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**STEPPING ON TOES: TERRITORIAL RIGHTS AND
ENCROACHMENT**

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I. INTRODUCTION

Franchisors want to expand their business, to increase revenue, and strengthen their brands. This necessarily involves opening new outlets and exploring so-called alternative methods of distribution, including opening locations in hospitals, universities, military bases, and other non-traditional locations, as well as doing business on-line.

Franchisees, on the other hand, are sensitive to, and concerned with, intra-brand competition, which could negatively impact their revenues by taking away customers. Certain states have enacted laws providing protections for franchisees when issues of territorial encroachment arise. And certain court decisions – most notably, last year’s California Superior Court decision in *Bryman v. El Pollo Loco, Inc.*¹, which was based upon the jury’s verdict in that case – have held that the franchisor’s opening its own location, or allowing another franchisee to open a location in close proximity to an existing franchisee’s business, constitutes a breach of the covenant or duty of good faith and fair dealing that is implied in all contracts, including franchise agreements.

As with many issues, the best way to avoid disputes between a franchisor and franchisee over territorial encroachment is to draft the franchise agreement so that it is as specific and clear about the rights being granted in any exclusive territory, what that territory is (if any), and under what circumstances a franchisor will be able to either open its own locations within that territory, pursue alternative methods of distribution within the territory, conduct business on-line, or grant locations to other franchisees. Franchisors should also consider conducting a competitive impact analysis to assess the potential effect of new, intra-brand competition on an existing franchisee’s business footprint, in order to determine whether and to what extent any expansion of the system is warranted.

This paper will explore all of these issues and provide guidance and recommendations for how franchisors and franchisees can best address the issue of territorial encroachment.

II. STATUTORY PROTECTIONS AGAINST ENCROACHMENT

Many franchise agreements protect franchisees from territorial encroachment by franchisor-owned outlets, or other franchised locations of the brand. These protections grant franchisees the right to protect their interests in their regional markets. But, at least in some jurisdictions, they do not provide the sole avenue of relief. In many cases, state law provides some relief as well.

The regulation of franchising is a relatively new process, with statutory regulation of franchising starting in 1970.² This included, among other things, efforts by states to adopt

¹ Case No. MC026045 (Cal. Super. Ct. Los Angeles Cnty. Aug. 1, 2018) (*appeal docketed, Handlers-Bryman v. El Pollo Loco*, Case No. B292585 (Ca. Ct. App. Feb. 5, 2019)).

² The California Franchise Investment Law passed in 1970 is considered to have ushered in the era of franchise regulation. See Susan A. Grueneberg & Jonathan C. Solish, *Franchising 101*, ABA Business Law Today Vol. 19 Num 4, (2010), <https://apps.americanbar.org/buslaw/blt/2010-03-04/grueneberg-solish.shtml> (discussing history of state franchise laws).

statutory protections for franchise territories across the United States.³ In some jurisdictions, these protections have been afforded generally to all franchised businesses; in others, these protections have been given only to franchised businesses in certain industries.

A. State Franchise Statutes

At least seven (7) states have enacted franchise statutes of general applicability that either directly or indirectly regulate the issue of exclusive territories and encroachment: Florida, Hawaii, Indiana, Iowa, Minnesota, Washington, and Wisconsin.⁴

1. Florida

The jurisdictional reach of the Florida franchise statute is uncertain. Courts have variously held that the statute applies only to parties with physical presences in Florida, and in other cases, where neither party is located in the state.⁵ But even if the statute applies, Florida is not traditionally viewed as a state that statutorily protects franchisees from encroachment by the franchisor or other franchisees. That is perhaps because the unique and extremely narrow protections afforded by the state statute are not easily categorized. Unlike other jurisdictions that expressly prohibit franchisors from selling new outlets or opening company outlets near existing franchisees, Florida's statute hinges on pre-sale disclosure. Specifically, in Florida, it is unlawful for a franchisor to "intentionally [] misrepresent or fail to disclose efforts to sell or establish more franchises or distributorships than is reasonable to expect the market" to bear.⁶

Although not heavily litigated, in at least one decision, the United States District Court for the Southern District of Florida declined to dismiss claims brought by a franchisee alleging that the franchisor had intentionally misrepresented that it would not open any other outlets near the existing franchised business.⁷ Specifically, the court held that the Florida Franchise Act imposes an affirmative duty on franchisors to disclose their intentions.⁸ The court held that this created an objective standard of relevancy,⁹ and that the franchisor could not escape liability by showing that no franchises were sold prior to the date of the existing franchisee's franchised location.¹⁰

³ See generally Deborah S. Coldwell, *2019 Judicial Update – Encroachment*, 52ND IFA LEGAL SYMPOSIUM at 58–59 (2019).

⁴ FLA. STAT. § 817.416(2)(a); HAW. REV. STAT. § 482E-6; IND. CODE § 23-2-2.7-1; IOWA CODE § 523H.1; IOWA CODE § 537A.10(6); MINN. STAT. § 80C.14 Subdiv. 1; MINN. R. 2860.4400; WASH. REV. CODE § 19.100.180(2)(f); WIS. STAT. § 135.03.

⁵ Compare *Burger King v. Austin*, 805 F. Supp. 1007, 1022–23 (S.D. Fla. 1992) (holding a choice of law provisions establishes that the parties "intended that they be regarded as doing business in Florida.") with *Barnes v. Burger King Corp.*, 932 F. Supp. 1441, 1443 (S.D. Fla. 1996) (holding that while the choice of law provision "subject[ed] [the agreement] to the Florida Franchise Act", it did not on its own constitute doing business in Florida and therefore the Plaintiff lacked standing under the act).

⁶ FLA. STAT. § 817.416(2)(a).

⁷ *Barnes*, 932 F. Supp. at 1420.

⁸ *Id.*

⁹ In other words, the franchisor had the burden of showing "not whether the defendant franchisor subjectively believed that the market could sustain both franchises, but, rather. . ." whether it is objectively reasonable to expect that the market could sustain both franchises. *Id.* at 1432.

¹⁰ *Id.*

Instead, the fact that the franchisor had contemplated the idea of additional franchises (embodied in informal discussions with prospective franchisees), was sufficient to constitute “efforts to sell” additional franchised outlets such that the franchisor breached its affirmative duty to disclose information to the existing franchisee.¹¹

Although not addressed in case law, the Florida Franchise Act presumably is limited to presale misrepresentations.¹² Accordingly, if, at the time of sale, the franchisor does not harbor any plans to sell franchised outlets in the vicinity of the existing franchise, then the statute would not apply, even if the franchisor subsequently changed its development plans and moved forward with new proposed outlets.

2. Hawaii

In Hawaii, the legislature has declared that it is an unfair method of competition for a franchisor to establish a similar business, or grant a franchise for the establishment of a similar business, at any location within an existing franchisee’s exclusive territory.¹³ A territory is exclusive only if it is expressly created in the existing franchisee’s franchise agreement.¹⁴ The statute also provides flexibility to franchisors by granting them the right to open additional outlets within an existing outlet’s exclusive territory if the existing outlet’s franchise agreement contemplates the opening of new franchises under certain conditions. Moreover, the act specifically excludes sales of goods or services by the franchisor (or a competing franchisee) to customers residing within the exclusive territory of an existing franchisee.¹⁵ As such, the statute does not, on its face, extend to internet sales activity or to marketing or business mailings into the existing franchisee’s territory. The statute only applies to franchises physically located within the state.¹⁶

3. Indiana

Indiana law makes it unlawful for any franchise agreement to contain a provision that allows “the franchisor to establish a franchisor-owned outlet engaged in a substantially identical business to that of the franchisee within the exclusive territory granted the franchisee by the franchise agreement.”¹⁷ The statute does not prohibit the franchisor from selling franchised outlets within a franchisee’s exclusive territory. Rather, it is limited to the opening of franchisor-owned outlets. It also does not explicitly contain any remedy, as it provides for no cause of action for violations of the statute.

¹¹ *Id.*

¹² See, e.g., FLA. STAT. § 817.416(2)(a) (expressly prohibiting misrepresentations regarding efforts to sell franchises in a prospective franchisee’s market area).

¹³ HAW. REV. STAT. § 482E-6.

¹⁴ *Id.*

¹⁵ *Id.* (“The fact that other franchisees or the franchisor may solicit business or sell goods or services to people residing in such geographical territory shall not constitute the establishment of a similar business within the exclusive territory.”).

¹⁶ HAW. REV. STAT. §§ 482E-3, 482-5(a), 482E-5(c).

¹⁷ IND. CODE § 23-2-2.7-1(2).

If the franchise agreement does not contain an exclusive territory, the franchise agreement cannot permit the franchisor to compete unfairly with the franchisee in a reasonable area.¹⁸ By its express terms, however, the Indiana statute only applies to franchises sold to residents of the State of Indiana, or franchises intended to be operated in the State of Indiana.

Moreover, the statute contains an exclusion that provides that a franchisor is not deemed to be competing with a franchisee if it is only temporarily operating a competing business for a reasonable time, or if it is in the process of selling a bona fide retail operation to a third party at a fair and reasonable price.¹⁹ Similarly, if the franchisor is in a bona fide relationship with a third party that has invested in the business, and is reasonably expected to fully acquire the business on reasonable terms, the franchisor's involvement in the business operations in the interim will not constitute unfair competition.²⁰ Collectively, these provisions appear to exist for the purpose of giving the franchisor flexibility in taking over struggling or failing franchised outlets in order to stabilize and resell the business. Practically speaking, however, the statute's repeated references to "reasonable" and "bona fide" businesses and relationships means that in the event of a dispute, the litigation over whether the business operations are legitimate and not violative of the statute will likely be protracted and costly disputes that are factually intensive.

4. Iowa

The State of Iowa has adopted robust anti-encroachment protections for franchisees physically located within the state.²¹ Under Iowa's 2000 Franchise Act, if a franchisor decides to open a new franchised outlet that sells essentially the same goods or services, under the same trademark, as an existing franchised outlet, it cannot do so within "unreasonable proximity" to the existing outlet if doing so has an adverse impact on the existing outlet's gross sales.²² If a franchisor does open an such an outlet (be it company-owned or franchised), the existing franchisee has a cause of action for money damages.²³ If the existing franchisee proves that it was in fact injured by the new outlet, it can recover up to three years of lost profits, calculated based upon the franchisee's annual gross sales during the twelve-month period immediately preceding the opening of the new franchised outlet.²⁴

¹⁸ *Id.*

¹⁹ IND. CODE § 23-2-2.7-2(4).

²⁰ *Id.*

²¹ Iowa has two franchise relationship laws, the first passed in 1992, the second in the year 2000. See, e.g., IOWA CODE § 523H.1 *et seq.* and Iowa Code § 537A *et seq.* The 1992 Act applies to franchises entered into before January 1, 2000. The 2000 Act applies to all franchises entered into on or after January 1, 2000. Although there are slight differences in the encroachment protections between the two Acts, for purposes of this article, the authors have confined their analysis to the protections afforded by the 2000 Act.

²² IOWA CODE § 537A.10(6)(a).

²³ *Id.*

²⁴ *Id.*, § 537A.10(6)(d). The franchisee must also subtract six percent from the annual gross sales for that immediately preceding year, and actual gross sales for the twelve-month period immediately following the opening of the new outlet. *Id.*, § 537A.10(6)(d)(1)(a)–(b). Practically speaking, this means that a franchisee's claim is likely not fully ripe until at least one year has passed since the opening of the new outlet.

There are four exceptions to the 2000 Franchise Act encroachment protections. First, a franchisor may avoid application of the encroachment protections if it has offered the new outlet to the existing franchisee on the same terms and conditions available to a new prospective franchisee.²⁵ Second, the statute does not apply if the adverse impact on sales is less than six percent of the existing franchisee's annual gross sales in the twelve-month period immediately preceding the opening of the new outlet.²⁶ Third, the statute does not apply if the existing franchisee is not eligible for a new franchise.²⁷ Finally, franchisors can escape the application of the statute if the existing franchisee was granted reasonable territorial rights under its franchise agreement, and the new proposed outlet does not violate those territorial requirements.²⁸ The exceptions are very broad, and a carefully worded franchise agreement that expressly delineates the franchisee's territory, and a franchise sales policy that ensures that new outlets will not violate existing territorial rights will likely avoid application of the statute in most instances.

Nonetheless, even if the franchisor satisfies one of the exceptions to the statute's application (such as a well-crafted, reasonable, territorial grant), it must still comply with some additional requirements. Specifically, franchisors are required to adopt and implement a formal procedure for hearing and acting on claims by existing franchisees that new outlets are encroaching on their territories, and for conducting formal mediation of such disputes.²⁹ A franchisor also must establish and make available to franchisees a written policy setting forth the reasonable criteria that the franchisor will use to determine whether an existing franchisee is eligible for an additional franchised outlet.³⁰

While the protections afforded by the Iowa encroachment law are facially extensive, burdensome, and complex, the reality of their practical implications is much more limited. The statute has a short-fuse limitations period that requires action within eighteen months of the impact, or thirty days after completion of the franchisor's mediation procedure, whichever is later.³¹ Moreover, courts have concluded that the Iowa encroachment protections only apply when the business that is encroaching on an existing franchised outlet is also physically located within the State of Iowa.³² Consequently, if the franchise is located in a border city, even if the

²⁵ *Id.*, § 537A.10(6)(a)(1). If the new proposed outlet is intended to be company operated, the franchisor need only show that the location was offered to the existing franchisee on the same terms and conditions that would ordinarily be offered to a franchisee for a similarly situated outlet. *Id.*

²⁶ *Id.*, § 537A.10(6)(a)(2). This dovetails precisely with the method for calculating damages under the statute's compensation provision. See, e.g., *id.*, § 537A.10(6)(d)(1)(a).

²⁷ *Id.*, § 537A.10(6)(a)(3).

²⁸ *Id.*, § 537A.10(6)(a)(4).

²⁹ *Id.*, § 537A.10(6)(b)(1)–(2).

³⁰ *Id.*, § 537A.10(6)(c).

³¹ *Id.*, § 537A.10(6)(e).

³² See, e.g., *Holiday Inns Franchising, Inc. v. Branstad*, 537 N.W.2d 724, 731 (Iowa 1995) (holding that the 1992 statute was ambiguous because it was unclear whether it applied to outlets located outside the State of Iowa, and declining to apply the statute to a franchised business located outside the state that purportedly encroached upon a franchised outlet located in Iowa). Although the *Holiday Inn* case was decided under the rubric of the 1992 Act, it is likely that a court would arrive at the same result applying the 2000 Act. The court's decision in *Holiday Inn* was predicated on the presumed legislative intent to limit the territorial scope of the 1992 Act to franchises physically located in the State of Iowa. As the 2000 Act was adopted after *Holiday Inn*, the legislature knew of the court decision, yet nonetheless retained essentially the same language limiting the territorial scope of the statute. As a result, the 2000 Act is likely

franchisor opens an outlet less than a mile away across the border in another state, the protections of the statute will not apply.

5. Minnesota

The Minnesota Franchise Act (“MFA”) prohibits any unfair or inequitable conduct by franchisors.³³ Minnesota regulators have delineated a suite of conduct which fall within the definition of “unfair or inequitable conduct” under the MFA.³⁴ More particularly, the regulations provide that it is unfair and inequitable for any franchisor to compete with the franchisee in an exclusive territory or grant competitive franchises in the exclusive territory previously granted to another franchisee if the terms of the franchise agreement provide that an exclusive territory has been specifically granted to a franchisee.³⁵

Franchisees can bring a private cause of action for violations of the regulations.³⁶ Although there has been scant judicial analysis of these protections, at a minimum, courts require an enforceable contract containing an explicit exclusive territory for a franchisee to take advantage of the protections of the regulations.³⁷ And in any event, the MFA generally applies only when an offer or sale is made or accepted in Minnesota, or where the franchise is intended to be operated in the state.³⁸

6. Washington State

Washington’s Franchise Investment Protection Act (“FIPA”) provides limited protection for franchisees from territorial encroachment under the statute’s franchisee bill of rights.³⁹ Specifically, FIPA prohibits a franchisor from granting competitive franchises or from directly competing in any exclusive territories specifically granted to a franchisee.⁴⁰ As originally enacted,

similarly limited to franchised outlets physically located in Iowa. See, e.g., *G.P.P., Inc. v. Guardian Prot. Prods., Inc.*, 1:15-CV-00321-SKO, 2015 WL 3992878, at *11 (E.D. Cal. June 30, 2015) (dismissing complaint alleging violations of both the 1992 Act and 2000 Act because the franchisee had failed to alleged that it had a physical presence in the state of Iowa).

³³ MINN. STAT. § 80C.14 Subdiv. 1.

³⁴ MINN. R. 2860.4400.

³⁵ *Id.*, 2860.4400(C).

³⁶ See, e.g., *Coyne’s & Co., Inc. v. Enesco, LLC*, 565 F. Supp. 2d 1027, 1050 (D. Minn. 2008) (refusing to dismiss claim brought for violation of the anti-encroachment provision of the regulations where plaintiff had sufficiently alleged that it qualified as a “franchisee” under the Minnesota Franchise Act.).

³⁷ *Coyne’s & Co., Inc. v. Enesco, LLC*, CV 07-4095 (MJD/SRN), 2008 WL 11349883, at *8 (D. Minn. Oct. 22, 2008) (holding that a franchisee had no right to seek relief under the encroachment protections of the regulations because the franchise was being operated by a receiver that had not assumed the franchise agreement, and therefore the exclusive territory provision in the agreement did not provide protection).

³⁸ MINN. STAT. § 80C.19. There are several wrinkles to the jurisdictional reach of the statute that are beyond the scope of this paper. See, e.g., Daniel J. Oates, Vanessa L. Wheeler & Katie Loberstein, *A State’s Reach Cannot Exceed its Grasp: Territorial Limitations on State Franchise Statutes*, 37 FRANCHISE L.J. 185, 201–02 (2017) (discussion of the scope of the MFA).

³⁹ WASH. REV. CODE § 19.100.180(2)(f).

⁴⁰ *Id.*

the provision required franchisors to grant exclusive territories.⁴¹ The provision was amended before its effective date, and now only prohibits franchisors from competing directly with franchisees or from granting franchises to a franchisee's competitors, where the franchise agreement explicitly grants an exclusive territory to the franchisee.⁴² The amendment to the statute suggests that a franchisor may compete against a franchisee unless the parties' franchise agreement grants territorial protection to the franchisee,⁴³ an interpretation that has been implicitly adopted by courts that have addressed the issue. For example, in *Goodyear Tire & Rubber Co. v. Whiteman Tire, Inc.*, the court found that a manufacturer did not violate a duty of good faith by operating its own retail facility in competition with the dealer because the dealership agreement did not reserve an exclusive territory.⁴⁴ To the contrary, the agreement expressly reserved to the manufacturer the right to compete in the dealer's trade area.⁴⁵

In addition, the protections afforded by FIPA are further limited by additional procedural hurdles. By its express terms, a violation of FIPA's franchisee bill of rights does not give rise to an independent cause of action. Instead, a violation of the bill of rights constitutes an unfair or deceptive act or practice under Washington's Consumer Protection Act ("CPA").⁴⁶ Accordingly, to establish a claim for violation of the bill of rights, franchisees must also satisfy all of the other elements of the CPA.⁴⁷ This includes showing: (1) an unfair or deceptive act or practice; (2) that occurs in trade or commerce; (3) a public interest; (4) injury to the business property; and (5) a causal link between the unfair or deceptive act and the injury suffered.⁴⁸ A violation of FIPA's bill of rights is designated as a per se unfair or deceptive act or practice that impacts the public interest, satisfying those elements, but franchisees must still satisfy all of the other elements of FIPA.⁴⁹

7. Wisconsin

⁴¹ Franchise Investment Protection Act, ch. 252, § 18(2)(f), 1971 Wash. Sess. Laws, 1st Ex. Sess. 1128, 1139 (making it an unfair or deceptive act for franchisor to compete with the franchisee or grant competitive franchises to others in the franchisee's relevant market).

⁴² WASH. REV. CODE § 19.100.180(2)(f).

⁴³ Donald S. Chisum, *State Regulation of Franchising: The Washington Experience*, 48 WASH. L. REV. 291, 375 (1973) ("[A]n exclusive franchise territory need not be granted, but once granted, it must be respected.").

⁴⁴ 86 Wash. App. 732, 935 P.2d 628 (1997).

⁴⁵ *Id.*

⁴⁶ *Id.*; see also *BP W. Coast Prods. LLC v. Shalabi*, No. C11-1341MJP, 2012 WL 2277843, at *8 (W.D. Wash. June 14, 2012) ("The CPA itself provides the sole cause of action to enforce violations of these provisions of . . . FIPA."); *AAMCO Transmissions, Inc. v. Harris*, 759 F. Supp. 1141, 1146 (E.D. Pa. 1991); *Chico's Pizza Franchises, Inc. v. Sisemore*, Bus. Franchise Guide (CCH) ¶ 8,041 (E.D. Wash. Aug. 29, 1983).

⁴⁷ *Shalabi*, No. C11-1341MJP, 2012 WL 2277843, at *8.

⁴⁸ *Id.*

⁴⁹ *Id.*; see also WASH. REV. CODE § 19.86.093. The jurisdictional reach of the CPA is very broad, applying to any unfair or deceptive act that has the capacity to directly or indirectly effect the people of the State of Washington. See, e.g., *Thornell v. Seattle Serv. Bureau, Inc.*, 184 Wash.2d 793, 803-04, 363 P.3d 587 (2015) (holding that out of state residents could bring a CPA claim against a Washington-based entity because its presence in Washington had the capacity to indirectly impact Washington residents).

The State of Wisconsin does not directly regulate franchise encroachment or territorial exclusivity. Instead, the state generally protects franchisees against actions taken by the franchisor that “substantially change the competitive circumstances of a dealership without good cause.”⁵⁰

The phrase “substantial change in competitive circumstances” is nebulous and requires a fact-intensive analysis. For example, if a specific dealer is suffering from financial hardship, any change implemented by the franchisor (including presumably the sale of a new franchise that affects the sales of the existing outlet), may constitute a substantial change in competitive circumstances.⁵¹ Accordingly, whether a proposed new franchise outlet effectuates a substantial change in competitive circumstances is likely difficult to establish without fully vetting the matter through a trial on the merits. However, franchisors can avoid the problem entirely by properly drafting their franchise agreements. If the dealership agreement is by its express terms nonexclusive, the sale of an additional outlet will not substantially change the existing dealer’s competitive circumstances.⁵² Nonetheless, the franchisor may be obligated to notify the existing franchisee at least ninety days in advance of the opening of the new outlet.⁵³

Conversely, if a franchisee has been granted an exclusive territory, franchisors may not sell products into that territory through other distribution channels, such as the internet, without running afoul of the statute.⁵⁴

B. Industry Specific Encroachment Restrictions

In addition to franchise statutes of general application, many states have adopted laws that regulate encroachment in the context of specific industries and distribution channels. Although the full panoply of statutes is beyond the scope of this article,⁵⁵ a brief review of the restrictions that apply to automobile dealerships is instructive of the logic behind anti-encroachment laws.

⁵⁰ WIS. STAT. § 135.03

⁵¹ See *Van v. Mobil Oil Corp.*, 515 F. Supp. 487, 491 (E.D. Wis. 1981).

⁵² *Super Valu Stores, Inc. v. DMart Food Stores, Inc.*, 146 Wis. 2d 568, 576–77, 431 N.W.2d 721 (Ct. App. 1988) (“[B]ecause Super Valu’s dealership agreement with Cahak specifically authorizes Super Valu to franchise other stores whenever and wherever it wishes, we do not see how the issuance of another franchise would change “the competitive circumstances of [the] dealership agreement” in violation of the law.”); see also 2 W. Michael Garner, *Franchise Desk Book WI-65* (3rd ed. 2011) (“Where a dealership agreement provides for a nonexclusive territory, the grantor may, in its sole discretion, franchise other dealerships within the territory without violation of the Wisconsin Fair Dealership Law.”).

⁵³ *Jungbluth v. Hometown, Inc.*, 548 N.W.2d 519 (1996) (citing WIS. STAT. § 135.03 (requiring 90 days prior notice of a substantial change in competitive circumstances)).

⁵⁴ See *Kaeser Compressors, Inc. v. Compressor & Pump Repair Servs., Inc.*, No. 09-C-521, 2009 WL 3055341, at *5 (E.D. Wis. Sept. 18, 2009); *Lee Beverage Co., Inc. v. I.S.C. Wines of California, Inc.*, 623 F. Supp. 867 (E.D. Wis. 1985).

⁵⁵ See generally W. Michael Garner, 2 *FRANCHISE AND DISTRIBUTION LAW AND PRACTICE* § 14.34 (2017-2018) for a complete discussion of motor vehicle franchise laws.

Beginning in the 1960s, states began passing laws to protect automobile dealerships from market oversaturation.⁵⁶ These laws typically require automobile manufacturers to notify existing dealers before opening a new outlet in the existing dealer's market area.⁵⁷ "The relevant market area for these dealerships varies by state, anywhere from 314 to 1256 square miles.⁵⁸ After receiving notice, the existing dealer has the right to dispute the new proposed outlet before an administrative agency.⁵⁹ The manufacturer must then show that there is good cause for the opening of a new outlet, using such factors as whether the new location is injurious or beneficial to the public welfare,⁶⁰ whether there is a growth or decline in population in the relevant market,⁶¹ the permanency of the existing dealer's investment,⁶² and whether franchisees of that line-make in the relevant market area are providing adequate competition and consumer service.

The automobile dealership statutes show not only the power of a coordinated lobbying effort by an industry segment; they also demonstrate that legislatures will continue to exert pressure on manufacturers and franchisors to curtail market oversaturation, and to more readily share in the proceeds of the franchised business with their franchisees. In addition to the requirements imposed by the parties' contractual agreements, franchisors must be careful in exercising their discretion to open new outlets. As discussed in more detail later, this includes carefully evaluating whether and when to expand their business footprint, and where appropriate, conducting competitive impact analyses to fully understand the consequences of potential expansion efforts.

⁵⁶ Uri Benoliel, *Criticizing the Economic Analysis of Franchise Encroachment Law*, 75 ALB. L. REV. 205, 210–11 (2012); W. Michael Garner, 2 FRANCHISE AND DISTRIBUTION LAW AND PRACTICE § 14.34 (2017-2018) ("The purpose of such statutes is to prevent oversaturation of an area with dealers in a particular line of cars.") (citing *New Motor Vehicle Bd. Of California v. Orrin W. Fox, Co.*, 439 U.S. 96 (1978)).

⁵⁷ Benoliel, *supra* note 56 at 210–11.

⁵⁸ *Id.* at 210 n.26. For example, on the larger end of the spectrum, in Rhode Island, the relevant market area is defined as the area with the radius of twenty miles around an existing dealer. Using the traditional formula for calculating the area of a circle, $A = \pi r^2$, that results in a protected territory of approximately 1256.64 square miles. In addition, some other states evaluate factors other than a simple calculation of geographic radius. For example, "Florida approaches the threshold issue differently by considering the county, county population, the geographic area within a radius of twenty miles from the site of the proposed appointee, and the position of 25 percent of the actual sales by a protesting dealer into an area encompassed by a radius of 12.5 miles from the site of the proposed dealer or relocated dealer during any twelve-month period within the prior thirty-six months." Allan B. Curhan, Lawrence P. Murray & Michael P. Murphy, *Encroachment, Coercion, and Termination of Automobile Franchises and Distributorships: Regulation of an Industry*, 25 FRANCHISE L.J. 127, 129 (2006) (citing FLA. STAT. § 320.642(3)(a)).

⁵⁹ *Id.* at 210 n.27 (citing CAL. VEH. CODE § 3062(a)(1); COLO. REV. STAT. § 12-6-120.3(1), (1.5); CONN. GEN. STAT. § 42-133dd(a); FLA. STAT. § 320.642(3); GA. CODE ANN. § 10-1-664(a), (b); 815 ILL. COMP. STAT. ANN. 710/4(e)(8); MASS. GEN. LAWS ANN. ch. 93b, § 6(a); MICH. COMP. LAWS § 445.1576(2), (3); TEX. OCC. CODE ANN. § 2301-652).

⁶⁰ Interestingly, a 1986 study by the Federal Trade Commission found that anti-encroachment statutes drive up the cost of new vehicles. See, e.g., FTC, THE EFFECT OF STATE ENTRY REGULATION ON RETAIL AUTOMOBILE MARKETS (1986). According to the report, states without statutes have lower prices on average. *Id.* But subsequent commentators have questioned the accuracy of the FTC's investigation. See, e.g., Rupert M. Barkoff & W. Michael Garner, *Encroachment: The Thorn in Every Successful Franchisor's Side*, ABA 16TH ANNUAL FORUM ON FRANCHISING W-5, at 40-41 (1993). So it is unclear what effect these provisions have on the economy.

⁶¹ Benoliel, *supra* note 56 at 201–11; see also Garner, *supra* note 55 at § 14.34.

⁶² Garner, *supra* note 55 at § 14.34 (citing CAL. VEH. CODE § 3063).

III. ENCROACHMENT CLAIMS BASED UPON THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

Where statutory protections are not available, some courts have allowed franchisees to pursue encroachment claims which assert that the franchisor's development of one or more additional locations in close proximity to the franchisee's location violates the implied covenant of good faith and fair dealing. The success of these claims depends on a variety of factors, such as whether the franchise agreement is silent when it comes to whether franchisees have been granted an exclusive territory, and/or whether the franchisor has reserved the right and discretion to develop more locations as it deems appropriate. The following section discusses the various considerations that courts have addressed when considering encroachment claims under the duty of good faith.

A. The Covenant of Good Faith and Fair Dealing

Every contract imposes on the parties a duty, or covenant, of good faith and fair dealing in its performance and its enforcement.⁶³ This duty is implied in virtually all agreements and requires each party to act fairly and in a commercially reasonable manner.⁶⁴ Its purpose is to ensure that the parties to a contract do nothing that would destroy each other's abilities to enjoy the fruits of the contract. Among the examples of what constitutes bad faith performance set forth in the Restatement, and which have been recognized by judicial decisions, are: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.⁶⁵

The implied duty of good faith "prohibits one party to a contract from acting in such a manner as to prevent the other party from performing his obligations under the contract."⁶⁶ The covenant cannot, however, be used to create obligations to perform any additional acts that are not otherwise required by the agreement's express terms; the covenant "does not obligate a [party] to take affirmative actions that the [party] is clearly not required to take" under the contract.⁶⁷ In a variety of contexts, some courts have held that, even where one party has a contractual responsibility that it can exercise with "sole discretion" or "absolute discretion," that party is still not relieved of its duty of good faith.⁶⁸

⁶³ RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

⁶⁴ *Id.*; see also *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 728 (7th Cir. 1979).

⁶⁵ RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981).

⁶⁶ *Parker v. The Columbia Bank*, 604 A.2d 521, *cert denied*, 610 A.2d 796 (1992).

⁶⁷ *Id.*; see also *McLean v. Keith*, 72 S.E.2d 44, 53 (1952) (while a party that enters into an enforceable contract is required to make reasonable efforts to perform his obligations under the contract, the court cannot, and will not, imply contractual terms to which the parties did not agree).

⁶⁸ For example, Florida courts have held that a grant of "absolute discretion" to a trustee does not relieve the trustee of his duty of good faith; where a contract afforded a party "substantial discretion to promote that party's self-interest," the duty of good faith nevertheless applied; and a collective bargaining agreement that gave the employer the sole discretion to discharge an employee for failure to perform was still subject to the implied duty of good faith. See, e.g., *Cox v. CSX Intermodal, Inc.*, 732 So. 2d 1092, 1098 (Fla. Dist. Ct. App. 1999). Similarly, in a class action brought by depositors against a bank that had the discretion to set fees, and which had increased the amount of fees it charged for processing insufficient funds checks over time, the Oregon Supreme Court held that, while the bank had the

In some states, a breach of the implied duty of good faith can be asserted as a separate cause of action, although most do not recognize or allow an independent cause of action for breach of the implied duty. In the latter group of states, a breach of the implied duty can be asserted as an element of a breach of contract action, rather than as a stand-alone claim for damages.⁶⁹

Thus, depending on the jurisdiction, franchisees have been permitted to assert a claim for breach of the implied covenant of good faith and fair dealing, either independently or in connection with a specific claim for breach of contract, to try to prevent or limit the franchisor's encroachment on its territory. As discussed below, the courts in these cases have not always agreed on whether and to what extent the implied duty restricts a franchisor's ability to open a competing location within the franchisee's market. And, with the exception of a few significant decisions in the 1990s and a recent jury verdict and accompanying judge's decision in a California state court case, all of which are discussed in subsection 1 below, the consensus among the courts appears to be that a duty not to encroach cannot be implied where a franchise agreement expressly denies a franchisee an exclusive territory and/or expressly affirms the right of a franchisor to develop new locations in an existing franchisee's territory.⁷⁰

1. Cases in Which Franchisees Successfully Asserted the Implied Covenant of Good Faith and Fair Dealing to Address Territorial Encroachment

One of the earliest and most significant cases in which a franchisee successfully asserted a claim that the franchisor breached its duty of good faith and fair dealing by encroaching on the franchisee's territory was *Scheck v. Burger King*.⁷¹ In *Scheck*, Burger King permitted a Howard Johnson's restaurant located two miles away from the franchisee's restaurant in Lee, Massachusetts to be converted into a Burger King.⁷² The franchisee argued, among other things, that this conversion violated the implied covenant of good faith and fair dealing and sought to recover damages allegedly caused by the competing business.⁷³ Burger King moved for summary judgment on the basis that the franchise agreement did not grant the franchisee any

contractual discretion to set such fees, it was required to exercise that discretion within the confines of the depositors' reasonable expectations. *Best v. U.S. National Bank of Oregon*, 739 P. 2d 554, 559 (Or. 1987).

⁶⁹ *Compare* *Zamos v. McNeil-PPC, Inc.*, No. 16-5038, 2017 WL 68577, at *4–5 (E.D. Pa. Jan. 5, 2017) (finding that Pennsylvania does not recognize a breach of the covenant of good faith and fair dealing as an independent cause of action) *and* *Blue Mt. Mushroom Co. v. Monterey Mushroom, Inc.*, 246 F. Supp. 2d 394, 400 (E.D. Pa. 2002) ("Pennsylvania law does not recognize a separate claim for breach of implied covenant of good faith and fair dealing."), *with* *Yi v. Circle K Stores, Inc.*, 258 F. Supp. 3d 1075, 1085–86 (C.D. Cal. 2017) (stating that California law implies a covenant of good faith and fair dealing in every contract, but a claim for breach of the implied covenant "may be disregarded as superfluous" of it relies upon the same allegations as a breach of contract claim) *and* *Toto, Inc. v. Sony Music Entm't*, No. 12 CIV. 1434 LAK AJP, 2012 WL 6136365, at *13 (S.D.N.Y. Dec. 11, 2012), *report and recommendation adopted*, No. 12 CIV. 1434 RJS, 2013 WL 163826 (S.D.N.Y. Jan. 15, 2013) ("[A] claim [for breach of the duty of good faith and fair dealing] may be brought, if at all, only if it is based on allegations different than those underlying the accompanying breach of contract claim.") (citation and internal quotation omitted).

⁷⁰ *See, e.g.*, *Coldwell*, *supra* note 3 at 62.

⁷¹ *Scheck v. Burger King*, 756 F. Supp. 543 (S.D. Fla. 1991).

⁷² *Id.* at 545.

⁷³ *Id.* at 545, 549.

exclusive territorial rights.⁷⁴ The court rejected Burger King's argument, finding that, even though the franchise agreement did not grant exclusive territorial rights to the franchisee, that did not mean Burger King had an unfettered right to open other franchises wherever it wanted to.⁷⁵ The franchisee was still entitled to enjoy the benefits of its bargain with the franchisor, that is, the fruits of the contract.⁷⁶

More specifically, the court in *Scheck* held that the franchise agreement's provision expressly denying the franchisee an exclusive territory was not so broad as to encompass the franchisee's expectation "that Burger King will not act to destroy the right of the franchisee to enjoy the fruits of the contract."⁷⁷ In applying the implied covenant of good faith and fair dealing, the court further noted in its summary judgment decision that, "[i]t is axiomatic that a contract includes not only its written provisions, but also the terms and matters which, though not actually expressed, are implied by law, and these are as binding as the terms which are actually written or spoken."⁷⁸ The court also referenced deposition testimony that Burger King had a policy of denying approval of new restaurants in locations deemed to pose a risk of "large sales deteriorations at a nearby existing Burger King," and found that Burger King's alleged failure to exercise this type of discretion and consider the impact of the new, competing franchise on the existing franchise was a sufficient basis for the franchisee's claim for violation of the implied covenant of good faith and fair dealing, and summary judgment would therefore not be granted.⁷⁹

Burger King moved for reconsideration, in response to which the court entered an order affirming its decision ("*Scheck II*").⁸⁰ Burger King argued in its reconsideration motion that the franchise agreement authorized Burger King to establish franchises wherever it pleased, and because express contractual language cannot be overridden, the implied covenant did not apply.⁸¹ The court disagreed. It held there was no explicit contractual language in the franchise agreement allowing Burger King to establish restaurants wherever it wanted. Consequently, the court was not overriding any explicit contractual language by applying the implied covenant of good faith and fair dealing to the situation at hand.⁸² The court in *Scheck II* noted that, if the franchise agreement had expressly both allowed the franchisor to open competing businesses at will *and* denied territorial exclusivity to the franchisee, the result may have been different. In other words, a more carefully drafted agreement would have prevented the franchisee from asserting a claim based on the implied covenant of good faith to prevent the conversion of the nearby Howard Johnson's restaurant into another Burger King restaurant.⁸³

⁷⁴ *Id.* at 549.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.* at 549.

⁷⁸ *Id.* at 548–49.

⁷⁹ *Id.* at 549.

⁸⁰ *Scheck v. Burger King*, 798 F. Supp. 692, 697 (S.D. Fla. 1992).

⁸¹ *Id.*

⁸² *Id.* at 696.

⁸³ *Id.* at 697, 699.

In *In re Vylene Enterprises, Inc.*⁸⁴ a bankrupt franchisee asserted that the franchisor breached the implied duty of good faith by building a competing restaurant 1.4 miles away from the franchisee's restaurant. The bankruptcy court concluded that the franchisor's construction of the competing restaurant breached the implied covenant of good faith and fair dealing, as well as certain express terms of the franchise agreement. The district court reversed the bankruptcy court's decision. On appeal, the Ninth Circuit held that the franchisor had breached the implied covenant of good faith and fair dealing by constructing the competing restaurant in such close proximity to the franchisee's restaurant.⁸⁵ The appellate court stated that the "bad faith character" of the franchisor's move to build a competing restaurant "becomes clear when one considers that building the competing restaurant had the potential to not only hurt Vylene, but also to reduce [the franchisor's] royalties from Vylene's operations."⁸⁶ While it was undisputed that the franchisee was not given an exclusive territory under the franchise agreement, the franchisee was still entitled to expect that the franchisor would not undermine its rights and benefits under the contract. The court relied on *Scheck* in finding that the franchisor breached the implied covenant of good faith and fair dealing.⁸⁷

By the late 1990s, the trend of decisions allowing encroachment claims based on the implied covenant of good faith and fair dealing to proceed subsided, and thereafter, the courts increasingly rejected franchisee's claims to imply a duty not to encroach on franchisors where the franchise agreement expressly denied franchisees an exclusive territory.⁸⁸ But the theory and claim may have been given new life, and at least are getting a lot more attention and consideration, following the jury's rendering of its verdict, and the Los Angeles County, California Superior Court's entry of its judgment based on that verdict, in *Bryman v. El Pollo Loco, Inc.*⁸⁹ In *Bryman*, the jury found, among other things, that El Pollo Loco breached the implied covenant of good faith and fair dealing in its franchise agreement with its existing franchisees by opening two competing, corporate (franchisor)-owned restaurants close to the franchisees' existing restaurant in Lancaster, California, and by failing to first offer the franchisees the opportunity to open and operate the two new restaurants. The jury awarded the Brymans a whopping \$8.8 million in damages. This decision was reached despite the fact that the franchise agreement did not grant the franchisees exclusive territorial rights *and* expressly allowed the franchisor to open or operate competing stores at any location.⁹⁰

In its 116-page opinion supporting the judgment it entered based upon the jury's verdict, the court reviewed the law on the implied covenant of good faith and fair dealing in the franchise context. The court relied to a significant extent on the decisions in *Vylene*, and *Locke v. Warner*

⁸⁴ *In re Vylene Enters., Inc.*, 90 F.3d 1472 (9th Cir. 1996).

⁸⁵ *Id.* at 1477.

⁸⁶ *Id.*, 90 F.3d at 1477.

⁸⁷ *Id.* at 1477.

⁸⁸ Coldwell, *supra* note 3 at 44. See also discussion of decisions rejecting such claims *infra* Section III(A)(2).

⁸⁹ Case No. MC026045 (Cal. Super. Ct. Los Angeles Cnty. Aug. 1, 2018) (*appeal docketed, Handlers-Bryman v. El Pollo Loco*, Case No. B292585 (Ca. Ct. App. Feb. 5, 2019)).

⁹⁰ Steven Yatvin, *El Pollo Loco Verdict Hinges On Good Faith, Fair Dealing*, LAW360 (June 5, 2018), <https://www.law360.com/articles/1050235/el-pollo-loco-verdict-hinges-on-good-faith-fair-dealing>.

Bros.,⁹¹ citing the latter for the proposition that, “[w]here a contract confers on one party a discretionary power affecting the right of the other, a duty is imposed to exercise that discretion in good faith and in accordance with fair dealing.”⁹² The court also relied on Locke’s holding that “in every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.”⁹³ Among the evidence the plaintiff submitted in support of its damages claim was a market study showing that as a result of the defendant’s construction of the first of the two competing restaurants, there was a thirty-six percent overlap in the respective parties’ trade areas, and that the plaintiff could potentially lose forty percent of its sales to the company-owned restaurant.⁹⁴

The court in *Bryman* further found that El Pollo Loco had violated California’s Unfair Competition Law by requiring the Brymans to sign franchise agreements in 1999 and 2009 relating to the development of new restaurants, because the agreements failed to properly disclose the Brymans’ protected territory and did not offer them the right to operate other restaurants the franchisor decided to develop and built in their restaurant’s immediate vicinity.

The judge went so far as to find the franchise agreements the Brymans signed to be “procedurally and substantively unconscionable and products of contracts of adhesion,” and therefore held that the contracts were unenforceable by El Pollo Loco and did not in any way limit the rights and remedies of the franchisees.⁹⁵ In particular, the judge took issue with the provision granting El Pollo the right to open or operate competing restaurants at any location including “in the immediate vicinity of or *adjacent* to the [franchisee’s] Restaurant.”⁹⁶ Notably, the court differentiated between the adjacent location clause within the contract and one that would have granted El Pollo Loco the right to open franchised locations, finding the later “would not compel a conclusion that the new franchise was granted for the purpose of unlawful, unfair competition.”⁹⁷ As the court further explained, the new company-owned restaurants presented unfair competition concerns, because they had a more favorable cost structure, and because the company had access to confidential sales data, giving it an additional – and unfair – advantage as a competitor to the franchisee.⁹⁸ In view of these factors and the advantages the franchisor had, as part of the injunctive relief granted, the court refused to enforce the franchise agreement’s territorial provisions. El Pollo Loco has appealed this decision, and its appeal is currently pending.⁹⁹

⁹¹ *Locke v. Warner Bros.*, 57 Cal. App. 4th, 354, 66 Cal. Rptr.2d 921 (1997).

⁹² *Id.*, 57 Cal. App. 4th at 363, 66 Cal. Rptr.2d at 925.

⁹³ *Id.*

⁹⁴ See *Bryman v. El Pollo Loco, Inc.* Statement of Decision at ¶ 5.

⁹⁵ *Id.*; See also Joyce Hanson, *El Pollo Loco Can’t Escape \$8.8M Award in Franchise Suit*, LAW360 (Aug. 3, 2018), <https://www.law360.com/articles/1070094> (hereinafter “Can’t Escape”).

⁹⁶ Steven Yatvin *supra* note 90 (quoting *Bryman* Statement of Decision at 2) (emphasis added).

⁹⁷ *Id.* (quoting *Bryman* Statement of Decision at 8).

⁹⁸ See *Bryman* Statement of Decision at ¶5.

⁹⁹ *Handlers-Bryman v. El Pollo Loco*, Appeal No. B292585, California Second Appellate District Court of Appeal.

2. Cases in Which Franchisees Were Unsuccessful in Asserting Encroachment Claims Premised Upon the Implied Covenant of Good Faith and Fair Dealing

As noted above, the courts have not all agreed on this question, and in several cases over the last twenty-five years, courts have rejected franchisees' claims that a franchisor's opening other locations in close proximity to the franchisee's operation violated the implied covenant of good faith and fair dealing. For example, in *Cohn v. Taco Bell*,¹⁰⁰ the Northern District of Illinois found that a franchisor was expressly permitted to open other restaurants within a franchisee's trading area pursuant to the terms of the franchise agreement. The court therefore granted the franchisor's motion to dismiss the franchisee's claim that opening a company-owned location near existing locations owned by the franchisee violated the implied covenant of good faith and fair dealing.¹⁰¹ In particular, the court relied on the following provision in Section 14.2 of the franchise agreement, which it interpreted to provide the franchisor with an unrestricted right to engage in the sale and distribution of food and beverages in the franchisee's territory, either directly or through licensees:

The Franchisee understands and expressly acknowledges and agrees that the Company has the exclusive unrestricted right to engage directly and indirectly, through its employees, representatives, licensees, assigns, agents and others, at wholesale, retail and otherwise, within the restaurant trading area and elsewhere in (a) the production, distribution and sale of food products and beverages (including without limitation, tacos, taco shells, sauces and fillings, and other Mexican style food products) under the Trademarks licensed herein or other marks . . .¹⁰²

The court rejected the franchisee's arguments that Section 14.2 was only intended to preserve the franchisor's option to sell its trademarked products *in grocery stores* in the franchisee's trading area, and did not give the franchisor an explicit right to open a company-owned restaurant in the franchisee's trading area, because, unlike Section 1 of the contract,¹⁰³ Section 14.2 did not specifically reference the establishment of "TACO BELL RESTAURANTS."¹⁰⁴ The court, however, interpreted the use of the words "TACO BELL RESTAURANT" in Section 1 to suggest a limitation on the franchisee's rights under the franchise agreement, namely, that the franchisee had a limited license to sell Taco Bell food and beverage products from a particular restaurant location.¹⁰⁵ The court further reasoned that Section 14.2 did not use the words "TACO BELL RESTAURANT" because the franchisor's right to engage directly in production, distribution

¹⁰⁰ *Cohn v. Taco Bell*, No. 92 C 5852, 1994 WL 13769 (N.D. Ill. Jan. 14, 1994).

¹⁰¹ *Id.* at *7.

¹⁰² *Id.* at *5–*6.

¹⁰³ *Id.* at *6. Section 1 of the agreement provided: "The Company hereby grants to the Franchisee a limited license to use the Trademarks solely in direct connection with the sale of food, beverage and other products referred to in Subsection 3.5 from the TACO BELL RESTAURANT to be established pursuant to the following agreement . . . [G]rant of this limited license to use the Trademarks is further subject to the terms, condition and limitations hereinafter set forth, including, among others, those contained in Section 14." *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at *7.

and sale of food products and beverages within the franchisee's restaurant trading area is *not* limited to a particular restaurant location.¹⁰⁶

The court also relied on Section 14.3, which provided that “[e]xcept as expressly permitted by this Agreement and the Manual, the license granted under the Agreement does not include any right or authority of any kind whatsoever to prepackage or sell pre-package food products or beverages under the Trademarks.”¹⁰⁷ The court found that the explicit reference to pre-packaged food in Section 14.3, and the absence of such a reference in Section 14.2, implied that that unrestricted right of the franchisor in Section 14.2 was not limited to the sale of Taco Bell food and beverage products to grocery stores.¹⁰⁸

Finally, the court rejected the franchisee's argument that the franchisor's opening of a competing location conflicted with promises made throughout the franchise agreement that the franchisor would use its “best efforts to furnish the Franchisee with advice and assistance in managing and operating a TACO BELL RESTAURANT,” and that “all changes [in the Trademarks] shall be made in good faith, on a reasonable basis and with a view toward the overall best interest of the TACO BELL RESTAURANTS.”¹⁰⁹ According to the court, the franchisor's “commitment to use its best efforts to assist the franchisees in day-to-day operation and management techniques and to make all changes in the Defendant's trademarks in good faith does not imply a commitment to shelter the Plaintiffs from competition encouraged by company owned restaurants.”¹¹⁰

The court concluded its opinion by finding that while a franchisor's right to encroach on a franchisee's trading area is “certainly not inviting to prospective franchisees,” the court was required to enforce the contractual provision as written and could not “redraft the agreement simply because one of the parties may have made an unwise bargain.”¹¹¹

Similarly, in *Clark v. America's Favorite Chicken Co.*,¹¹² the Court of Appeals for the Fifth Circuit relied on the plain language of the parties' franchise agreements to find that the franchisor did not breach the implied covenant of good faith and fair dealing by developing and establishing competing franchise systems within the franchisees' territory. The court found that the franchise agreements expressly reserved to the franchisor the right to do so:

Franchisee understands and agrees that its license under said Proprietary Marks is non-exclusive to the extent that Franchisor has and retains the rights under this Franchise Agreement: . . .

[t]o develop and establish other franchise systems for the same, similar, or different products or services utilizing Proprietary Marks

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at *8.

¹¹¹ *Id.*

¹¹² *Clark v. America's Favorite Chicken Co.*, 110 F.3d 295 (5th Cir. 1997).

not now or hereafter designated as part of the system licensed by this Franchise Agreement, and to grant licenses thereto, without providing Franchisee any right therein. . . .¹¹³

The court reasoned that this language unambiguously reserved the rights of the franchisor to enter the franchisees' areas and compete against them under a different set of proprietary marks.¹¹⁴ Consequently, there could be no breach of the implied covenant for such conduct.¹¹⁵

The franchisees attempted to avoid the implications of the express reservation of rights by focusing on the allegedly improper way in which the franchisor had conducted itself and its operations.¹¹⁶ However, the court found that the franchisees failed to produce any evidence of bad faith or ill motive on the franchisor's part, other than some allegations that the franchisor shared trade and marketing secrets with competing restaurants.¹¹⁷ The court therefore found the allegations of bad faith and unfair dealing amounted to little more than a complaint about the nationwide marketing and advertising plan the franchisor adopted, which was also permitted by the franchise agreements.¹¹⁸ Thus, the court rejected the franchisees' claim that the franchisor breached the implied covenant.¹¹⁹

In *Davis v. McDonald's Corp.*,¹²⁰ the franchisee argued that the franchisor breached the implied covenant of good faith and fair dealing because Davis had a commercially reasonable expectation that McDonald's would not substantially impact sales at his restaurants through the development of new locations. The franchisee conceded that the franchise agreement did not grant him an exclusive territory.¹²¹ In finding that the franchisee did not state a claim for a breach of the implied covenant, the court relied on Paragraph 28(e) of the franchise agreement, which provided that "no 'exclusive,' 'protected' or other territorial rights in the contiguous market area of such Restaurant is hereby granted or inferred."¹²²

The franchisee insisted that paragraph 28(e) did not apply to the area immediately contiguous to his restaurant, and that the immediate area surrounding his restaurant was protected from encroachment.¹²³ He claimed that his interpretation was supported by the franchisor's view that it would be precluded from building another restaurant next door to one of the franchisee's restaurants and by a written policy McDonald's had which enabled franchisees

¹¹³ *Id.* at 297.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 298.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Davis v. McDonald's Corp.*, 44 F. Supp. 2d 1251 (N.D. Fla. 1998).

¹²¹ *Id.* at 1256.

¹²² *Id.*

¹²³ *Id.*

to seek economic assistance from the franchisor if their sales were sufficiently impacted by the development of new restaurants.¹²⁴

But the court found that the written policy was not incorporated into the franchise agreements by reference, and the agreements constituted the complete and exclusive expressions of the parties' agreement.¹²⁵ The court then analyzed the language of the franchise agreements to discern the intent of the parties, and found that the terms of the agreement unambiguously denied the franchisee any protected market area, making any expectation of such protection unreasonable.¹²⁶ Accordingly, the court refused to apply the covenant of good faith and fair dealing to impose a condition on McDonald's which contradicted the express terms of the agreements.¹²⁷

In *Burger King Corp. v. Weaver*,¹²⁸ the Eleventh Circuit Court of Appeals upheld the Southern District of Florida's finding that the franchisor had not breached the implied covenant by operating a restaurant in a location that was in direct competition with two of the franchisee's restaurants. The facts in *Weaver* were very similar to the facts in *Scheck*. Weaver had owned and operated a Burger King franchise in Montana since 1976 and purchased a second Burger King franchise in the same area and another in another town in the late 1980s.¹²⁹ Burger King subsequently authorized the construction of a competing restaurant on a nearby Air Force base which was adjacent to the town where Weaver's first two franchises were located.¹³⁰ Weaver alleged that the competing restaurant caused his revenues and profits to decline, and he stopped paying the rents, fees and other charges he owed Burger King under the franchise agreements.¹³¹

Initially, the lower court denied Burger King's motion for summary judgment on the franchisee's claim that Burger King breached the implied covenant.¹³² The court rejected Burger King's reliance upon the following language in one of the franchise agreements: "[t]his franchise is for the specified location only and does not in any way grant or imply any area, market or territorial rights proprietary to franchisee."¹³³ The court found this language was ambiguous and did not expressly authorize Burger King's conduct.¹³⁴ The court further reasoned that, "[t]aken to its logical extreme, [the franchisor's] construction of the franchise agreements would entitle it to set up a competing franchise *next door* to an existing franchise the day after the existing franchise

¹²⁴ *Id.*

¹²⁵ *Id.* at 1257–58.

¹²⁶ *Id.* at 1258.

¹²⁷ *Id.* at 1259.

¹²⁸ *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999).

¹²⁹ *Id.* at 1313.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Burger King Corp. v. Weaver*, 798 F. Supp. 684 (S.D. Fla. 1992).

¹³³ *Id.* at 687.

¹³⁴ *Id.* at 689.

had opened for business.¹³⁵ If that were the plain and intended meaning of the ‘territorial rights’ language . . . this Court entertains serious doubts about whether a rational franchisee would ever enter into a franchise agreement with [the franchisor].”¹³⁶

However, in response to Burger King’s second, renewed motion for summary judgment (and after the case had been reassigned to another judge), the trial court entered an order dismissing the franchisee’s breach of implied covenant claim.¹³⁷ The court found that the franchisee failed to allege that Burger King violated any express provision of the franchise agreements, and held that Florida courts do not recognize a claim for breach of the implied covenant of good faith and fair dealing absent a breach of an express contract provision.¹³⁸ The court thus held that the franchisee’s claim for breach of the implied covenant of good faith and fair dealing failed as a matter of law.¹³⁹

The Eleventh Circuit agreed that the franchisee’s claim for breach of the implied covenant failed as a matter of law, because the franchisee cited no express provision of the franchise agreement that had been breached. According to the court, the failure to identify an express contractual provision that has been breached is fatal to a claim for breach of the implied covenant of good faith and fair dealing.¹⁴⁰

Other cases in which courts held that a franchisee could not assert a breach of the implied covenant against an encroaching franchisor include: *Barnes v. Burger King Corp.*, 932 F. Supp. 1420 (S.D. Fla. 1996); *Burger King Corp. v. Agad*, 941 F. Supp. 1217 (N.D. Ga. 1996); *Camp Creek Hosp. Inns, Inc. v. Sheraton Franchise Corp.*, 139 F.3d 1396 (11th Cir. 1998); *Cook v. Little Caesar Enterprises, Inc.*, 972 F. Supp. 400 (E.D. Mich. 1997); and *Payne v. McDonald’s Corp.*, 957 F. Supp. 749 (D. Md. 1997).

* * * * *

It will be interesting to see how the appellate court decides the *El Pollo Loco* case, and whether that case is reversed and/or is merely an aberration, given the otherwise general trend rejecting encroachment claims based upon the implied covenant of good faith. It certainly seems that, where the contract clearly provides that the franchisee does not have an exclusive territory or rights, and the franchisor has the absolute and unfettered discretion to place additional franchises wherever it decides to, most courts will reject a claim for breach of the implied covenant. It therefore behooves franchisors to draft franchise agreements with as detailed, specific, and airtight reservations of rights provisions as possible. But the question and analysis of these claims will also continue to be a very fact- and contract term-sensitive exercise. For example, in *Camp Creek Hosp. Inns, Inc. v. Sheraton Franchise Corp.*,¹⁴¹ the express terms of

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Weaver*, 169 F.3d at 1314.

¹³⁸ *Id.*

¹³⁹ *Id.* at 1318.

¹⁴⁰ *Id.*

¹⁴¹ *Camp Creek Hosp. Inns, Inc. v. Sheraton Franchise Corp.*, 139 F.3d 1396 (11th Cir. 1998).

the parties' license agreement permitted Sheraton to authorize competing franchises wherever it wanted, including, literally, "directly across the street" from the plaintiff's franchise. Sheraton did not technically open a competing franchise, rather it took over another company's hotel located 3.5 miles away from the franchisee's hotel and began operating it itself, a situation that was technically not addressed in the license agreement. The Eleventh Circuit held that a genuine issue of material fact existed as to whether Sheraton's operation of the competing hotel violated its duty of good faith and fair dealing toward Camp Creek. The court further stated, in dicta, that "there can be no doubt" that Sheraton's operation of a hotel in a different state would warrant summary judgment for the franchisor on the breach of the implied covenant claim, whereas Sheraton's operation of a hotel "directly across the street" from Camp Creek's hotel would violate the implied covenant.¹⁴² Thus, the parties – and, if it gets to that point, the court – will need to carefully consider the particular situation at hand and what level of liability or exposure it presents.

IV. THE DRAFTING OF CONTRACT PROVISIONS AND THEIR IMPACT ON ENCROACHMENT ISSUES AND DISPUTES

To best address territorial exclusivity issues (and to help prevent disputes from arising between franchisors and franchisees relating to territorial exclusivity), franchisors should be careful to reserve to themselves the right and discretion to craft territories of their choosing when drafting their franchise agreements. The following section relies on commentary, sample provisions and case law involving this issue (with the cases running the gamut when it comes to territorial issues – some involve franchise agreement that contain provisions explicitly authorizing the opening of competing outlets, some involve franchise agreements that contain provisions denying exclusivity, and others involve agreements that do not contain any language regarding territorial exclusivity) to offer suggestions for how to go about crafting territorial provisions.

A. Exclusive Territory Provisions

As with any contract, a franchisor must be careful to keep in mind principles of contract construction and interpretation when developing its franchise agreement.¹⁴³ After all, any ambiguity will be read against the franchisor (the drafter); the franchisor's drafting of terms must be clear and precise.¹⁴⁴

With respect to defining an exclusive territory within a franchise agreement, a franchisor must first consider whether it is willing to afford a franchise with an exclusive territory that is measured based on the "radius" from the franchised business or in the form of a "metes and bounds" description related the area surrounding the franchised location.¹⁴⁵ Though the radius approach seems simpler on the surface, a poor use of it can create uncertainties in a territory leading to possible issues down the road.¹⁴⁶ On the other hand, while the "metes and bounds" approach is appealing for its preciseness, both governmental and natural boundaries can

¹⁴² *Id.*, at 1404–05.

¹⁴³ See generally Patrick J. Maslyn, Cheryl L. Mullin & Daniel Waddell, *Franchise Agreement Drafting*, 38TH ANNUAL IFA LEGAL SYMPOSIUM (2005).

¹⁴⁴ See *id.* at 2–4.

¹⁴⁵ See Charles Modell, *Drafting Exclusive Territory Provisions in Franchise Agreements*, 16 FRANCHISE L.J. 74, 74 (1996); Jennifer Dolman, Scott Korzenowski & Eric Wulff, *STOP INVADING MY SPACE: Encroachment Issues in Franchising*, 51ST IFA LEGAL SYMPOSIUM at 2–3 (2018).

¹⁴⁶ See Dolman, Korzenowski, & Wulff, *supra* note 145 at 2–3.

change.¹⁴⁷ As a result, a well-drafted metes and bounds approach often elects to define the boundaries as at the time of drafting.¹⁴⁸

Though there are possible pitfalls with the radius approach, a well-crafted provision can skirt these issues. Starting with the definition of “radius”, the language chosen should maximize the clarity of the franchisee’s territorial rights in the event of a dispute.¹⁴⁹

Notably, the primary dictionary definition for the term “radius” is as follows: “a line segment extending from the center of a circle or sphere to the circumference or bounding surface[.]”¹⁵⁰ This definition, if imported into a franchise agreement (either explicitly or by failure to define an alternative measurement), would lead to a circular boundary around the franchise location, which can lead to some troubling results. As explained in a Franchise Law Journal article entitled “*Drafting Exclusive Territory Provisions in Franchise Agreements*”:

If distance is measured “as the crow flies,” the protected territory could become quite expansive. For example, would it be reasonable to use such a measurement when two prospective sites are separated by natural boundaries? The issue becomes even more acute when the two sites are separated by physical boundaries that prevent travel between the two locations. As an example, assume there is a franchisee located on the eastern side of a lake. Assume the lake measures only one mile east and west, but five miles north and south. Could the franchisee [with a two mile “exclusive territory”] claim that its territory includes the western shore of the lake? The western shore does fall within a two mile radius of the eastern shore, even though a car would have to travel at least five miles from the center of the eastern shore to the opposite shore. This same situation occurs when a river runs between two sites, and the nearest bridge is several miles from either or both sites. Two sites on either side of a mountain may be an hour or more apart, even though the physical distance between the sites, if one could tunnel through the mountain, is less than two miles.¹⁵¹

Another issue that needs to be dealt with in connection with drafting “exclusive territory” provisions concerns what occurs if the franchised business closes or is forced to relocate. Such a scenario is by no means out of the question, and ambiguity on this point can cause confusion and dispute in the event that a franchisee takes one or both actions (i.e., relocation following by closure) during the term of the franchise agreement.¹⁵²

¹⁴⁷ See *id.*

¹⁴⁸ See *id.*

¹⁴⁹ Modell, *supra* note 145.

¹⁵⁰ *Radius*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/radius> (last visited July 1, 2019).

¹⁵¹ Modell, *supra* note 145, at 74.

¹⁵² See *id.* at 75.

A third issue that needs to be dealt with in “exclusive territory” provisions relates to a franchisor’s power to: (1) license or open other units outside of the franchisee’s territory; (2) license or open units inside the franchisee’s territory that operate under a different trade name (and sell different products or services) from the franchisee; and (3) license or open other units that are with the franchisee’s territory, that use the same trade name and sell the same products or services, but that are in non-traditional sites (e.g., airports, arenas, theme parks, hospitals). Put differently, “exclusive territory” provisions should expressly detail what a franchisor may or may not do with respect to its activities within and outside the franchisee’s territory, so that there is no confusion of whether the franchisor is fulfilling its implied duty of good faith and fair dealing to the franchisee. Absent such clarity, a franchisee can make a colorable, and potentially successful, argument that the franchisor has failed to act in accordance with the implied covenant and other contractual provisions.¹⁵³

Fourth, “exclusive territory” provisions in franchise agreements should deal with internet distribution of franchised-branded products/services and other forms of distribution that may impact on a franchisee’s territorial rights.¹⁵⁴ For example, if there is a deal between Uber Eats and a franchisee, whereby Uber Eats delivers the franchisee’s products to consumers within another franchisee’s exclusive territory, that deal can create serious conflict between franchisee and franchisee, and between franchisor and franchisees.¹⁵⁵ To stem such conflict, “exclusive territory” provisions can deal with this novel method of distribution.

Certain, model “exclusive territory” language, as found in the ABA Annotated Franchise Agreement (2018), is instructive:

(a) So long as Franchisee, its Affiliates and the Principals are in full compliance with this Agreement and all other agreements between Franchisee, its Affiliates and the Principals and Franchisor and its Affiliates, then Franchisor will not operate or authorize anyone except Franchisee to commence operation of a Store using the Marks and System from a physical location in the Designated Area.

* * * * *

The rights granted to Franchisee are site specific, for use only at the location identified in this Agreement, and provide no rights of exclusivity to Franchisee. Accordingly, Franchisee’s rights do not include (i) an exclusive area or protected territory within which Franchisor or its affiliates agree not to issue competing franchises or operate competing businesses, (ii) any right to sell products and items identified by the Marks at any location other than the Authorized Location or through any other channels or methods of distribution, including the Internet (or any other existing or future form of electronic commerce) and pre-packaged retail sales, (iii) any right to sell products and items identified by the Marks to any person or entity for resale or further distribution, or (iv) any right to

¹⁵³ See *id.*

¹⁵⁴ See *id.* at 75–76.

¹⁵⁵ Telephone Interview with Charles S. Modell, Shareholder, Larkin Hoffman (July 2, 2019).

exclude, control or impose conditions on the location or development of future stores at any time.

* * * * *

1. Reservation of Rights

(a) Franchisor and its Affiliates (and their respective successors and assigns, by purchase, merger, consolidation or otherwise) reserve all rights that this Agreement does not expressly grant to or confer upon Franchisee, including, without limitation and notwithstanding Section __ above:

(i) The right to establish and operate and license others to establish and operate Special Outlets in the Designated Area, regardless of proximity to or competitive impact upon the Franchised Business;

(ii) The right to establish, operate and license others to establish and operate Stores, Special Outlets or other establishments located anywhere outside the Designated Area's physical boundaries, regardless of proximity to or competitive impact upon the Franchised Business and regardless of whether these establishments market their products and services in, or draw customers from, the Designated Area;

(iii) The right to distribute private label products, pre-packaged food products, memorabilia, and other products and merchandise, whether or not identified by or associated with the Marks, to or through any commercial establishments that are not affiliated with Franchisor or associated with the Franchise Network, including (for example) department stores, supermarkets and convenience stores, both inside and outside the Designated Area, regardless of proximity to or competitive impact upon Franchisee's Store;

(iv) The right to distribute private label products, pre-packaged food products, memorabilia, and other products and merchandise whether or not identified by or associated with the Marks, to all Persons whether inside or outside the Designated Area through catalogues, telemarketing campaigns, an Internet website and other direct-order techniques;

(v) The right to distribute catalogues and similar sales solicitation materials in the Designated Area, broadcast television and radio commercials for direct-order merchandise into the Designated Area, initiate telephone contact with and accept telephone orders from residents of the Designated Area, and fill orders for direct-order merchandise in the Designated Area, regardless of proximity to or competitive impact upon the Franchised Business;

(vi) The right to operate, and grant to others the right to operate, retail food establishments (including Stores) identified by tradenames, trademarks, service marks or trade dress, other than the Marks, pursuant to such terms and conditions as Franchisor deems appropriate, both inside and outside the Designated

Area and regardless of proximity to or competitive impact upon the Franchised Business;

(vii) The right to advertise and promote sales of any products and/or services (including those offered by Stores) both inside and outside the Designated Area and advertise and promote franchises, regardless of proximity to or competitive impact upon the Franchised Business; and

(viii) The right to acquire or be acquired by (regardless of the form of the transaction) a business which operates or licenses others to operate premises within the Designated Area, and Franchisor or its successors or assigns will have the right to operate and license other to operate such businesses under the trademarks or service marks of such other business at, from and/or physically contiguous to the Franchised Business's premises within the Designated Area regardless of proximity to or competitive impact upon the Franchised Business.

(b) Franchisee acknowledges and agrees that Franchisor has no express obligation or implied duty to insulate or protect Franchisee's revenues from erosion as the result of the Franchised Business competing with other foodservice businesses or with Special Outlets in the ways and to the extent this Section provides or contemplates. Franchisee expressly waives and relinquishes any right to assert any claim against Franchisor based on the existence, actual or arguable, of any such obligation or duty.¹⁵⁶

* * * * *

Importantly, a franchisor should not accept this model language "on its face." Since every franchise has its own needs and challenges, trying to craft a model franchise provision that fits every situation is simply not possible.¹⁵⁷ Other possible aspects that a franchisor may consider adding into the exclusive territory provision are having an assigned territory increase in size (after the franchisee meets explicit requirements) or shrink (as population increase or after a period of time).¹⁵⁸

Breaking a territorial exclusive provision can be quite costly for a franchisor, but so too can leaving a franchisee with an oversized exclusive area.¹⁵⁹ As such, a franchisor may want to place required duties that a franchisee must continually meet if they are to retain the exclusivity of their territory.¹⁶⁰ Though one, of course, should always be careful to never be too onerous less they fail to attract any franchisee.

¹⁵⁶ See Robert A. Lauer & Larry Weinberg, *Introductory Terms, Grant, Territory and Reservation of Rights*, ABA Annotated Franchise Agreement, 18-19, 22 – 24 (2018).

¹⁵⁷ See Judith M. Bailey, *A Form Unit Franchise Agreement*, 12 AZ. STATE L.J., 585, 585 (1980).

¹⁵⁸ *Id.* at 591, n.18.

¹⁵⁹ See Robert. W. Emerson, *Franchise Encroachment*, 47 AM. BUS. L.J. 191, 206–207 (2010).

¹⁶⁰ See *id.* at 210.

Finally, and of equal significance, a franchisor should appreciate that “no one is clairvoyant and can predict tomorrow’s opportunities and challenges.”¹⁶¹ Thus, a franchisor should periodically review its territoriality clauses to ensure that they (i.e., the clauses) are current and tailored “to meet the challenges and opportunities unique to [the franchisor’s] franchise system.”¹⁶²

B. Case Law Involving Territorial Exclusivity Issues and the Application or Interpretation of Relevant Contract Provisions

As one would expect, a wide variety of factors that go into the drafting of franchise agreements can have an effect on encroachment claims, such as the existence (or nonexistence) of an exclusive territory. The following is a discussion of the cases that address these issues, and the consequences for the franchisor in carefully drafting (or not) the franchise agreement.

1. Cases Where the Franchise Agreement Contained Explicit Authorization to Open Competing Outlets

a. *Patel v. Dunkin’ Donuts of Am., Inc.*

In *Patel v. Dunkin’ Donuts of Am., Inc.*,¹⁶³ the franchisee sought an injunction against defendant-franchisor in response to the franchisor’s allowing another franchisee to open an outlet within one mile of the existing franchisee’s location.¹⁶⁴ The franchise agreement at issue contained the following provision:

“DUNKIN’ DONUTS, in its sole discretion, has the right to operate or franchise other DUNKIN’ DONUTS SHOPS under, and to grant other licenses in, and to, any or all of the PROPRIETARY MARKS, in each case on such terms and conditions as DUNKIN’ DONUTS deems acceptable.”¹⁶⁵

Additionally, the franchise agreement had an integration clause that maintained that the contract was the “full and complete agreement” between the franchisor and the franchisee.¹⁶⁶ Thus, under the express terms of the franchise agreement, the franchisor retained the right to open and operate other locations without any restrictions.

Undeterred by the language contained in the franchise agreement, the franchisee proceeded to file a complaint against the franchisor asserting that the franchisor’s actions

¹⁶¹ Modell, *supra* note 145, at 76.

¹⁶² *See id.*

¹⁶³ 146 Ill. App. 3d 233 (1986).

¹⁶⁴ *Id.* at 234.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

constituted both a breach of the franchise agreement and the implied covenant of good faith and fair dealing.¹⁶⁷ In granting the franchisor's motion for judgment on the pleadings and denying the franchisee's motion for a preliminary injunction, the lower court held that the franchise agreement did not in any way prevent the franchisor from opening a new location in close proximity to the franchisee's location.¹⁶⁸ The lower court also observed, among other things, that the franchisee failed to state a cause of action against the franchisor because its alleged damages were "speculative."¹⁶⁹

The franchisee appealed the lower court's decision. The franchisee argued, *inter alia*, that it was not attempting to assert a claim of territorial exclusivity against the franchisor,¹⁷⁰ but rather, that the covenant of good faith and fair dealing prohibited the franchisor from opening a competing location that would result in injury to the franchisee's business and profits.¹⁷¹

The Appellate Court refused to adopt the franchisee's argument and upheld the lower court's decision. Although the Appellate Court recognized "that a covenant of good faith and fair dealing is implied in every contract as a matter of law, absent an express provision to the contrary[.]" it reasoned that the covenant was not applicable to this case since the franchise agreement provided the franchisor with the right to open a new location near the franchisee's location.¹⁷² The Appellate Court thus found that the franchisee was in essence attempting to insert an exclusive territory clause into a franchisee agreement which explicitly contained language to the contrary.¹⁷³ The express terms of the agreement withstood the franchisee's challenge.

b. ***Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.***

In *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*,¹⁷⁴ a franchisee brought suit against its franchisor (Holiday Inns, Inc.) alleging, *inter alia*, that the franchisor breached the franchise agreement when it acquired a nearby hotel.¹⁷⁵ The franchise agreement allocated to the franchisee the right to operate a Holiday Inn hotel at a certain location in downtown New Orleans. However, the franchise agreement also explicitly reserved for the franchisor the right to construct and operate other Holiday Inn hotels "at any place other than on the site licensed."¹⁷⁶

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 234–35.

¹⁶⁹ *Id.* at 235.

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 235–36.

¹⁷² *Id.* at 236 (explaining that "[i]n the case at bar, the parties did address the competition issue in the franchise agreement by giving defendants the right to establish a new business at its own discretion and on its own terms").

¹⁷³ *Id.* at 236–37.

¹⁷⁴ 732 F.2d 480 (5th Cir. 1984).

¹⁷⁵ *Id.* at 482.

¹⁷⁶ *Id.* at 483.

After the franchisor terminated the franchise agreement, the franchisee sought a preliminary injunction to prevent the termination.¹⁷⁷ In addition to denying the franchisee's motion for a preliminary injunction, the district court granted the franchisor's motion for summary judgment on the franchisee's remaining claims.¹⁷⁸

The Fifth Circuit Court of Appeals affirmed the district court's decision, adopting a steadfast approach to enforcing the explicit terms of a franchise agreement. The Fifth Circuit ruled that the terms of the franchise agreement were clear and did not grant the franchisee a territorial license. Further, the Fifth Circuit was unpersuaded by the franchisee's attempt to assert the covenant of good faith and fair dealing as a means of limiting or restricting the franchisor's contractual rights. The Fifth Circuit held, in relevant part, as follows:

The [franchisee]'s argument that [the franchisor] breached the implied general obligation of good faith that permeates every contractual relationship must fall with our holding that the terms of the franchise agreement do not grant the [franchisee] a territorial license. *The implied obligation to execute a contract in good faith usually modifies the express terms of the contract and should not be used to override or contradict them.*¹⁷⁹

Accordingly, the Fifth Circuit found that the language of the franchise agreement specified the *non-exclusivity* of the franchisee's territorial right, which was limited only to the franchisee's location in downtown New Orleans.¹⁸⁰

2. Cases Where the Franchise Agreement Contained a Provision Specifically Denying an Exclusive Territory

a. Chang v. McDonald's Corp.

In *Chang v. McDonald's Corporation*,¹⁸¹ the franchisee alleged that McDonald's Corp. (its franchisor) breached the franchise agreement by opening two restaurants in close proximity to the franchisee's location and by refusing to renew the franchisee's license agreement.¹⁸² The express language of the relevant contract read, in pertinent part, as follows:

(a) the term of this License terminate[s] October 19, 1996 with no promise or representation as to the renewal of this License or the grant of a new License;

* * * * *

¹⁷⁷ *Id.* at 484.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.* at 485. (internal citations omitted) (emphasis added).

¹⁸⁰ *Id.*

¹⁸¹ No. 95-16012, 105 F.3d 664, 1996 WL 742455 (9th Cir. Dec. 19, 1996).

¹⁸² *Id.* at *1.

(e) [t]his License establishes a Restaurant at the location specified ... [and] no 'exclusive,' 'protected' or other territorial rights in the contiguous market area ... is hereby granted or inferred.¹⁸³

The agreement also included an integration clause which provided that the contract "constitutes the entire agreement between the parties and supersedes all prior and contemporaneous, oral or written, agreements or understandings of the parties."¹⁸⁴

In granting the franchisor's motion for summary judgment, the district court held that the franchise agreement did not provide for exclusive territorial rights or for renewal.¹⁸⁵ In particular, the district court found that the franchisee had no contractual rights, express or implied, to an exclusive market area under the agreement, and similarly, that the franchisee had failed to bargain for either exclusive territorial or renewal rights.¹⁸⁶

In affirming in the lower court's decision, the Ninth Circuit Court of Appeals affirmed that the express terms of the agreement control the court's interpretation of the agreement.¹⁸⁷ The Ninth Circuit also agreed that the franchisee failed to bargain for exclusive territorial rights and was unmoved by the franchisee's argument that the franchisor violated the implied covenant of good faith and fair dealing.¹⁸⁸ The Ninth Circuit observed:

In Illinois [whose law applied to this case], the covenant of good faith and fair dealing is not an independent source of duties, but instead "guides the construction of explicit terms in an agreement. The covenant is essentially used to determine the intent of the parties when a contract is ambiguous. *The covenant requires that a party vested with contractual discretion exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.*"¹⁸⁹

The Ninth Circuit, in short, found that there was no need to apply the implied covenant of good faith and fair dealing to the situation since the covenant could not be used as means of nullifying the explicit agreement between two parties, and where the act at issue was explicitly permitted by the agreement's terms.¹⁹⁰

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* at *2.

¹⁸⁶ *Id.* at *1.

¹⁸⁷ *Id.* at *2.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at *2 (internal quotations and citations omitted) (emphasis added).

¹⁹⁰ *Id.* at *2-3.

3. **Cases Where the Franchise Agreement was Silent Regarding Territorial Exclusivity**

a. **Fickling v. Burger King Corp.**

In *Fickling v. Burger King Corp.*,¹⁹¹ nine franchisees of Burger King Corp. (the franchisor) (“BKC”) asserted that BKC had, among other things, breached oral territorial agreements with the franchisees and the implied covenant of good faith and fair dealing when it granted two new franchises to a local military installation.¹⁹² Notably, the franchise agreements in question was silent on whether Burger King had granted an exclusive territory, and contained integration language, whereby each contract “constitute[d] the entire agreement of the parties,” that could “only be modified or amended by written document.”¹⁹³

In dismissing all of the franchisees’ claims, the United States District Court for the Eastern District of North Carolina rejected the franchisees’ oral exclusive territory argument and their assertion of a breach of the implied covenant of good faith and fair dealing.¹⁹⁴ More specifically, the court found, in applying Florida law, that any oral agreements purporting to grant an exclusive territory were barred by the statute of frauds, and that the franchise agreements could not be rewritten to include such a provision through any such oral arguments.¹⁹⁵ Doing so would contradict the unambiguous language contained in the franchise agreements.¹⁹⁶

The Fourth Circuit Court of Appeals affirmed the lower court’s decision.¹⁹⁷ Significantly, the Fourth Circuit observed that “[u]nder Florida law, the obligation of good faith will not be implied in derogation of the express terms of a contract.”¹⁹⁸ Thus, the express terms of the franchise agreements, and in particular their silence about the existence of any exclusive territory, were found to be of supreme importance relative to the principle of good faith and fair dealing that is inherent in each contract.¹⁹⁹

b. **Snyder v. Howard Johnson's Motor Lodges, Inc.**

In *Snyder v. Howard Johnson's Motor Lodges, Inc.*,²⁰⁰ the lead plaintiff, a principal owner of a motel corporation that operated a Howard Johnson Lodge (subject to a license) and the sole beneficiary of a land trust which leased a restaurant adjoining the motel to a related corporate-

¹⁹¹ No. 87-1725, 843 F.2d 1386, 1988 WL 30675 (4th Cir. Apr. 4, 1988).

¹⁹² *Id.* at *1.

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ *See generally id.*

¹⁹⁷ *Id.* at *2.

¹⁹⁸ *Id.* at *1 (citations omitted).

¹⁹⁹ *Id.*

²⁰⁰ 412 F. Supp. 724 (S.D. Ill. 1976).

defendant, brought an action against a number of defendants alleging various claims, including breach of contract and violations of federal and state anti-trust laws.²⁰¹ The relevant contract/license agreement contained no provision restricting any defendants' ability to build another lodge in the lead plaintiff's area.²⁰² Further, the contract/license agreement contained an integration clause which provided:

"This instrument contains an agreement of the parties, and no representations, inducements, promises or agreements, oral or otherwise, not embodied herein or in similarly executed instruments shall be of any force or effect."²⁰³

The plaintiffs attempted to utilize the implied covenant of good faith and fair dealing and expand or convert it into a covenant whereby the defendants would not compete in the local market.²⁰⁴ Despite this creative approach, the court held that "[w]hile fair dealing is implied in any contract, the court is unable to extend this principle to imply a covenant against competition."²⁰⁵ In refusing to recognize an implied bridge between the implied covenant of good faith and fair dealing and a covenant not to compete, the court observed:

To imply a negative covenant in any written agreement requires the court to rewrite what the parties intended but did not include in the written agreement. To that extent the court is imposing its notions of equity and fair play. . . . The court can only declare implied covenants when there is a reasonable basis to imply certain duties of the parties. . . . The basis for an implied covenant is that the parties to the contract would have expressed that which the law implies had they thought of it or had they not supposed it was unnecessary to speak of it because the law provided for it. . . . Territorial protection was not a provision either ignored or thought unnecessary by the parties. Negotiations concerning both territorial exclusive rights and a first right of refusal occurred before the written agreement. In light of all the circumstances, the court cannot interpret the defendant's words and conduct as implying a covenant not to compete in the [[local] motel market.²⁰⁶

Hence, a restrictive covenant (i.e., a covenant not to compete) could not be created through the assertion of the implied covenant of good faith and fair dealing.

Interestingly, however, the court found that plaintiffs could assert a claim under the implied covenant of good faith and fair dealing with respect to a related lease agreement and the operation

²⁰¹ *Id.* at 726.

²⁰² *Id.* at 727.

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ *Id.* at 727–28 (quotation marks and citations omitted).

by defendants of a restaurant, allegedly in a sub-standard manner.²⁰⁷ The court observed that the financial success of the restaurant and the related, licensed-lodge were reliant on one another.²⁰⁸ The court concluded that the implied covenant of fair dealing may be applicable here, for “[w]here the fruits of a contract to one party depend on the efforts of another, a covenant of fair dealing can be implied.”²⁰⁹ As a result, the court denied the defendants’ motion for summary judgment in that regard, as well as others highlighted in the opinion.²¹⁰

V. COMPETITIVE IMPACT ANALYSES

Although, as seen above, courts have not been consistent in addressing issues of encroachment, and the language of the franchise agreement carries great weight in determining whether a franchisee has a claim for encroachment, a franchisor’s adherence to its good faith obligations should not be taken lightly. Franchisors that prudently evaluate the impact of their decisions to expand the franchise system are far more likely to survive intense judicial scrutiny than are those that elect to expand without evaluating the consequences (both intended and unintended). Moreover, franchisors that carefully evaluate expansion decisions are more likely to ensure strategic, stable growth of the franchise system.²¹¹ Accordingly, franchisors increasingly conduct competitive impact analyses before authorizing the sale of a new franchised outlet, or opening a company-operated outlet that may have a competitive impact on an existing franchisee. In particular, franchisors in the hospitality industry have long taken great pains to evaluate the impact of a proposed expansion before opening a new hotel, and in some cases, have implemented procedures for deciding whether to authorize expansion of the brand.

And there are good reasons beyond the limitation of litigation risk for caution when expanding the brand. By explaining to franchisees up front that the franchisor retains the right to open new outlets, and that they will have the opportunity to provide feedback about the process (even if it does not change the result of the decision), the franchisor can more easily manage franchisee expectations.²¹² It also can provide an outlet for franchisees to air grievances without resorting to litigation, and give the franchisor the opportunity to explain its decision-making process.²¹³ Ultimately, when done correctly, having a policy in place on addressing the potential competitive impact of opening new outlets can lead to a healthier franchise system, and better relationships with franchisees.²¹⁴

A. Competitive Impact Studies

²⁰⁷ *Id.* at 728.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ Erika L. Amarante, Andraya C. Frith & Karen B. Satterlee, *Territory, Exclusivity and Encroachment: Thinking Ahead of the Curve and Dealing with the Fallout*, 32ND ANNUAL FORUM ON FRANCHISING at 13 (2009).

²¹² Scott D’Angelo, Robert H. King, Jr. & Michael D. Joblove, *The Impact of Encroachment*, 39TH IFA LEGAL SYMPOSIUM 26 (2006).

²¹³ *Id.*

²¹⁴ Amarante, Frith & Satterlee, *supra* note 211 at 13.; Mort Aronson, Roy Flora & Randall Hammer, *Protected Territories – Effective Development Tool or Legal Liability*, 39TH IFA LEGAL SYMPOSIUM at 9 (2006).

Before taking the step of conducting a study, franchisors also need to determine what constitutes the type of “impact” that necessitates action (i.e., conducting a study, notifying existing franchisees, not approving a new outlet, or compensating existing franchisees). Some may decide that impacts based on effects on gross sales or net sales should be considered.²¹⁵ And ultimately, franchisors need to decide what, based on their franchise system, constitutes a “material” impact on the existing franchisee’s outlet. Depending on the franchise system, the variance could be dramatic. In some cases, a change in three percent in gross sales could be a material adverse impact.²¹⁶ In others, it may be ten percent.²¹⁷ A deep understanding of the franchisor’s franchise system is critical to making this threshold determination.

The franchisor’s policy also needs to take into consideration who will be impacted by the new outlet. Typically, policies should exclude outlets that are replacing closed outlets from any evaluation.²¹⁸ The policies should not cover prospective franchisees that are not part of the franchise system.²¹⁹

1. Methods and Timing for Conducting a Study

What constitutes a competitive impact study varies widely from franchise system to franchise system. Some franchise systems limit their process to conducting an internal review of the impact of brand expansion. The decision on whether to expand with a new outlet is a completely internal affair that is based on the experience of the franchisor in growing the brand.²²⁰ This is a common approach for sophisticated franchisors with substantial experience and a long history of sustained brand growth.²²¹ The results of these studies may or may not be made available to potentially affected franchisees, but if the results reveal no significant impact, the franchisor can at least proceed knowing that it performed due diligence that it can use to show that its decision was not arbitrary or driven solely by a desire to collect additional fees or divert business to company-owned outlets.²²²

²¹⁵ Aronson, Flora & Hammer, *supra* note 214 at 10.

²¹⁶ Amarante, Frith & Satterlee, *supra* note 211 at 14.

²¹⁷ *Id.* To add additional complexity to the issue, some franchisors look to the competitive impact over a specified period of time (e.g., projected impacts in the first twelve months after opening of the new franchised outlet). Accordingly, even if the long-term impact may result in a cumulative reduction that exceeds the presumed reduction, that is not taken into consideration during the franchisor’s evaluation as too speculative. D’Angelo, King & Joblove, *supra* note 212 at 25 (“[T]he impact of a new location will usually diminish after the first few years the new location is open.”).

²¹⁸ Amarante, Frith & Satterlee, *supra* note 211 at 14. This is not a strict rule, however, as it may depend on the scope and size of the new outlet as compared with the closed business. *Id.*

²¹⁹ *Id.* at 13 (“[S]uch policies are meant to serve their existing franchisees only, not benefit prospective franchise candidates.”).

²²⁰ Aronson, Flora & Hammer, *supra* note 214 at 10 (noting that franchisors should “establish some body with sufficiently senior executives who understand the operation of the franchise system, the development goals and the relationships with existing franchisees to consider the report on the market information and potential impact to the existing franchisee.”).

²²¹ See, e.g., Ronald R. Fieldstone, *Franchise Encroachment Law*, 17 FRANCHISE L.J. 75, 75 (1998) (noting that sophisticated franchises are often able to conduct an internal review that consists of market studies of the identity and location of customers of the franchised outlet, generalized geographical analyses of the proposed location in relation to the existing outlet, detailed market analyses, and revenue projections).

²²² See *id.*

Other franchisors employ outside consultants or use software programs for the purposes of assessing, in significant detail, the potential impact of a new outlet on existing outlets.²²³ These consulting reports are intended to provide an objective, outside assessment of the consequences of expansion. Typically, franchisors that use outside consultants make the results of the final analysis available to franchisees. In theory, making these reports available to franchisees should engender trust in franchisors' decision-making process, and help the franchisee accept the reality that brand growth (at least in the particular proposed instance) may be beneficial in the long run.

Depending on the brand, the timing for conducting an analysis can vary greatly. In some cases, franchisors conduct extensive internal reviews of a possible expansion before any potential applications are even contemplated. Sometimes the process begins after a suitable site is selected. And other times, no competitive analysis is conducted unless one is specifically requested by existing franchisees in response to the proposed expansion. Similarly, depending on the policies adopted by the franchisors, some have determined that a study is necessary only when it may impact specific exclusive rights provided by the franchise agreement. As some commentators have noted, however, in light of the case law on the implied duty of good faith and fair dealing, unless the franchise agreement is completely unambiguous in its grant of the right to the franchisor to expand at its sole discretion,²²⁴ franchisors should conduct pre-sale due diligence on the effects of expansion on existing franchisees.²²⁵ In fact, based on the authors' experience, most of the franchise systems that have implemented impact policies do not grant protected territories.²²⁶

2. Factors Considered in Competitive Impact Analysis

When conducting a competitive impact analysis, whether internally or using an outside consultant, franchisors should consider reviewing the following issues:

- The competitive marketplace in the geographical region surrounding the proposed new outlet, both in terms of existing franchised outlets of the franchisor's brand, and competitors,²²⁷ and including:

²²³ D'Angelo, King & Joblove, *supra* note 212 at 21 ("In order to ensure the necessary level of familiarity with the franchisor's system, some franchisors maintain an approved 'stable' of consultants that they use to perform the studies.").

²²⁴ As discussed *supra* Section IV, the language of the grant of exclusivity, or conversely, in the intentional refusal to refuse an exclusive territory to the franchisee, is a critical issue in determining whether the franchisee has a claim against the franchisor for some adverse competitive impact. Indeed, in all franchise contracts, the franchisor should include a reservation of rights to expand the brand. Amarante, Frith & Satterlee, *supra* note 211 at 13.

²²⁵ Aronson, Flora & Hammer, *supra* note 214 at 10.

²²⁶ Amarante, Frith & Satterlee, *supra* note 211 at 13.

²²⁷ Competitors outside the brand are often overlooked, but they represent an important part of the overall analysis. Fieldstone, *supra* note 221 at 76. For example, although opening a new competing outlet may cause short term injury to existing franchisees, if the effect is to eliminate competitors, the long-term result might be improved sales. *Id.* Similarly, if the market can bear an additional competitor, it is possible that the failure to open a new franchised outlet may leave an opening for a competitor to fill the space. Consequently, if the location is feasible, it may make the most sense to bring in a business under the franchisor's brand so as to head off competition from outside brands.

- Investments made by existing competitors to the new proposed outlet in their operations;
- Market penetration of existing outlets;
- Quality of operations by existing outlets, including customer satisfaction.
- Interviews with franchisees and their employees about potential anticipated impacts of opening the new outlet;
- Analysis of sales data for the existing outlets in close proximity to the proposed new outlet over some sufficiently lengthy preceding period of time;
- Consumer habits in the industry or market segment, and the effects those habits might play on competition in light of the new outlet;
- Geographical considerations (physical distance, natural and artificial barriers, foot traffic, traffic patterns, etc.);
- Population and demographic considerations;
- Effect on goodwill and brand growth in the relevant market by increased presence and marketing efforts.

As with many issues associated with trademarks, branding, and commerce, these issues are non-exclusive, and no one issue should be determinative. Rather, the franchisor will need to evaluate the outcome of the study based upon the total mix of information it receives from the due diligence, and make an informed decision based upon its past business practices and knowledge of the industry. To put it plainly, the decision on whether to expand can be more of an art than science.

B. Different Policy Approaches to Dealing with Impact Studies

In most instances, prudent franchisors have a policy in place for notifying existing franchisees about potential expansion opportunities that may affect the franchisee's business.²²⁸ Depending on the industry and type of franchised business, this will require an in depth understanding of the general scope of the impact caused by opening a new outlet.²²⁹ For some franchise systems, that may mean an outlet within one mile, whereas for others it may mean an outlet within ten miles, and the analysis may entail myriad other considerations beyond geography, such as population, and the state of the competitive marketplace with other brands.²³⁰

Once potentially affected franchisees have been notified of the proposed new outlet, the franchisor has different alternative policies it can adopt and implement. Some policies include a procedure for raising and discussing objections to the proposed new outlet. Other policies eschew such objections and instead proceed directly to negotiation over compensation for the impacts.

1. Policies for Considering Franchisee Objections to Proposed New Outlets

One way to curtail franchisee complaints and claims is to implement an objection procedure for franchisees that feel they have been injured by a decision to expand the brand into

²²⁸ Aronson, Flora & Hammer, *supra* note 214 at 10; Amarante, Frith & Satterlee, *supra* note 211 at 14.

²²⁹ Aronson, Flora & Hammer, *supra* note 214 at 10.

²³⁰ See generally, Amarante, Frith & Satterlee, *supra* note 211 at 14–15 (further noting that in particularly dense markets, the franchisor may want to limit notice to the four to five closest franchisees).

their market vicinity. Often these procedures contain strict submission requirements and deadlines that require the existing franchisee to notify the franchisor of any objections to the newly proposed outlet within a specified period of time after receiving notice of the proposed expansion,²³¹ noncompliance with which results in a waiver of the franchisee's complaints about and objections to the expansion.²³² Although the franchisor has likely already evaluated the effect of the new outlet opening, the franchisor should request the franchisee's input on all of the previously-described factors that would ordinarily go into the competitive impact analysis.

The franchisor typically then has the submitted information reviewed by a committee of individuals internally who are familiar with the franchisor's business goals and prior evaluation of the expansion decision.²³³ It is possible that the franchisor missed some vital detail or made an error that could alter the calculus of the decision. However, in the absence of a mistake or oversight by the franchisor, it is likely that the franchisee's complaints will not alter the original decision by the franchisor. The franchisor must retain ultimate decision-making authority over expansion, however, and cannot grant its franchisees a veto over its decision-making, particularly if the franchise agreements contain post-termination noncompetition agreements. If the franchisees (who are prohibited from operating competing outlets after expiration of their franchise terms) can decide who is permitted to operate a competing outlet, they can effectively freeze out all competition in the marketplace, giving rise to antitrust concerns.²³⁴ Alternatively, if the franchisee's contribution to the process demonstrates a material competitive impact, the franchisor may still proceed with the new outlet, but consider providing compensation to the affected franchisee.

2. Policies for Providing Compensation to Franchisees for Proposed New Outlets

In some circumstances, a simple way of avoiding potential liability for opening a new outlet is by offering the proposed location to an existing franchisee.²³⁵ If the franchisee refuses to commit to developing an outlet at the proposed location, then it likely has failed to mitigate any damages caused by development at the proposed location. While this alternative may seem appealing, it is not always a viable option. For example, in many instances, a new outlet may compete with a number of existing franchisees. By selling development rights to the new outlet to only one operator, the franchisor will not resolve the issues as to the other impacted outlets. Moreover, in many cases, the new outlet may come available at the instance of a third party that is interested in joining the franchised system. Under these circumstances, the prospective franchisee may have found the location and (1) already commenced lease

²³¹ Imposing strict time limitations is often necessary to protect the franchisor's interest in real estate selected for the newly proposed outlet. Finding and securing prime real estate locations is often extremely time sensitive, and franchisors cannot allow franchisees to hold up expansion of the system over frivolous objections.

²³² Amarante, Frith & Satterlee, *supra* note 211 at 15.

²³³ *Id.* at 16; see also *Lindquist & Craig Hotels & Resorts, Inc. v. Holiday Inns Franchising, Inc.*, (CCH) Bus. Franchise Guide ¶ 11,514 (C.D. Cal. Sept. 24, 1998) (noting that Holiday Inn uses internal committee to evaluate impact on existing franchisees following outside audit by third party).

²³⁴ *American Motor Inns, Inc. v. Holiday Inns, Inc.*, 521 F.2d 1230 (3d Cir. 1975) (holding that franchise agreement that had post term noncompetition covenant and also granted franchisees right to veto expansion with new franchised outlets violated Sherman Antitrust Act).

²³⁵ Fieldstone, *supra* note 221 at 75.

discussions/negotiations or (2) own the location. The franchisor cannot make that same opportunity available to existing franchisees.

If offering the prospective outlet to the existing franchisee is not an option, the franchisor can offer to buy back²³⁶ the franchisee's outlet if the impact exceeds a certain percentage of the franchisee's sales, or sell the franchised outlet to a third party.²³⁷ Some franchisors also offer royalty relief, or make lump sum payments to franchisees that have shown a material adverse impact to their business arising out of the development of a new outlet.

Where the parties are unable to agree on a reasonable resolution of their dispute, and the franchisor is intent upon proceeding with the new outlet, some franchise systems have specified dispute resolution mechanisms to resolve the impasse. In some agreements, franchisors mandate mediation of the dispute; others provide a forum to arbitrate the narrow issue of compensation due as a result of encroachment.²³⁸

Finally, as some commentators have noted, prudent franchisees should take steps to mitigate the impact of new competition on their business. This includes things such as evaluating potential pricing changes to take the new competition into account, working with the new operator to promote and market their shared brand in the marketplace, and carefully monitoring other competitors in the marketplace operating under different brands to see how they are adjusting to the addition of competition to the mix.²³⁹

C. Takeaways

Adopting a policy on how to address encroachment disputes requires a complex understanding of the franchisor's business, the relevant marketplace for its products and services, and its franchise system as a whole. Well-considered policies are useful in foreclosing claims for breach of the implied duty of good faith, because they show thoughtful, planned action by the franchisor to grow the franchise system. At the same time, adopting a policy for appearances, and not implementing it consistently, potentially gives rise to even more liability.²⁴⁰ But ultimately, adopting a policy is good for the health of the franchise system itself; it forces the franchisor to spend time and resources considering and thoughtfully planning out the expansion of its brand. This alone should be reason enough for franchisors to devote time to developing a policies and procedures for harmonizing franchisee business operations and ensuring streamlined business growth.

VI. ENCROACHMENT THROUGH E-COMMERCE OR THROUGH OTHER ALTERNATIVE DISTRIBUTION CHANNELS

²³⁶ Fieldstone, *supra* note 221 at 75.

²³⁷ Amarante, Frith & Satterlee, *supra* note 211 at 16.

²³⁸ Barkoff & Garner, *supra* note 60 at 45.

²³⁹ Fieldstone, *supra* note 221 at 76.

²⁴⁰ Barkoff & Garner, *supra* note 60 at 45. Indeed, in addition to liability under the duty of good faith, state laws prohibiting discrimination between franchisees could provide an additional basis for liability if a franchisor indiscriminately applies its encroachment policy.

Encroachment does not only occur when a franchisor allows another outlet in close proximity to an existing franchisee's physical outlet. There are other, more modern or alternative forms of encroachment that are occurring with increasing frequency these days. These include, first and foremost, the franchisor's marketing and selling its products or services into the franchisee's territory or market via the internet and e-commerce.

The internet has obviously made it far easier for businesses to reach consumers, and for consumers to make purchases via the click of a button while at home. The rapid expansion of e-commerce over the last several years has caused some strains on and challenges to the traditional franchise model and arrangement. This is because, more and more, and in order to be successful, franchisors need to be everywhere – for example through physical outlets, a website (or other on-line means to market and sell goods and services), social media and other forms of digital presence, and mobile apps. This phenomenon has been referred to as the "Amazon Effect," and its impact is being felt by all sorts of franchised and other businesses.²⁴¹ It generally encompasses "the ongoing evolution and disruption of the retail market, both online and in physical outlets, resulting from increased e-commerce and convergence in the marketplace."²⁴²

However, franchisor's efforts and strategies to expand their on-line presence and business can be viewed suspiciously by franchisees as an attempt by the franchisor to infringe upon their business and customers and cannibalize their revenues. Franchisors are having to deal more frequently with online encroachment issues and claims arising from the internet-based component of their businesses. Questions often arise, for example, regarding whether the franchisor or the franchisee, or both, should receive credit for and revenues from internet sales, and whether the franchise agreement limits in any way the franchisor's right and ability to do business on the internet.²⁴³

Also, franchisors now regularly address these issues by including provisions in their franchise agreement that specify what rights and restrictions the parties have when it comes to doing business on-line. Even where the franchise agreement grants an exclusive territory, frequently there will be carve-outs for on-line business engaged in by the franchisor; often, franchise agreements contain a broad reservation of rights granted to the franchisor to shrink the franchisee's exclusive rights. In the early days of e-commerce, encroachment claims would be asserted by the franchisee through use of the implied covenant of good faith and fair dealing, whereas, in recent years, and because franchise agreements often have provisions addressing on-line business and competition, courts and arbitrators will hear claims relating to the breach of such franchise agreement terms, and will have to interpret and enforce such provisions.²⁴⁴

Franchisors and franchisees can mutually benefit from the franchisor's conducting business on-line, whether it be by operating a website through which customers can, for example, order food to pick up or be delivered, through mobile apps, social media and in other ways. Many

²⁴¹ Adam Hartung, *How the 'Amazon Effect' Will Change Your Life and Investments*, FORBES (Feb. 28, 2017).

²⁴² See Dolman, Korzenowski, & Wulff, *supra* note 145 at 13.

²⁴³ *Id.* at 15.

²⁴⁴ *Id.* at 16. There is little case law on the impact that state franchise statutes have on encroachment claims arising out of product and service sales over the internet. Franchisors should carefully review the requirements of encroachment statutes before engaging in internet commerce in the few jurisdictions that have statutory encroachment protections.

franchisors require franchisees to pay a certain amount or percentage of their revenues for marketing engaged in by the franchisor, which will include on-line marketing. Also, a restaurant franchisor may steer on-line food orders, and thus business, to franchisees in the particular customer's geographic area.²⁴⁵ But, in general, the growth of e-commerce has blurred the territorial boundaries that traditionally were used to protect franchisees from intra-brand competition.²⁴⁶ Franchisors will have to continuously update and fine-tune their franchise agreements to address and be prepared for the most up to date forms of on-line marketing and commerce.

Putting aside the internet and e-commerce, there are other situations that can give rise to an encroachment claim by the franchisee, including when the franchisor establishes outlets in nontraditional, captive or seasonal locations (such as universities, military bases, workplaces and expositions), and when the franchisor distributes its products for resale to non-franchised outlets, such as department stores, grocery stores, pharmacies, convenience stores, and kiosks. Encroachment claims can also arise from cross-brand competition, such as where a single franchisor owns a number of competing brands of franchises.²⁴⁷

As with the other types of encroachment claims, the best way of minimizing the risk that there will be disputes arising from the franchisor's beginning to distribute and sell its products or services through alternative distribution channels is to include specific language in the franchise agreement detailing what the parties' rights are in such situations. For example, using broad yet more specific language when discussing what rights the franchisor has to open additional outlets and operations should help reduce the chance that encroachment-related disputes will arise. The franchise agreement can reserve to the franchisor the right to develop nontraditional markets for its goods and services, such as reserving the right to utilize all "alternate channels of distribution."²⁴⁸ Similarly, the agreement can also expressly prohibit the franchisee from also engaging in these alternative distribution channels and methods, including within the franchisee's defined territory.²⁴⁹

In some franchise agreements, a compromise approach is employed, whereby, if the franchisor engages in promoting its products and services in the franchisee's defined territory through alternative distribution channels or methods, there is some measure of profit-sharing used to help compensate the franchisee for the revenues it could or will lose due to such alternative distribution channels. This type of provision will also likely help support the franchisor's argument that the franchise agreement expressly reserves to the franchisor, and not the franchisee, the right to develop the alternative distribution channels.²⁵⁰

VII. CONCLUSION

Try as franchisors might to reduce the risk of encroachment claims by their franchisees

²⁴⁵ Coldwell, *supra* note 3 at 43.

²⁴⁶ *Id.*

²⁴⁷ *Id.* at 40.

²⁴⁸ *Id.* at 61.

²⁴⁹ *Id.*

²⁵⁰ See, e.g., Newspaper, LLC v. Party City Corp., No. 13-1735 ADM/LIB, 2013 WL 5406722, *5 - *6 (D. Minn. Sept. 25, 2013).

through the inclusion of specific provisions in the franchise agreement reserving to themselves the right to expand into the franchisee's territory (even an exclusive one) or to conduct business on-line which could have the effect of reducing the franchisee's revenues, it is inevitable that encroachment claims will continue to be brought. It will be interesting to see if the *Bryman v, El Pollo Loco* decision is the beginning of a new era of courts giving more credence to franchisee's encroachment concerns and claims or is merely a one-off detour from the pre-existing trend of courts dismissing encroachment claims based on the implied covenant of good faith and fair dealing. It will also be interesting to see if more state legislatures take steps to enact laws that protect franchisees from encroachment under certain circumstances. The starting and end point will likely be the analysis of what the franchise agreement itself provides and whether it covers the situation and issues that have arisen. This is why it is imperative for franchisors to draft their agreements with franchisees as specifically as they can and to make sure they reserve to themselves the discretion to open additional outlets and do business on-line, and for franchisors to make sure they understand what their rights and restrictions will be under the franchise agreement.

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Daniel J. Oates is a partner with the Seattle office of Miller Nash Graham & Dunn, LLP. Dan's practice is focused on franchising and distribution litigation. Dan's litigation experience includes disputes ranging from pre-sale disclosure violations and fraud, to breach of contract claims, to post-sale relationship disputes (arising under contract or by statute). Dan has served on the editorial board of the ABA's *Franchise Law Journal* since 2013, and currently serves as the Editor-in-Chief. He earned his J.D. (*summa cum laude*) from Seattle University School of Law in 2007. Dan is admitted to practice in Washington and Oregon, all of the federal district courts in these states, and the United States Court of Appeals for the Ninth Circuit.

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