case study

The Cold Stone Truth: A case study of the Cold Stone Franchise

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Introduction

Cold Stone Creamery, Inc. (Cold Stone), first opened in 1988 by Donald and Susan Sutherland, became a wholly owned subsidiary of Kahala Franchising, LLC (Kahala) after being acquired in 2007. In 1995, Cold Stone opened its first franchise in Tempe, Arizona and has grown to approximately 1,300 franchises in 47 states and 16 Countries. Cold Stone is an ice cream parlor chain that serves 'super premium' ice cream based 'Creations'. These 'Creations' are made to order for each customer- blending their favorite combination of fruit, nuts, candy, or cookies into their choice of premium ice cream flavors on a frozen granite stone. Other treats on the Cold Stone menu include ice cream cakes, shakes, blended coffees, and smoothies.

The National Independent Association of Cold Stone Creamery Franchises (NIACCF) was formed in 2010 as a result of strained relations between Cold Stone Creamery franchisees and the parent company. Within two months of the formation of the association, the CNBC documentary, Behind the Counter: The Untold Story of Franchising, aired portraying the franchise in a negative light- highlighting the same issues that the NIACCF was formed to address. Today, the NIACCF is in the midst of a lawsuit against Cold Stone to shed light on the accounting practices that the company has chosen not to share with the franchisees. This case looks at the links between these issues, the impact of the actions taken by the parent company and the franchisees, and the affect that these actions have had on the profitability of the franchise.

Background Information

CNBC Documentary: Behind the Counter: The Untold Story of Franchising

Like other business ventures, a strong brand name is a franchise's most valuable asset. By maintaining a strong brand, Cold Stone is able to maintain its existing market share when faced with increasing competition, as well as continued growth of the brand by attracting new and qualified franchisees. Under the Cold Stone name, small businesses are able to attract customers who have previously been exposed to the product, services, and experience before they get to the counter. As Cold Stone has experienced, outside factors can threaten the brand name they have worked so hard to establish- impacting the parent company and its franchisees.

In December 2010, CNBC began its first broadcast of Behind the Counter: The Untold Story of Franchising. The CNBC special, comprised of five separate segments, was promoted as "an inside look at a trillion dollar industry", highlighting separate franchises in conjunction with different aspects of franchising. In addition to Cold Stone, Five Guys Burgers and Fries, Camp Bow Wow, Proctor & Gamble, and Dunkin' Donuts were featured as part of the broadcast. While the segments were largely positive, Cold Stone was shown in a less than positive light- alleging that, among other things, the Cold Stone business model was flawed, making it nearly impossible for franchisees to successfully and profitably operate a Cold Stone franchise. The public reaction to Behind the Counter: The Untold Story of Franchising was immediate, with some viewers pledging to boycott their local Cold Stone franchise to send a message to the franchisor (Kosman, 2010).

In the research and development of this documentary, CNBC based a majority of its claims against Cold Stone on interviews with former Cold Stone franchisee Mr. Rolle, who previously operated three franchises in Florida. After closing his stores, Mr. Rolle filed suit against Cold Stone for fraud in the inducement of vendors, who they simultaneously took 'kickbacks' from, that drove costs up to the point that making a profit was nearly impossible. Cold Stone then counter sued Mr. Rolle for failing to make payments on a promissory note taken out to finance the Cold Stone franchises he operated. Ironically, these claims are nearly identical to the pending lawsuit that the NIACCF has filed against Cold Stone. Today, Mr. Rolle maintains a blog that is 'dedicated to documenting and maintaining the history of the broken business model of Cold Stone Creamery' (Kosman, 2010).

Following the broadcast, Cold Stone and its franchisees were concerned about the ramifications this documentary would have on their sales and immediately took action to mitigate the impact. Cold Stone realized the implications of this negative publicity immediately, and sent a cease-and-desist letter to CNBC explaining the multiple inaccuracies included in the documentary and demanding that it be retracted by CNBC. Realizing the negative impact that viewer reaction could have on the Cold Stone brand, and subsequently individual franchisees, Cold Stone responded to the challenge by teaming with their franchisees in a united front. To do this, they retained prominent franchising lawyer, Mr. Robert Zarco, of Zarco, Einhorn, Salkowski & Brito, who also pro-

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vided legal representation to the NIACCF (Snell & Wilmer, 2011).

Under a united franchisor/franchisee front, and led by Mr. Zarco, Cold Stone took action to stop CNBC from continuing to broadcast the documentary. The company stood by its assertion that the allegations of 'hidden fees' associated with subleasing of locations were false and that the company had not profited from them. The company also denied that it had forced franchisees to buy unnecessary equipment and that their cost structure was flawed, as alleged by Mr. Rolle. On December 24th, 2010, CNBC agreed to halt broadcasting of the documentary and provided Cold Stone and its franchisees with the opportunity to 'set the record straight' through an interview with CNBC reporter Mr. Darren Rovell (Alvarez, 2010).

In January 2011, Cold Stone Brand President Mr. Daniel Beem, Cold Stone Franchisee Mr. Rudy Puig, and attorney Mr. Zarco met with Mr. Rovell to provide clarity around their franchising practices. The interviewees defended Cold Stone's cost structure, saying that it was achievable and that the deck wasn't 'stacked against' the franchisees as described in the original documentary. Cold Stone also explained that all rebates it received from vendors were reinvested in the company's FMP benefited the franchisees through 'direct contributions to marketing, product innovation, technology, social media, and subsidies for other products'(Snell & Wilmer, 2011).

Following this interview, CNBC revised their original documentary to present a more balanced view of the Cold Stone franchise. They interviewed additional franchisees, some whom supported the original viewpoint, but presented the facts about each franchisee that was interviewed. One franchisee, who spoke to CNBC, alleged that he wasn't able to make a profit from his Cold Stone store because of the vendor rebates that drove up his costs, but also acknowledged that he wasn't able to meet the suggested cost structure achieved by other successful franchisees. In the end, Cold Stone and its franchisees were pleased with the revised CNBC story (Alvarez, 2010).

Rise of the National Independent Association of Cold Stone Creamery Franchisees (NIACCF)

While Cold Stone was able to challenge the assertions made in the CNBC special by working closely with its franchisees to protect the Cold Stone brand, the franchisor/franchisee relationship at the company had been strained in the time leading up to the broadcast. In October 2010, shortly before the documentary originally aired, the NIACCF was formed as an association of franchisees and area developers within the Cold Stone Creamery franchise system. NIACCF membership currently numbers approximately 180 franchisees and area developers who pay membership fee of approximately $35 per month for each franchise represented. The organization's mission is to 'help to increase store profitability and build the asset value of the stores for franchisee benefit and the possibility of future resale' (To The Cold Stone Creamery Franchisee Community, 2011).

The NIACCF was originally formed 'for the purposes of uniting independently owned Cold Stone franchises and area developers and for educating and representing its members on issues affecting their Cold Stone franchise interests'. Another objective of the NIACCF is to 'articulate and advocate the needs, interests, and goals of its members in the context of a constructive and cooperative relationship with the franchisor'. The NIACCF has represented Cold Stone franchisees in encouraging Kahala to be more transparent on issues such as "why our sweet cream mix price has increased, what is taking place with the money from our gift card breakage, how our advertising dollars are being spent, how we can purchase other products from alternative, less expensive vendors, and when a forum can be established". To provide legal representation, the NIACCF turned to none other than Mr. Zarco, who was retained by Kahala to represent Cold Stone in the dispute with CNBC only two months after the organization was formed (To The Cold Stone Creamery Franchisee Community, 2011).

The need for an association to represent the interest of Cold Stone franchisees and area developers is evident from the number of Cold Stone franchisees reaching out for assistance to save their suffering businesses. The economic recession has decreased the disposable income of many Cold Stone customers, who began to see the $4 per scoop 'Creations' as a luxury item that they could no longer afford. As sales dropped, franchisees have looked to Kahala for ways to cut costs to increase their profit margins- but these requests have largely been unanswered. By banding together as the NIACCF, franchisees have taken action to encourage their parent company to help keep their stores operating.

NIACCF: Complaint for Declaratory Relief

The strained relationship between franchisor, Cold Stone Creamery, and its franchisees has continued to deteriorate, with a lawsuit filed on behalf of the NIACCF in January 2012, again by the law firm of Zarco, Einhorn, Salkowski & Brito, in Miami-Dade County, Florida for 'declaratory relief in resolving disputes between the parties'. The suit claims that Cold Stone has 'failed to provide information pertaining to, and properly account for, certain monies that Cold Stone Creamery, Inc. has received from third parties, which monies were designated to be utilized for the benefit of the Cold Stone Creamery franchisees'. More specifically, the suit seeks to gain clarity around the following (Complaint for Declaratory Relief, 2012):

- Accounting of Vendor Rebates. These rebates, or 'kickbacks', were intended to be invested into Cold Stone's FMP, which promotes the Cold Stone brand and raises awareness in the market. Franchisees are seeking an accounting of what percentage or amount of vendor rebates, earmarked for Cold Stone's FMP, are actually being used for marketing. In addition, the suit requests disclosure of:

    - The percentage or amount of vendor rebates earmarked for the FMP and the purposes the funds are being used for
    - The percentage of the aggregate purchase price of vendor products that are retained for use by the FMP and for what purposes the funds are being used
    - The percentage or amount of vendor rebates earmarked for FMP use that are actually utilized for marketing purposes
    - To what extent prices are increased for products purchased by the franchisees from the vendors to offset the rebate payment to Cold Stone
- Gift Card Breakage. This term refers to gift cards that have been sold, but not redeemed. Revenues from breakage are nearly entirely profit because companies do not provide products or services for unredeemed gift cards. The NIACCF has requested a detailed accounting of the amount of unclaimed gift cards and the incurred interest. In addition, the suit requests clarity around:
    - Whether revenue generated from the sale of unredeemed gift cards has been retained by Cold Stone and/or utilized by Cold Stone for any purpose
    - If interest earned from gift card breakage is being used to offset the costs of the third-party gift card program that are incurred by the franchisees

In an email to NIACCF members in November 2011, association president, Mr. Puig (a representative of Cold Stone franchisees in the CNBC interview) stated, "during the past seven months we have pushed hard for Kahala to be more transparent…To date, our letters and requests to Kahala have pretty much fallen on deaf ears, but that is not going to deter us from our mission" (Ruggles, 2012). This suit was filed after Cold Stone agreed, on several occasions, to provide their franchisees with the requested information, but to date this information has not been provided. In addition to the requested information, the NIACCF also seeks an award for the costs incurred as part of this suit (To The Cold Stone Creamery Franchisee Community, 2011).

Analysis of Dilemma

Management Dilemma

Since 2010, Cold Stone Creamery has faced multiple claims of unfair practices from its franchisee base and national media outlets. With the exception of the actions taken in response to the CNBC documentary, Cold Stone has chosen to remain silent instead of publically addressing these issues, stating that 'the company does not comment on pending legal matters'. Because Kahala is a privately held company, they are not required to provide financial statements that could shed light on the company's financial health and potential reasons behind the lack of transparency that franchisees have faced.

In response to the CNBC documentary that threatened the Cold Stone brand, the franchisor and franchisees were able to put aside their differences to unite against what they claimed to be 'false and defamatory' claims against the franchise. Mr. Zarco, attorney for the NIACCF, proved to be an asset to the parent company when he agreed to provide legal representation to Cold Stone in their negotiations with CNBC, by rallying the franchisees behind the parent company. While Mr. Zarco provided representation to Cold Stone, he 'made it clear that his ultimate allegiance would always remain with the franchisees in the event of a dispute (Snell & Wilmer, 2011)'. To further solidify his allegiance to the franchisees, Cold Stone signed a waiver of conflict of interest stating that they 'will never assert that my [Mr. Zarco] representation of the NIACCF in this matter will constitute a conflict for me to represent franchisees and area developers in the future' (Sparks, 2012).

With the risks of conflict of interest mitigated, Cold Stone sent a retainer letter, along with a non-refundable fee of $50,000 payment, to Zarco's law firm. In the retainer letter, it was again emphasized that 'the law firm of Zarco Einhorn Salkowski & Brito will undertake representing the interests of the NIACCF in connection with their claims against CNBC and Cecil Rolle' (Snell & Wilmer, 2011).

Having been retained by Cold Stone, Mr. Zarco sent the cease-and-desist letter to CNBC as previously discussed. In this letter, Zarco dedicated nearly half of the content to discrediting Mr. Rolle, whom he painted as a disgruntled franchisee, a non-credible witness and an exception to the Cold Stone franchisee community, saying that "he has, for years, demonstrated a vindictive and willful intent to harm, maliciously defame, and consistently interfere with Cold Stone, its franchisees, and the Cold Stone brand" (Zarco, 2010). The letter goes on to claim that the Mr. Rolle 'falsely represents that Cold Stone relies on 'kickbacks' from vendors and that Cold Stone requires franchisees to purchase equipment from companies that it controls (Zarco, 2010)'. While this strategy led CNBC to interview additional franchisees to portray a more balanced picture of the organization, it discredited one of Cold Stone Creamery's most vocal franchisees.

It is interesting that this letter discredits the claims that Mr. Rolle made to CNBC in the development of their documentary, but that two years later, Mr. Zarco is representing the NIACCF in a lawsuit against Cold Stone to gain transparency around these same issues. It is also interesting that Mr. Puig, NIACCF president, defended Cold Stone in the CNBC interview stating that rebates received from vendors were reinvested in the company's FMP to benefit the franchisees through 'direct contributions to marketing, product innovation, technology, social media, and subsidies for other products'. Mr. Puig is now named as a plaintiff in the ongoing NIACCF lawsuit against Cold Stone to gain transparency around the accounting for monies earned by Cold Stone from vendor rebates.

Explanations of the Dilemma

Cold Stone Franchise Issues

When asked about the NIACCF's lawsuit against Cold Stone, Mr. Frank Caperino, a NIACCF association member operating two Cold Stone franchises in the San Diego area said, "we're paying too much for our products and we're making less profit every year". In 2005, average revenue generated from a Cold Stone franchises was $400,000, but by 2011, average revenue had dropped to $352,000. Specialty chains, like Cold Stone, have perhaps been hit harder by the recession than other eating establishments, as consumer's disposable income has decreased, but Kahala has declined to provide specifics around the profitability of the typical Cold Stone franchise (Neddleman, 2012).

"Litigation sends a signal to the franchisor and others that something is wrong". The economic downturn could have contributed to the increase in franchisee associations, which are said to be 'forming at a faster rate than ever before'. Eric Stites, managing director of Franchise Business Review commented on this increase saying, "when franchises aren't making money, that's when you see them form associations and sue the franchisor" (Needleman, 2012).

Regardless of the outcome of the pending lawsuit by the NIACCF against Cold Stone, there are other reasons that the Cold Stone franchisees are suffering. Over the last decade, almost 1 in 3 Cold Stone franchisees have defaulted on the Small Business Administration (SBA) loans, resulting in a failure rate of 31% for all Cold Stone franchisees (CNN, 2010). Numerous failed franchisees contend that the operating costs associated with a Cold Stone franchise are so steep that they struggled to make a profit. Franchisees also contend that their margins were further cut by two-for-one coupon promotions and requirements for purchasing expensive ingredients from a single supplier (Gibson, 2008). Cold Stone has since stopped issuing two-for-one coupons.

Rapid expansion, leading to Cold Stone franchises being geographically crowded together, may have also contributed to the hardships faced by franchisees. In response to rapid expansion of Cold Stone franchises that cannibalized sales, Mr. Goldman, a Cold Stone franchisee said, "I'm sure there are sites that should never have been picked and franchisees that should never have been picked." While Cold Stone claims that only about 2% of franchisees are approved, the problems associated with rapid expansion have been legitimized by Kahala's plan to slow expansion and reduce new store construction costs in an attempt to increase the annual sales of each store from about $360,000 annually to $500,000 (Gibson, 2008). But these changes may be too little too late for franchisees. As shown in Figure 1, Decrease in Cold Stone Locations, the number of Cold Stone Creamery franchises has been on the decline since the Kahala's 2007 acquisition. Figure 2- Decrease In Company Owned Stores, shows that the number of Cold Stone locations owned and operated by the franchisor have also been on the decline in recent years. In addition to these closures, the number of Cold Stone franchises for sale is approximately 303 locations, or 28% of the stores currently in operation (Cold Stone Creamery, 2012).

While the Kahala plans to slow expansion of additional Cold Stone franchises, this decision may not be entirely the decision of the company. After failing to provide audited 2010 financial statements, the Federal Trade Commission restricted Cold Stone from selling new franchises. Michael Regan, executive vice president at Kahala, confirmed that the company was late in filing these statements, but blamed the delay on an outside accountant. The company has since filed financial statements, but a source close to the situation was quoted saying that not having an audited disclosure statement "is extraordinarily odd for a going concern" (Kosman, 2011).

Figure 1

Decrease In Cold Stone Locations

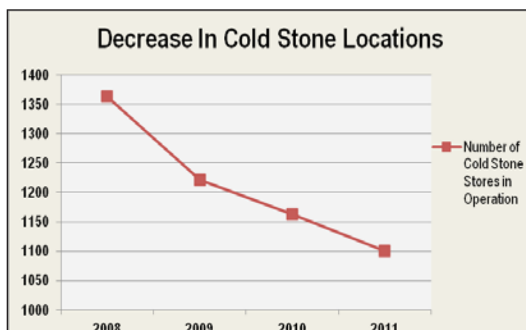

Figure 2

Decrease In Company Owned Stores

Conclusion

This case study focuses on the events that have taken place, dating back to 2010, that have shed light on the troubles of the Cold Stone franchise and the actions that Cold Stone has taken in response to these events. Through research, it is evident that Cold Stone franchisees are suffering due to rising costs and decreasing sales. This fact was originally brought to light by the CNBC in the documentary Behind the Counter: The Untold Story of Franchising and further solidified by the rise of the NIACCF, both in late 2010. While Cold Stone has chosen to maintain the confidentiality of various accounting practices that could potentially provide some relief to suffering franchises, the outcome of the lawsuit aimed at shedding light on these practices is still pending. At the end of the day, the survival of the Cold Stone brand largely depends on the success of each individual franchise, and we will wait to see what actions Cold Stone takes to promote the success of its franchises.

Discussion Questions

1. Consider yourself a member of the NIACCF who is concerned about the Cold Stone business model and the affect that it is having on the success of your franchise. Do you think that Cold Stone should be required to provide accounting data maintained by the parent company?
2. As a top executive from Cold Stone Creamery, do you think that your company should be required to provide accounting data to franchisees or that this information should be kept within the parent company.
3. Again, as a member of the NIACCF, how do you feel about your organization being represented by Robert Zarco? Do you think that his representation has your best interest at heart, or that he is influenced by payments received from Cold Stone Creamery?
4. As a customer of Cold Stone Creamery, do the allegations against the company of mistreatment of franchisees affect your decision to purchase the company's ice cream?
5. As the Chief Operating Officer (COO) of Cold Stone Creamery, would you have chosen to address the lawsuit brought by the NIACCF, or would you have taken a different approach?

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