Implementing ESG for a More Sustainable Franchise Relationship

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A franchise relationship presents unique challenges to the parties, but it also presents unique opportunities, including with environmental, social, and governance ("ESG") matters. ESG typically encompasses company policies, standards, and even broader philosophy, taking into consideration the well-being of "stakeholders" rather than just the profits of shareholders. This article addresses ESG within franchise relationships and considerations to help franchisors and franchisees embrace ESG initiatives successfully.

For many decades, most companies have prioritized maximizing shareholder profit over competing priorities, often informed by a theory of corporate governance based on a fiduciary duty by the board of directors to the shareholders and the shareholders alone. More recently, however, many companies have implemented ESG to consider their impact on "stakeholders" beyond shareholders. Stakeholders include anyone whom the company's actions impact—customers, employees, suppliers, communities, and others.

In most cases, altruism generally lies at the core of ESG considerations—taking care of others in a community is simply the right thing to do. Increasingly, however, stakeholders demand that businesses adopt ESG policies and philosophies. Some shareholders consider corporate values before investing, and some consumers refuse to patronize businesses whose values do not align with their own. Advocacy groups, proxy advisors, and other ESG ratings groups compile data about corporate carbon emissions, employee well-being, political contributions, and human rights records. As such, while ESG initiatives may be rooted in altruism, they are also often prudent considerations from a financial perspective.

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The Interplay between ESG and Existing Law

Beyond altruism, the law often imposes obligations on companies that have a byproduct of achieving ESG objectives. For example, minimum wage laws ensure a baseline of financial well-being for employees. Health and safety codes prevent profit-motivated corner-cutting that could hurt customers. Importantly, but often forgotten, common law also protects stakeholders. For example, tort liability can protect customers (who may well be "business invitees") from harm on a company's premises, and contract law protects franchisors and franchisees from the brunt of broken promises.

In some states and municipalities, these laws go further and more explicitly relate to what many people previously considered within the realm of private ESG initiatives. For example, bans on single-use, non-biodegradable straws seek to create a cleaner environment. Additionally, carbon neutrality deadlines should lead to stronger commitments by companies to reduce their impact on climate change. Collectively, these and other laws implement ESG-motivated public policy. Naturally, companies must follow these laws. But some companies wish to go above and beyond the law's requirements by implementing additional voluntary ESG-motivated initiatives.

Franchised businesses within the same system may face different state, local, or even national laws. Franchisors, therefore, need to consider what state and local laws impact their franchisees across the system and identify any potential brand standards, supply requirements, or other system obligations that may conflict with the applicable law or other public policy. Given that most franchise agreements include provisions requiring franchisees to comply with all applicable laws, such circumstances might require a compromise by the franchisor. For example, franchisors may need to approve an alternative style of takeaway container for certain franchisees or consider modifying the system-wide brand standard to better align with more ESG-sensitive jurisdictions. With this consideration comes a potential impact on costs for franchisees, especially increased costs to franchisees that operate in less ESG-sensitive jurisdictions.

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Franchisor and Franchisee Actions

Organizationally, franchise parties with formal ESG programs often house them under the supervision of their general counsel, as ESG goals often overlap with legal mandates, and formal reporting of ESG initiatives (which shareholders, consumers, watchdog groups, and governmental entities increasingly want to see) can look much like regulatory compliance reporting. For many franchisors and larger franchisees, models typically followed by non-franchise companies can serve as suitable foundations upon which they can layer franchise-specific considerations.

Smaller franchisees, especially those operating only one location, will often have fewer resources or less robust infrastructure to implement ESG policies. Despite that, even single-unit franchisees or those operating within tight resource constraints may consider dedicating some time within owners' or board meetings to the discussion of ESG policies, perhaps starting with the basic objective of listing stakeholders and prioritizing potential ESG policies that can serve each stakeholder's needs. Furthermore, franchisors may consider creating or facilitating programs that can assist franchisees in implementing their own ESG policies.

Substantively, a particular company's ESG policies often depend on that company's industry. As an example, many franchise systems in the food service and restaurant industry have considered the environmental impact of plastic straws and their alternatives. Whether replacing plastic straws with paper straws or other compostable alternatives, instituting a policy of requiring customers to ask for straws rather than simply giving them to customers alongside a beverage, or eliminating straws altogether, food service and restaurant franchise companies should expect that their use of plastic straws will continue to face ESG scrutiny.

An example of a food service business making a pivot in response to ESG concerns is how Starbucks redesigned the lid for its iced beverages, reducing the need for straws. Smoothie King, meanwhile, aimed to reduce nonrecyclable waste use by shifting from Styrofoam cups to recyclable plastic. Some franchisees questioned the change, however, voicing that customers in their area preferred Styrofoam to plastic. Smoothie King responded by partnering with a Vio Foam supplier and ordering specially made cups that biodegrade 92 percent in four years under conditions that simulate both wetter and biologically active landfills. Customers now have a choice between a recyclable cup and one that will significantly biodegrade.

Food waste also receives significant ESG attention. The U.S. Department of Agriculture estimates that about one-third of food planned for human consumption in the United States goes to waste, and the U.S. Environmental Protection Agency estimates that food waste in the United States results in CO2 emissions equivalent to that of 42 coal-fired power plants. Jean Buzby, *Food Waste and its Links to Greenhouse Gases and Climate Change*, U.S. Dep't of Agric., https://www.usda.gov/media/blog/2022/01/24/food-waste-and-its-links-greenhouse-gases-and-climate-change. Food service and restaurant systems can address food waste in a variety of ways, from portion sizing to careful tracking of sales patterns to ensure a restaurant does not order too much from a supplier or unnecessarily prepare too much food during slower day parts. The right variety on a menu can also serve ESG ends, with meatless options often having a lower carbon output, and gluten-free, low-carb, and dairy-free options giving customers more freedom to choose options that suit their health and lifestyle needs.

Finally, in the hotel industry, hospitality companies have introduced efforts to reduce water and energy usage by replacing linens only upon request rather than on a daily basis. Other hotel system ESG efforts include sourcing electricity through renewable power sources; providing customers with EV chargers to encourage EV usage; replacing single-use plastic miniature toiletry bottles in favor of larger, refillable containers; and even recycling used guest soap and donating new bars to those in need. *See e.g., Hilton 2021 Environmental, Social and Governance Report*, https://esg.hilton.com/our-reporting. A more recent hotel innovation that may appear to simply be part of an improved guest experience also serves ESG ends: sending digital keys to guests' phones. These digital keys reduce the need for plastic cards while also saving guests from having to get a key from the front desk, encouraging the use of the franchisor's mobile app, and reducing the risk of guests getting locked out of their rooms.

ESG Considerations Unique to Franchising

Franchisors and franchisees interested in implementing ESG have somewhat unique

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considerations that do not exist in corporate-only operations. The franchise model creates a different set of stakeholders. A franchisor's stakeholders include its franchisees, franchisees' employees, and the franchise system's guests or customers (in addition to any company's typical stakeholders, such as shareholders and board members). A franchisee's stakeholders include the franchisor and the franchisor's employees, other franchisees and their employees, and the franchise system's guests or customers.

While specific ESG considerations will vary depending on the franchisor and industry, franchising-specific considerations include:

- ESG-driven preferences for locally sourced, sustainable food create tension with historical franchisor preferences for a centralized distribution or purchasing system. Some restaurant franchisors have found a middle ground that achieves both ends: fresh produce sourced locally by franchisees and frozen produce sourced centrally by the franchisor, ensuring freshness and sustainability without unnecessarily sacrificing cost or quality considerations.
- Potential economic tensions stemming from a hotel franchisor shifting to digital keys and away from plastic keycards—a seemingly reasonable shift during favorable business conditions but much more difficult for an individual franchisee struggling with profitability or systems experiencing unfavorable macroeconomic conditions.
- Competing ESG priorities are at play when a franchisor requires shifting away from Styrofoam cups and plastic straws in an effort to prioritize environmental concerns over its own profits, but in making this switch may underappreciate certain equity considerations in requiring minority- and immigrant-owned franchisee businesses to absorb higher costs after already investing significant personal or family savings in their franchised units.
- The extent to which franchisors can reasonably implement ESG policies on an ongoing basis through modifications to brand standards or operations manuals (e.g., the addition of a new menu item to provide more meatless options) versus through amendments to the franchise agreement and franchisee consent, particularly where the ESG initiative may call for new fees payable to the franchisor or even third parties.
- Finally, situations where franchisees may demonstrate a stronger desire to pursue ESG initiatives than the franchisor. For example, a franchisee may wish to cut down on single-use plastic only to face a franchisor unwilling or reticent to make an exception to brand standards requiring certain packaging or other single-use plasticware.

While ESG programs in franchise systems certainly can present challenges, the franchise model can nevertheless flex its ESG muscle, particularly when it comes to soliciting a broad array of feedback—from customers, franchisees, and suppliers. Franchise systems have a unique ability to create ESG laboratories for determining which policies can make a real impact and which fall short.

Conclusion

In a world in which customers, governments, and investors increasingly demand sustainability and social responsibility, franchise systems must consider their commitment to ESG objectives. As franchise systems identify, set, and pursue ESG targets, thoughtful and cooperative action among franchisors and franchisees remains critical to success. ■

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