How To Avoid Unlimited "Exclusive Territories" Imposed By a Court

by

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HOW TO AVOID UNLIMITED "EXCLUSIVE TERRITORIES" IMPOSED BY A COURT

One of the long-term areas of potential disagreement in franchising concerns "encroachment" or the ability of a Franchisor to place company-owned or franchised units in a market where a franchised location already exists.

Obviously, viewpoints differ as to the impact of introduction of a new unit in the general vicinity of an existing franchised unit. Franchisees, understandably focusing on the impact on their individual unit rather than on the growth of the entire system, will be concerned that the introduction of a new unit in their marketing area will reduce sales and lower profitability. Since the Franchisee is ultimately concerned with the bottom line on a unit-by-unit basis, and the Franchisor may be primarily compensated by a percentage of gross without a direct connection to per unit profitability, the Franchisee may feel that the Franchisor is enhancing its system-wide revenues at the expense of individual Franchisees who may be impacted by the introduction of new units (or alternative channels of distribution) in their marketing area. The fact that the Franchisor may also be receiving additional income, in the form of initial franchise fees from new franchise units in the area, can be an additional source of tension between the Franchisee and the Franchisor.

At the same time, the Franchisor may see legitimate benefits for the entire system from the introduction of additional units. These can include:

- Increased market share/presence for the franchise system as a whole.

- Acquisition of desirable locations for the system and exclusion of competitors from those locations.

- Improved customer awareness and other benefits (including convenience) to customers.

- Increased funds available for local and/or national co-operative advertising.

- Economies of scale with suppliers, etc.

- Leadership for the franchise system in establishing new markets and means of distribution and placing all units in a superior position with respect to competitors.

Obviously, the impact of a particular new unit or means of distribution being introduced into a market will vary on a case-by-case basis. Does the placement of a new donut and coffee franchise at the American Airlines Terminal at LAX, or inside Caesar's Palace, was what really reduced sales at a unit located on a street corner 3/4 of a mile away? Will the introduction of frozen waffles, bearing the system's trademark, in the local supermarket really impact business at the local pancake house and will the impact be positive or negative?

Putting to one side all of these real-life business variables, when

Franchisees believe that introduction of a new unit will adversely affect their profitability, they will often try to use a legal theory, known as the "covenant of good faith and fair dealing" to limit the Franchisor's ability to introduce new units, or alternative channels of distribution, into the area. In essence, this theory holds that the Franchisor may have a duty to not do any thing that would interfere with the Franchisee's ability to enjoy the benefits of the Franchise Agreement.

While most courts have rejected the application of this theory to encroachment situations, a recent Federal appeals court case arising in California (<u>In re Vylene</u>, CCH Business Franchise Guide ¶ 10,981, 1996) has held that the placement of a competing restaurant within 1.5 miles of a Franchisee's Naugles unit could have violated the covenant of good faith and fair dealing <u>even though the Franchisee did not have any rights to an exclusive territory (and had certainly not paid for one) under the Franchiser Agreement</u>. The case has at least two serious problems with it:

<u>First</u>, the court's opinion ignores a series of cases (dealing primarily with the Burger King system) that have <u>no</u>t applied the covenant of good faith and fair dealing to restrict a Franchisor's ability to place additional units in a Franchisee's market.

<u>Second</u>, the implied covenant, by its very nature, is vague and provides no meaningful guidance for business people. For example, if a Franchisee is given a one mile radius and the placement of a unit at 1.2 miles might violate the implied covenant, what about a unit at 1.5 miles, or 3 miles, etc.? What about the situation where the new unit is 1.1 miles away on the map, but the nearest route be road takes 2.5 miles due to an intervening freeway or river? Essentially, imposing this vague "good faith and fair dealing" standard leaves the Franchisee and Franchisor without any guidance as to how they are to manage their developing relationship.

Fortunately, <u>Vylene</u> and other cases like it (such as <u>Scheck v. Burger King</u>) can be relatively easily handled through intelligent drafting of the Franchise Agreement. Whether the franchise is drafted for a "spot" location (with no exclusivity within a radius) or if a radius is given, the Franchise Agreement should make it clear that the Franchisor has the <u>entirely unrestricted</u> right to place other units (or alternative channels of distribution) wherever it wishes, outside any radius granted and irrespective of the distance from any existing unit or the number of units in an area.

Although the drafting of the "Territory" clause in any Franchise Agreement is one of the more challenging and creative tasks for a franchise lawyer, and each clause must be different depending on the type of business involved and the expansion strategy of the Franchisor, it's probably safe to say that almost every Franchise Agreement should, at some point, contain a clause with wording similar to the following:

> You understand and agree that, except as expressly described above, you do not have any "exclusive territory" or any "exclusive," "protected" or

"reserved" territorial or similar rights and there is, and will be, no limitation on our rights to locate and/or consent to the location of other XYZ units or other distribution facilities of any type at any location, regardless of the distance from, impact on, or vicinity of, your XYZ unit or the number of XYZ units in an area or market.

According to our clients, language similar to the above, in conjunction with related language supporting the Franchisor's position, has not raised any significant marketing hurdles in connection with selling franchises. In addition, we've been successful in inserting language in Franchise Agreements specifically negating the implied covenant of good faith and fair dealing. All of these steps will be useful to Franchisors in avoiding results such as that in the Vylene case.

We strongly recommend that Franchisors review their current Franchise Agreements and UFOCs to verify that their existing language does not leave them exposed to having an exclusive territory imposed on them in a way inconsistent with their marketing plans and strategy for the long-term development of the system.

Mr. Holmes is the Managing Partner of Holmes & Lofstrom, LLP, a U. S. -based law firm which is a member of the International Franchise Association, and specializes in international franchising transactions, including bringing Australian-based concepts to North America. He has been involved in the legal and business aspects of franchising for nearly 30 years and can be reached at D.Holmes@HolmesLofstrom.com or in the firm's Northern California office at 805-547-0697. Firm references and biographies are available on request.