal matters."

Management's response to the group's lawsuit hasn't yet been filed. "We are confident with our position," she said.

A typical Cold Stone Creamery franchise posted $352,000 in revenue in 2011, down from $400,000 in 2005, according to the group of franchise owners who filed the lawsuit.

At least a dozen new franchisee associations have risen out of conflict in the past year, according to several attorneys who helped these associations to incorporate. They are "forming at a faster rate than ever before" and "they're taking a more aggressive and more vocal stance," says Robert Zarco, the Miami attorney who is representing the Cold Stone franchisee group.

Eric Stites, managing director of Franchise Business Review, a market-research company, said, "When franchisees aren't making money, that's when you see them form associations and sue the franchiser."

The food sector was hit particularly hard during the recession. On average, food franchisees make a profit of $88,382 annually and pay an initial investment of $450,000, according to Franchise Business Review.

Specialty chains like Cold Stone Creamery may have suffered more than others, Mr. Stites said.

The Kahala spokeswoman declined to provide specifics on the profitability of the typical franchisee or the figures provided by third parties.

Franchisees typically sign agreements that require them to follow the rules of the franchiser, which commonly require arbitration to resolve a dispute.

"Litigation sends a signal to the franchiser and others that something is wrong," said John Gordon, an independent chain-restaurant analyst in San Diego who served as a consultant on a Burger King case.

In that case, in November 2009, **Burger King** Corp. franchisees sued the fast-food company, claiming that it acted in bad faith when it mandated that its double cheeseburgers be sold for just $1. A settlement was reached last April. As part of the settlement, Burger King agreed to come up with a new systemwide policy for making decisions about what is listed on its value menu.

In September 2010, a group of Edible Arrangements franchisees filed a lawsuit against **Edible Arrangements International** Inc., claiming management "abused its discretionary authority" when the fruit-basket chain operator mandated in March 2010 that all U.S. locations must be open on Sundays and stay open for an additional two hours every other day of the week, among other grievances.

"Our franchise agreement is illusory," said Sherri Vertorano, an Edible Arrangements franchisee in Mooresville, N.C., who is part of the lawsuit.

Tariq Farid, president of Edible Arrangements, denied the allegations in the lawsuit and said any new operating procedures the company implements are intended to benefit its franchisees.

Mr. Farid declined to provide specifics on the profitability of the typical franchisee. The Wallingford, Conn.-based company has more than 1,000 outlets, and posted $425 million in systemwide revenue last year, up from $380 million in 2010.