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## Using litigation to fix a troubled franchise

By Jonathan Maze

**B**ob Barnes and his business partners knew Schlotzsky's Deli was in trouble when they bought the Texas-based sandwich chain three years ago—it had been bankrupt, after all—but even they were surprised at how bad it was.

“It was a mess,” said Barnes, a longtime restaurateur with concepts like Rosa's Café and Taco Villa and a one-time vice president for Del Taco. “Everybody had been losing. Company stores were closed. Franchisees were closing. Employees were being laid off. The company was in bankruptcy and it looked like shareholders were going to lose everything. Vendors were losing.”

So how did the group get the company back on track? It filed a lawsuit, fought it all the way to trial and won.

Sure, the investors did other things—notably a big boost in marketing—but today the company's victory in its lawsuit against a distributor, recently affirmed by a U.S. appeals court, is being given credit for keeping the chain afloat.

A lawsuit of this type is known as “bet the company” litigation, because a loss could have meant the end of the company.

“Getting involved in a lawsuit was the last thing I wanted to do,” Barnes said. “It's just something business people don't want to do. But we didn't have

any choice. We felt we were being treated unfairly. There's no way a company can survive unless you have maximum input over your supply chain.”

Schlotzsky's was started in Austin, Texas in 1971 and at one point it had more than 700 locations around the world, mostly in the U.S.

The company ran into some financial problems beginning in 2003, thanks to falling revenues, rising costs and heavy debt. It had undertaken a major redesign and menu improvement to boost sales, but the effort floundered and in 2003 the company lost \$11.7 million. The company closed 15 of its unprofitable stores. Franchisees were also closing, and by 2005 Schlotzsky's was down to 430 locations.

The company stopped paying its bills. It fired its management team in the summer 2004. By August it was bankrupt and for sale.

The chain was also having major supply problems. Storeowners say they frequently had to buy their own supplies. And the situation was worsened with the company's bankruptcy—manufacturers wouldn't provide certain products with the Schlotzsky's brand, fearing that the company was about to go under.

Many franchisees say they had to use plain paper cups and plain sandwich wraps.

Sam Wooten, who owns a Schlotzsky's in California, said he was only able to survive that period in the company's history because he discovered a Restaurant Depot near his home where he could pick up supplies. “I was pretty lucky,” he said.

The distribution problems increased supply costs for many franchise owners, even as sales



The past owners of Schlotzsky's Deli say that the only way they could have improved the chain was to fight a lawsuit all the way to trial. They won, and sold the chain to Focus Brands for a big profit.

were falling. And in many markets the store closures were reducing the chain's market presence, making ads less effective and further reducing sales.

So when a group of investors led by Blockbuster franchisee Bobby Cox bought the company for \$28.5 million and finalized the deal in January 2005, it met with many, angry franchisees. "Nobody trusted anybody in that kind of an environment," said Barnes, Cox's business partner who became Schlotzsky's CEO. Ronnie Jordan, a third partner, would be CFO.

The new owners, who took the public company private, met with franchisees around the country. They also boosted marketing by using franchisees' royalty funds. But the biggest issue was the distribution system.

Amid the distribution problems, the Schlotzsky's Independent Franchisee Association asked a distributor, Kentucky-based Sterling Purchasing and National Distribution Company, to assess its ability to act as a supply chain manager. The association felt that Sterling could bring some consistency to the distribution system.

The question was whether the franchisees could give Sterling the ability to act as a distributor. Before the sale, Schlotzsky's signed a deal allowing Sterling to act as a non-exclusive distributor, but the two couldn't agree on an exclusive arrangement.

The new owners signed a deal with two companies, one to handle the east coast, the other to handle the west. The new management then sued Sterling, effectively seeking its removal from the system and charging the company with misrepresenting its status by holding itself out as an exclusive distributor.

Sterling denied the allegations and filed a \$27 million countersuit, saying that Schlotzsky's violated the franchise agreement by trying to force storeowners to get supplies through only approved dealers.

"We didn't intend to be in a lawsuit within 90 days," Barnes said. "That wasn't the plan." Yet the new owners felt that the company needed to control its distribution system to be able to succeed.

"The big issue was who controls the

system," said Edward "Jack" Dunham, Schlotzsky's attorney in the case. "The system was circling the drain. It was a big risk" filing the lawsuit.

Indeed, a loss in the countersuit, Dunham and Barnes said, could have killed the company.

That's also why the new owners didn't settle and allowed the case to go to a jury trial, a rarity in business litigation. Less than 2 percent of such lawsuits end up in front of a jury. The rest are dismissed or settled, usually long before they get close to trial.

That trial took place a year later and the jury agreed with Schlotzsky's, awarding the company 75 percent of the requested attorney's fees. An appeals court affirmed the decision this spring, ending the case.

The victory allowed the new distribution system to stand. That, and the new owners' marketing and improvement efforts, also made Schlotzsky's a target—for buyers. Focus Brands approached Schlotzsky's owners with an idea to include "micro-versions" of two of its concepts, Cinnabon and Carvel, into Schlotzsky's locations.

Steve Romaniello, Focus Brands CEO, said the discussions evolved from there. He said that the chain had strong fundamentals—the chain's stores took in more revenue than a typical sandwich place and the company's products were unique. "If you put a bunch of sandwich concepts' sandwiches end to end you'd have a hard time telling which is which," Romaniello said. "You don't have that problem with Schlotzsky's."

Under Cox Companies, Schlotzsky's comparable store sales were increasing, he said, and the new owners had yet to even add the franchisee support system they were planning—a support system Focus already had in place.

"They had done a phenomenal job righting the ship," Romaniello said. "Franchisees were performing well. It had positive momentum. We really felt we could add something."

So Focus agreed to buy Schlotzsky's for \$85 million, nearly triple what the Cox Companies paid for the chain. "It was a surprise to us," Barnes said. "We had no intention of selling."

Today, Focus is hoping to double the

chain's size over the next five years by working with multi-unit franchisees in markets where it already has a presence.

Some franchisees say the system has yet to reach the sales level they were at in the days before the financial problems and bankruptcy. But those contacted for this story say that their sales are up and the system is in better shape. When he was first reached, Sam Wooten couldn't talk because he had a lunch crowd lined up "out the door." When asked to summarize the chain's state, he gave a simple answer.

"Back then it sucked," he said, "now it's terrific." [ET](#)

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