# THE NETWORK EXPANSION CONFLICT HANDBOOK
# DEVELOPING A SUCCESSFUL SOLUTION

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**JOHN E. HELLRIEGEL**
**CHIEF OPERATING OFFICER**
**HEEL-QUIK, INC.**
**MARIETTA, GEORGIA**

**LEWIS G. RUDNICK, ESQ.**
**PARTNER**
**PIPER MARBURY RUDNICK & WOLFE**
**CHICAGO, ILLINOIS**

**WILLIAM SLATER VINCENT**
**ASSISTANT PROFESSOR OF BUSINESS LAW**
**COLES COLLEGE OF BUSINESS**
**KENNESAW STATE UNIVERSITY**
**KENNESAW, GEORGIA**

**International Franchise Association**
**1350 New York Avenue, NW**
**Suite 900**
**Washington, DC 20005**

**(202) 628-8000**
**www.franchise.org**

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# FOREWORD

The authors of this book would not have been able to undertake such a project successfully if it had not been for the valuable information and insights provided by several key members of the franchise community. Therefore, we would like to, at this time, recognize the following for their invaluable assistance in this endeavor: Rupert Barkoff, senior partner, Kilpatrick Stockton LLP; Dick Holbrook, President & COO, AFC Enterprises, Inc. ; Hannibal Meyers, Vice-President, Churchs; Michael Leven, CEO & President, U.S. Franchise Systems, Inc.; John Leven, Vice-President, U.S. Franchise Systems, Inc.; Richard Rennick, CEO, American Leak Detection, Inc.; Sid Feltenstein, Chairman & CEO, Yorkshire Global Restaurants, Inc.; Raymond Margiano, CEO & President, Heel-Quik, Inc.; Leone Ackerly, CEO, Mini-Maid Services, Inc.; Steven Siegel, Dunkin' Donuts Franchisee; and George Zografos, Dunkin' Donuts Franchisee. The ability of the authors to enlist the assistance of the above people is a testament to the importance and timeliness of the topic of network expansion conflict. Last, but not least, the authors wish to thank their wives, Judy, Cookie, and Sandra, for allowing us to share our family time with the franchise community in the writing of this book.

John E. Hellriegel
Lewis G. Rudnick
William Slater Vincent

## EXECUTIVE SUMMARY

Franchise Expansion--the wave of the 21st century in the world of franchising. Every franchisor must continuously expand its chain in order to increase market share and maintain its competitiveness.

Expansion can occur in three areas:

(1) the traditional addition of new outlets--either by franchisees or the franchisor into new or existing markets;

(2) non-traditional outlets, such as on military bases, college campuses, interstate highways, or in co-branded facilities;

(3) sale of the franchisor's product or service through a different distribution system--such as the Internet.

All three forms of expansion are essential for their chains. However, franchisees within the chain, who have made large investments in their business, do not want any expansion to have an impact on their business. The franchisee recognizes that it will face competition from other chains offering the same product or service. But they are understandably concerned when the competition comes through the expansion of their own chain, expansion which can negatively impact on their business. Franchisees do not believe they should have to compete with their own network.

This conflict has created one of the hottest issues in franchising today--"ENCROACHMENT--or in legal terms--FRANCHISE NETWORK EXPANSION CONFLICT.

This *Handbook* explores the issues of Network Expansion Conflict. It suggests a blueprint for developing a network expansion conflict policy and implementing it in such a way that it is fair to both the franchise company and to its franchisees.

An Appendix follows which includes examples of such policies.

# CHAPTER 1
## <u>INTRODUCTION</u>

In 1966, "The Atlanta Journal and Constitution" reported that a Longhorn Steaks franchise in Alabama was suing its franchisor claiming that the Georgia-based franchise had encroached on its territory by opening other restaurants in the state.

The franchisee alleged it had suffered $7.5 million in damages. The owners claimed the whole state of Alabama after they opened franchises in Birmingham. Instead, Longhorn Steaks, Inc. had opened company-owned sites in southern Alabama.

The lawsuit, filed September 13, 1996, further alleged that Longhorn Steaks' Chief Executive Officer offered to buy the Alabama franchisee's operation.

The franchisor declined comment on this point, but filed as its defense that the franchisee-franchisor agreement did not prevent Longhorn Steaks from opening company-owned restaurants in Alabama. (Higginbotham, October 5, 1996).

This was one of many court proceedings that arose out of this issue, referred to in this *Handbook* as "Network Expansion Conflict", or its popular name—"Encroachment."

The authors believe that "encroachment" implies that the franchisor has breached its contract, or at least has acted in bad faith with one or more franchisees. Network Expansion Conflict more accurately describes the dynamics when a franchisor expands its network, either by adding traditional or non-traditional outlets or new distribution channels. While expansion does not necessarily imply "encroachment," it does, in some circumstances, bring the franchisor and franchisee(s) into conflict.

The Longhorn Steaks lawsuit challenged whether the franchisor had breached its agreement with the franchisee.

This *Handbook* attempts to resolve this issue in a way that preserves a healthy franchise relationship.

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Network Expansion Conflict (hereafter referred to as NEC) is a relatively modern issue that has developed between franchisor and franchisee, stemming from the continuing growth and maturity of franchise systems.

Earlier issues concerned lack of franchisor disclosure when purchasing a franchise; terminations and non-renewal of franchise relationships; inadequate communications between franchisor and franchisee; the requirement that the franchisee must purchase all or most of its products from the franchisor.

Most statutes on federal or state levels only addressed these issues when they concerned current or potential franchisees. Prior to 1980, NEC claims were virtually non-existent. They are now a relatively new phenomena in the courts (Barkoff and Garner 1994). It is only in the past decade that NEC litigation has occurred, particularly in the fast-food industry (Fox and Su 1995).

> "Many fast-food franchisees say they can't make it because their key competitor is their own product. In general, franchisors can decide how many units can be opened in any one area." [Galen March 22 1993].

> "Indeed, dissidence is spreading throughout the fast-food industry. Franchisees of both the Subway sandwich chain and Checkers Drive-in Restaurants chain recently formed independent groups to see to their interests. Such wariness isn't unexpected: As the fast-food industry matures, franchisers' efforts to keep growing often collide with entrenched operators." [Gibson April 17, 1996].

One commentator described today's multiple paths of encroachment: "…in addition to worrying about other locations edging closer geographically, franchisees have to deal with them creeping through the Internet, mail order, kiosks, airports, gas station mini-marts and grocery stores" [Chun 1996, p. 150].

To be sure, there is a heightened level of tension between the franchisor's interest in growth and the franchisee's interest in avoiding encroachment.

> "Franchisees are from Venus, franchisors are from Mars. Or is it the other way around? The differences in their perspectives are explained to some extent by their divergent economic interests. Franchisors typically earn money when overall system sales increase, while franchisees typically earn money when their franchised outlet turns a profit. Franchisors receive a lump sum franchise fee, usually, upon signing a franchise agreement for the opening of a new outlet, and then receive a percentage of that new outlet's gross revenues as an ongoing royalty fee. The more openings, and the more system sales, the more money for the franchisor. Franchisees, on the other hand, are more likely to be interested in ensuring profitable operations of their individual franchised outlets than in maximizing system wide revenues or opening new distribution points.
> There are common interests, of course. Both franchisor and franchisee share an interest in managed growth of the system. No franchisor benefits from disgruntled or bankrupt franchisees. Both share an interest in doing well against their inter-brand competitors. But when a franchise outlet generates substantial sales, the divergent interests can overcome the common ones. A franchisee may be enjoying the profits generated by a successful outlet as a just reward for work done well and a risk that paid off. A franchisor may view the same highly successful outlet as evidence that the market it serves is ripe for another outlet." [Thomson & Wolfson 1997, p.1].

Despite the lack of territorial protection in the franchise agreement, franchisees are concerned about their franchisor's market development. They are accustomed to drawing their customers from a broad base, and object to a new unit opening close enough to lure away any of their business (Spandor 1997).

Franchisees realize that outlets not franchised can expand in any targeted market without fear of litigation or concern that they are adversely affecting other similar outlets. However, if a franchisee's own network opens more outlets in a particular area or develops a new distribution channel affecting their business, NEC becomes a problem. Even if a lawsuit is not filed, human and financial resources can be expended in resolving such conflicts.

This *Handbook* will give the reader an overview of the issue of NEC covering such issues as:

- Defining "NEC".
- Economic issues of NEC (e.g., how much impact is required and for what duration for real NEC issues to exist; to what extent is economic impact offset by: (1) a stronger brand resulting from more traditional or non-traditional outlets or the opening of additional distribution channels; and/or (2) the absence of interbrand competition that would have exploited the opportunities that created the NEC).
- Reviewing legislative and regulatory approaches used to address the problem of encroachment on both the federal and state levels.
- Exploring the approach of various associations in addressing the issue.
- Analyzing various directions franchisors have gone in tackling NEC.
- And how a franchise company and its franchisees can develop and implement an NEC policy resulting in a successful solution to the problem for all parties.

## CHAPTER 2
## NEC DEFINED

NEC is a concept not easily defined. It exists in many different forms (Miller 1997). Adding to the confusion is that NEC is referred to by various other names. One well-known franchise lawyer Rupert Barkoff (Kilpatrick & Stockton LLP) has stated:

> The encroachment phenomenon is given various 'handles'.
>
> 1. Franchisors use the words 'system expansion'. For example, the recent International Franchise Association Code of Principles and Standards of Conduct uses this term. In a prior draft, the term 'encroachment' had appeared.
> 2. Franchisees use the colorful term 'cannibalization'.
> 3. While the fast food industry seems to have grown accustomed to the word encroachment, the hotel industry uses the word 'impact'.
> 4. It has been reported that the McDonald's system has coined its own term, "impaction," to describe encroachment.

As one author wrote, "At best, it is shorthand for the perceived incursion by the franchisor, either directly or through an affiliate - perhaps another franchisee - into a territory, area or zone that has been granted exclusively to the franchisee or that, although nonexclusive, should be exempt from competitive activity from the franchisor because it necessarily falls within the market area which the franchisee must develop exclusively to survive" [Fox and Su September 30, 1996].

NEC may occur in a variety of circumstances. A typical situation is when a franchisor approves a new location, either company-owned or franchised, which is close enough to an existing outlet that the new location can draw away some of the customers and business from the existing outlet. However, what is too close could be a geographic mile or several miles, depending upon the relevant marketplace (Miller 1997).

Another form of conflict can arise if a franchisee operates from a vehicle, or the principal sales activity occurs at the customer's home or place of business, or by telephone or electronic mail. In networks of this type, NEC may occur if the franchisor established too many outlets in a given market.

The ever-growing alternative channels of distribution can cause NEC when a franchisor offers its products or services at a supermarket, for example, or through mail order sales, telemarketing or the internet. In these cases, the customer can obtain the product or service without visiting the outlet which carries the franchisor's trademark.

Existing franchisees lose customers because they can obtain the identical products or services without visiting the franchisee's outlet (Barkoff and Garner Second Quarter, 1994).

It is important to note that while all types of NEC can cause loss of business to existing franchisees, they also have the potential to benefit franchisees in various other ways.

The additional outlets--traditional or non-traditional--in a franchisee's market strengthens the brand name, and may prevent expansion and development of other competition into the market.  This could very well offset any loss of customers.

A co-branding relationship developed by the franchisor might have both a positive and negative impact on an existing franchisee.

A franchisor's development of an internet marketing and sales strategy might draw business away from an existing franchisee, but at the same time strengthen its market presence and give it a revenue producing function in a new distribution channel.

**CHAPTER 3**
# DEVELOPMENT OF NEC POLICIES BY FRANCHISE COMPANIES

All franchisors want their franchise networks to grow. Expansion and market penetration is the name of the game. The problem is that franchisors and franchisees often have a different perspective of how growth should be achieved.

When growth occurs in a franchisee's market, in the form of additional outlets and/or new channels of distribution, the franchisee's focus turns to the protection of his or her business.

Franchisors seek to develop all types of growth opportunities. To address the conflict that can arise from network growth, franchisors have the option to create an NEC policy. A key issue is whether the policy can be created unilaterally, or in cooperation with its franchisees.

NEC is such a sensitive and emotional issue that unilateral action on the part of the franchisor may cause rancor, impede cooperation, and potentially poison other areas of the franchisor/franchisee relationship.

If franchising is to be a partnership, the interests of both franchisor and franchisee must be considered. Franchisees want to participate in their brand's development and share in the management of the system's growth.

The necessity for their participation should include a process whereby franchisors and franchisees work together toward the same winning goal--growth of the brand, while providing protection for franchisee investment.

The focus of this *Handbook* is on a policy developed cooperatively by franchisor and franchisees.

Development of an NEC policy is not an easy task and the process will vary from one franchise network to another. In fact, it may seem an impossible task, but franchisors have found ways to create policies and procedures that address the vast majority of NEC issues. The key ingredients of an NEC policy are fairness, timely action, participation by both parties, honesty and respect for the other party's position.

This chapter will discuss how to develop an equitable NEC policy. In the appendix, you will find examples of successful franchisor NEC policies that vary in their comprehensiveness.

## Designing an Encroachment Policy

By its very nature, NEC is an emotional issue. The goal of an NEC policy should facilitate network expansion and protect the interests of existing franchisees. It is essential that both franchisor and franchisees understand and accept that each has crucial and legitimate interests to protect in the process of developing an NEC policy and related disputes. The most successful NEC policies will be those that are developed through the cooperation of the franchisor and its franchisees, each fully understanding the interests and objectives of the other.

At the outset, franchisors and franchisees should realize that it will not be possible to craft a single formula to resolve all NEC issues. NEC resolution is a continuing process, meant to be changed if and when experience dictates. The policy should contain a menu of choices, rather than rigid procedures. It is also important that the policy be complete, easily understood, pro-active, and provide for a quick resolution of the issues. A franchisor can enhance an NEC policy by indicating to its franchisees that their concerns are being given equal priority and will be dealt with seriously.

The need and desire for a franchise network to expand and remain competitive in a changing marketplace can conflict with the concerns of existing franchisees to protect their markets and their investment. Franchisees must understand, however, that expansion is the lifeblood of a franchise network and that over the long term, it is impossible for a franchisee to be successful and enhance the value of its businesses without a successful franchisor.

Franchisors have been able to add new outlets and develop additional distribution channels without negatively impacting established franchisees.

The basis of a successful NEC policy is mutual trust and integrity, including realistic expectations of both parties. Legislation cannot solve the encroachment issue. There is no single formula that will solve all NEC problems. This is a dynamic process that needs a menu of choices rather than specific solutions. In the end, franchisees must be confident that, if the system for preventing problems fails, their franchisor will work with them to formulate appropriate remedies.

## Policy Development

The main purpose of an NEC policy is to avoid unnecessary disputes, misunderstandings and problems between franchisor and franchisee(s). The policy must then be pro-active and developed with participation by franchisees. Creating this policy may take a long time involving spirited dialogue with the goal to produce a workable policy accepted and supported by both parties. The policy must ensure that the franchise relationship is the sole winner--not the franchisor nor its franchisee(s).

The first approach should be creation of a task force, including senior company personnel and franchisees. They must develop acceptable guidelines that will anticipate and deal effectively with every type of NEC problem. The task force’s challenge is to craft a process that deals with all NEC issues based on hard facts, not emotion. To develop a working encroachment policy, both franchisor and franchisee(s) need to define and agree to the following:

1. A definition of expansion conflict, i.e., what constitutes adverse impact on an existing franchisee-operated outlet as the result of a new traditional or non-traditional outlet, or on the market served by a franchisee as a result of

exploitation of an alternative distribution channel.

2. Factors that determine if NEC will occur (applicable to both traditional and nontraditional outlet development and the utilization of new distribution channels).
3. Site development criteria used by the franchisor in the development process.
4. Early warning signs of potential NEC.
5. The procedures and actions triggered by a determination that adverse impact may occur, likely will occur and/or has occurred.
6. Avenues of relief for the franchisee, such as:

   - Review by a higher corporate level executive;
   - Review by a committee of franchisor representatives and franchisees;
   - Impact studies performed by independent specialists and the allocation of the cost thereof;
   - Prohibition of the development that would cause excessive impact;
   - Financial compensation if impact exceeds a defined threshold;
   - Internal dispute resolution procedures;
   - Third party mediation.

7. Communication and reporting procedures to franchise community.

8. Periodic re-evaluation of the policy.

To be effective, the NEC policy must consider each of the above subjects. Most important is to define the adverse impact which may or has already occurred. Such definition can then confine the issue to a specific set of guidelines, which can focus on those key issues, and hopefully set the framework for their resolution.

Allied Domeq Retailing, USA, offers this kind of definition for its Dunkin' Donuts division. Its policy clearly defines NEC for an existing location, as well as for a development territory.

### A. Site Development Criteria

The most important elements of an NEC policy are the site development process and decisions regarding alternative distribution channels. Franchisees need confidence that the criteria being used by the company to evaluate a potential location or opening up a new distribution channel will guarantee that NEC does not occur or, if it does, is satisfactorily resolved.

The franchisor should clearly state the factors that will be considered when approving new site and distribution channel development. International Dairy Queen cites the following examples of such factors:

- The desirability of maintaining a competitive environment in a particular area with other networks in the same business;
- The benefits to existing franchisees in a particular area attendant to the growth of the franchise network; and
- The possible effect, if any, that establishing the new location may have on existing franchisees in proximity to the proposed new location;

The franchisor should clearly state what factors will be taken into consideration when evaluating the potential impact of a new location. Examples of such factors are:

- Does the proposed new location or channel of distribution fall within the trading areas of one or more existing franchisees;

- How will distance between the existing and proposed locations be considered. (Distance cannot be the sole deciding factor);

- The advantages of having a same brand outlet at the new location rather than a competing brand;

- The advantage of minimizing opportunities for competitors to enter the market; and

- What other considerations will be a part of the evaluation, such as, competition, physical barriers, traffic patterns, population density, employment, recreational activity, performance of existing outlets, etc.

**B. Factors that determine if NEC exists**

Developed next are:

- The analytical tools which the franchisor must use to determine whether an NEC issue exists;
- Who will have the responsibility for the evaluation using these analytical tools;
- Whether the potentially impacted franchisee(s), or any franchisee organization (e.g., advisory council, committee established for NEC dispute resolution) has any role in the resolution of an NEC dispute;
- Whether the determination of NEC be made at one level of franchisor management or will a second level review the initial decision in specific circumstances (e.g., protest by impacted franchisee(s); existence of franchisee outlets within a specified proximity);
- Third party involvement such as an independent organization that evaluates the impact;
- What general time frames are involved in completing the evaluation; and
- Procedures for notifying the potentially affected franchisee(s) of the franchisor's decision.

### C. Early Warning Systems

There must be a clear policy for notifying franchisees who may be impacted. This should include sufficient time for the franchisees to study and respond to the situation. Communication of the franchisor's development plans and progress in each area where existing franchisees may have an interest will set a cooperative tone to the process. Notification of proposed new locations and/or new distribution channels should allow franchisees enough lead-time to present their case to the franchisor.

- The responsibilities of the franchisor and the objecting franchisee(s) should be clearly specified. Franchisee objection to a proposed new location or distribution channel should be set forth in detail.

- Define what action will be taken and the time frames for such action. For example, franchisee(s) must, within a stated time frame from notification, provide the franchisor with the factors against the proposed location or distribution channel, or the action that the franchisor should take to ameliorate the impact such as expanded advertising in the market, assistance to upgrade older facilities to better compete with new outlets, assistance to improve overall quality of operations and/or some form of compensation.

- Establish a profitable role for franchisees in the development of a new distribution channel such as a role for franchisees in internet marketing by the franchisor. The franchisor's stated time frame to study and respond to the franchisee's arguments should be clearly set forth.

### D. Avenues of relief for the franchisee

- Franchisee appeals procedure - develop a procedural framework for actions to be taken by a franchisee, if he or she disagrees with the franchisor's decision;
- Determine who will be involved in the appeals process. For example, will the franchisee advisory council or impact committee or the franchisee association participate? What are the time frames for resolution?

Options available to the franchisee that may be included:

- Request that a higher level of franchisor management review the dispute.
- At the request of the franchisee(s), an independent professional assessment of impact will be conducted, the results of which will have specific effects on the resolution of the NEC dispute.
- Request that the local or regional franchisee advisory council or committee or association review the dispute.
- Initiate internal dispute resolution process agreed to by the franchisor and franchisees (a general network-wide process or one designed for a specific area or type of NEC).

- Mediation by a neutral party, such as under the National Franchise Mediation Program.
- Submit the dispute to third party mediation format developed by the franchisor and its franchisees.
- Submit the NEC to binding or non-binding arbitration.
- Determine the allocation of costs when neutrals, mediators and/or arbitrators are used.

**E. Action plans to compensate one or more franchisees, for impact which exceeds the thresholds and responsibilities of franchisor and objecting franchisee(s)**

- Franchisor responsibilities - define the procedure for analyzing potential adverse impact. Establish who in the franchisor organization will perform the analysis and what time frames will govern the process.
- Franchisee responsibilities - provide accurate data for the period before and after new location opening. Examples of such data are: sales, product mix reports, customer counts, profit and loss statements, participation in franchisor marketing programs, etc.
- Close monitoring of situations where there has been a sales decline that may be attributable to a new outlet or channel of distribution is critical to the process. Once the alarm has sounded, the franchisor will need to react immediately to gather factual information from the impacted outlet(s).

  This information may include: sales data, product mix data, customer counts, profit and loss statements, operational standards data, franchisee participation in marketing programs, other market changes that may have impacted sales, and any other information useful in determining the extent of the impact and why.

Based on the information collected the franchisor, in consultation with the franchisee(s), can develop an action plan appropriate to the circumstances. Examples of appropriate remedies are programs to build sales, upgrade outlet operations and appearance, marketing support, debt restructuring, remodeling financing, payment modifications, realignment of territory, assistance with special development opportunities, substitute locations, fee or rent relief and financial compensation.

**F. Communication and reporting procedures to the franchise community**

Communication of the NEC process to franchisees should be smooth and concise through periodic reports of the NEC situations to franchisee leadership. Resolution of the NEC should be open for discussion through designated communication channels. Both the franchisor and franchisees should be monitoring the effectiveness of the NEC resolution as it continues.

**G. Periodic re-evaluation of the Policy**

Enhancements and refinements to the NEC review process should be made if and when modification is deemed necessary, either from the viewpoint of the franchisor or franchisee. As noted previously, an NEC policy is a continuous process. There are no pat answers for every possible situation. Policies may have to change as conditions change.

### H. E-Commerce

It is becoming increasingly common to do business over the internet. An ever increasing number of companies are selling their goods and services from a website. Many franchisors likewise have developed web sites through which they take orders for the goods and services identical to those offered by their franchisees. It may be essential for a franchisor to develop an e-commerce presence. If the franchisor does not develop such a presence, its competitors who do may take business away from both the franchisor and its franchisees. However, internet sales can be seen by franchisees as encroaching on their exclusive territory or natural market.

Franchisors need to develop internet capability for reasons other than business to consumer sales of goods or services (so called B2C commerce). For example, a franchise network can effectively use, and may be at a disadvantage without, an intranet or extranet for rapid real time, communication with and among the franchisor, franchisees and suppliers.

Franchisors increasingly use the internet for recruiting franchisees and employees and for buying the goods and services they need (so called B2B commerce). A well designed web site can be an effective advertising medium for an entire franchise network, promoting the network's brand and the franchisees (with each franchisee having its own web page).

However, it is sales to consumers, B2C commerce, that provokes NEC issues. If the franchisor does not develop a strong on-line presence, it is at a potentially significant disadvantage to its competitors who do. Therefore, in developing a NEC plan e-commerce must be considered.

The potential problem with B2C commerce conducted by a franchisor is that it has the potential to take sales away from the brick and mortar locations. Therefore, in the development of policy concerning B2C commerce, a formula must be developed by the franchisor and its franchisees that, in an equitable fashion, allocates the functions, costs, and revenues from internet sales among the franchisor and its franchisees.

In its most basic form, the selling of goods and services over the internet is nothing more than another channel of distribution. In most franchise networks that have addressed this issue, there has been agreement between the franchisor and its franchisees that both sides must work together for the common good, because e-commerce is here to stay. Therefore, in developing an NEC policy, as it concerns e-commerce, it is important that franchisees do not see the internet as competition but as an economic benefit.

Several franchisors have already addressed this issue with their franchisees.

One such franchise system is GNC (General Nutrition Center). After much consultation with their franchisee advisory council, they have decided to pay the franchisees a percentage of any sales done over the internet. As a result, GNC determined what the percentage would be and how it would be allocated among its franchisees. But the bottom line is that both the franchisor and its franchisees will benefit directly from internet sales.

## CHAPTER 4
## OTHER APPROACHES TO NEC

### A. LEGISLATIVE

At the present time, there is no federal legislation directly addressing encroachment. However, it hasn't been due to a lack of effort on the part of various Congressmen to pass such legislation. If any of these bills had been enacted into law, they would have overridden the franchise agreement as it concerned territorial matters. The biggest problem with this approach is that the same standard must be applied to all franchise systems. It is well known that what works for one franchise system in a particular industry will not work for another franchise system in another industry. This approach would result in chaos.

Even though many states have enacted laws that regulate franchising either directly or indirectly, only seven states have enacted provisions that arguably or specifically deal with NEC. Hawaii, [HAW. REV. STAT. § 482E-6(1)d(2)(E); SEE ALSO BUS. FRANCHISE GUIDE (CCH) ¶ 4110], Indiana, [IND. CODE.§ 23-2-2.7-1; SEE ALSO BUS. FRANCHISE GUIDE (CCH) ¶ 4140], Minnesota, [MINN. RULES. § 2860.4400; SEE ALSO BUS. FRANCHISE GUIDE (CCH) ¶ 4230], and Washington, [WASH. REV. CODE §19.100.180; SEE ALSO BUS. FRANCHISE GUIDE (CCH) ¶4470], have laws which bar a franchisor from encroaching on a franchisee's exclusive territory, whether by appointment of a new franchisee or by the location of a franchisor-owned outlet within the exclusive territory of an existing franchisee.

These laws add a statutory cause of action to the breach of contract claim that the franchisee would have if a franchisor violated these prohibitions.

Indiana's statute further states that the franchisor cannot compete unfairly with the franchisee within a reasonable area even if the franchise agreement contains no exclusive territory.

Wisconsin's Fair Dealership Law does not discuss an exclusive territory but has a prohibition on "changes in competitive circumstances" [WISCONSIN STATUTES, 1993-94, CHAPTER 135, SECTIONS 135.01 THROUGH 135.07; SEE ALSO BUS. FRANCHISE GUIDE (CCH) ¶ 4490]. Florida's, [FLORIDA STATUTES, 1993, CHAPTER 817, SECTION 817.416(2)(a); SEE ALSO BUS. FRANCHISE GUIDE (CCH) ¶ 3090], franchise law takes the approach of making it unlawful to intentionally misrepresent or fail to disclose efforts to establish more franchises than is reasonable to expect the market area to sustain.

Iowa, [IOWA CODE ANN. § 523 H.6 (WEST 1996) (Title XX); SEE ALSO BUS. FRANCHISE GUIDE (CCH) ¶ 4150], has a very comprehensive statute dealing with encroachment which gives a cause of action to the existing franchisee if the franchisor or another franchisee opens a new outlet or location. Originally, the statute allowed the franchisee to sue the franchisor if the franchisor opened a new outlet or location if such outlet or location wasn't first offered to the existing franchisee or if it adversely impacted the gross sales of the existing franchisee by 5 percent or more during its first 12 months of operation. However, due to the unanticipated impact this language had on franchisors continuing to open new outlets or locations in Iowa, this provision has since been substantially watered down.

The new provisions concerning encroachment are the result of two amendments to the original Iowa statute, which was so restrictive and unworkable that franchisors were convinced that Iowa was not a franchising friendly state. The result: many franchisors declined to offer franchises in Iowa (except, in some cases, pursuant to prior commitments) from 1992 to 2000.

The experience with attempts to resolve NEC by legislation has demonstrated the futility of designing reasonable standards for a business relationship used in 75 different business segments and which can effectively incorporate in a regulatory formula the numerous factors that are relevant to properly resolving an NEC dispute.

### B. DISCLOSURE

NEC is addressed in the Federal Trade Commission's "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" rule, in state franchise disclosure statutes, and the Uniform Franchise Offering Circular Guidelines. Each of these sources require a franchisor to describe the territorial rights to be granted to a franchisee and any limitations or exceptions to such rights. With respect to territorial rights granted to a franchisee, the Uniform Franchise Offering Circular Guidelines require the franchisor to disclose (1) whether it has established or may establish another franchisee who may also use the franchisor's trademark; (2) whether it has established or may establish a company-owned outlet, or other channels of distribution selling or leasing similar products or services under a different trademark; (3) whether it or its affiliate has established or may establish other franchises or company-owned outlets or another channel of distribution selling or leasing similar products or services under a different trademark; and (4) whether continuation of the franchisee's territorial exclusivity depends on achievement of a certain sales volume, market penetration or other contingency and under what circumstances the franchisee's territory may be altered [16 C.F.R. § 436.1 et seq; SEE ALSO BUS. FRANCHISE GUIDE (CCH), EXTRA EDITION, NUMBER 161, May 25, 1993, pp.53-55].

### C. ASSOCIATION APPROACHES

Various associations in the franchising community have in recent years set forth standards to address encroachment. The first such association to do so was the International Society of Hospitality Consultants ("ISHC") which developed *Model Concepts For The Impact Studies* ("Concept") for the hotel/motel industry. The hotel/motel industry has had to deal with encroachment issues for a number of years, giving lodging franchisors more experience than most franchisors in resolving this issue [Coldwell 1996].

The *Concept* established that even though it is the sole decision of the franchisor to license a new location, if it might affect an existing franchisee, a panel will be created to determine what impact, if any, the new location would have on the existing franchisee. Once the impact on the existing franchisee is determined, the franchisor would offer the franchisee: (1) the opportunity to establish a facility at the new location, or (2) remuneration in an amount based on the impact on the existing franchised facility

[Coldwell 1996].

### D. International Franchise Association Ombudsman Program

The IFA and Self-Regulation -- The IFA Board of Directors, after two years of in-depth examination of ways in which to improve and strengthen the IFA Code of Principles and Standards of Conduct, has adopted a comprehensive self-regulation program. The key components of the IFA's Self-Regulation program are:

- A Code of Ethics that is stronger and more clearly stated;
- An Investor Awareness and Education Program;
- A Franchise Compliance Education and Training Program;
- A Code Enforcement Mechanism;
- A Reward and Recognition Program; and
- An Ombudsman Program.

**The Purpose of the IFA Ombudsman Program is to:**

- Enable franchisors and franchisees to identify disputes early and to assist them in taking preventative measures;
- Assist franchisors and franchisees by acilitating dispute resolution and recommending non-legal methods an approaches to resolving disputes;
- Encourage franchisors and franchisees to work together to resolve disputes;
- Provide confidentiality throughout the process;
- Provide objective and unbiased advice and guidance to all of the participants.

**Benefits to IFA Members**

The IFA Ombudsman program will provide benefits to both franchisees and franchisors.

Franchisees gain a low cost method (in fact there is no cost for the initial conversation with the ombudsman) – and a resource to resolve disputes peacefully. It enables them to clarify issues about their relationship with their franchisor and enhance a sense of fairness in the franchise relationship.

Franchisors also gain a low cost method to assist them in resolving disputes with their franchisees. For many franchise systems a resolution process may not exist within their systems because of the financial and human resources necessary to create an internal program.

Both the franchisor and franchisee benefit from the opportunity to reduce and resolve issues before they become major disputes that could result in litigation or other disruptive activities.

The IFA and the entire franchising community benefit from the Ombudsman's contribution to IFA's self-regulation commitment.

For additional information, please contact the IFA at (202) 628-8000 or visit their web site at www.franchise.org (See Appendix D).

## E. NATIONAL FRANCHISE MEDIATION PROGRAM ("NFMP")

Another step in the right direction is the National Franchise Mediation Program which is a voluntary and informal process by which franchisors and franchisees can resolve their disputes through mediation. This program is administered by the Center for Public Resources Institute for Dispute Resolution ("CPR"). CPR is a non-profit organization that specializes in alternatives to the high costs of litigation. So far the mediation success rate is almost 90%.

To initiate the process, a Dispute Letter is delivered by the franchisee or the franchisor to the other party and CPR. First, the parties must try to resolve their dispute through direct negotiation. If the dispute has not been successfully resolved within twenty (20) business days following receipt by the CPR of the Dispute Letter, then the CPR will select mediator candidates.

The selected mediator, agreed to by the franchisee and franchisor, assists the parties in negotiating solutions. However, the mediator has no power to impose a solution on the parties. Of the approximately 150 franchise disputes that have been formally submitted to the NFMP process, almost 90 percent have been resolved amicably. This figure does not include those disputes that were amicably resolved prior to formal mediation through direct negotiation. [*Franchise Opportunities Guide* Fall/Winter 1997 Edition, p. 242] and [CPR Web Home Page January 3, 2001].

## F. FRANCHISOR APPROACHES

Franchisors have taken various approaches in addressing the issue of exclusive franchise territories. Reviewing Item 12 of a sample of UFOCs shows a variety of different approaches to the respective territorial rights of the franchisor and franchisee [Coldwell 1996].

These approaches go from granting a franchisee the right to operate only at a particular location, to granting an exclusive territory to the franchisee whereby the franchisor is not allowed to open either a franchised outlet or a company outlet within the boundaries of the "exclusive" territory.

Usually the franchisor will reserve the right to operate through other channels of distribution, though some allow the franchisee some of the revenue from such sales. Coldwell did not find any specific policies or procedures for resolving NEC disputes explicitly incorporated into franchise agreements or described in UFOC's of those franchisors he reviewed [Coldwell 1996]. As expected, the language concerning the territorial rights granted to the franchisee in the franchise agreement followed Item 12 of the franchisors' UFOC [Coldwell 1996].

Because of an early judicial decision, many franchise agreements now clearly specify the franchisor's right to establish additional outlets anywhere it chooses, as well as to distribute its products using different types of outlets, channels of distribution and competing brands. To accomplish this, franchisors alternate between using very broad language and being painstakingly specific [Coldwell 1996].

Franchisors are developing policies and procedures by which to resolve NEC in the best interests of both the franchisee and the franchisor. One of the best examples is the Burger King "Procedures For Resolving Development Disputes." Burger King was a pioneer in developing a comprehensive written procedure to resolve NEC disputes in the best interests of both parties. The Burger King plan has also been incorporated into the network's franchise agreement [Barkoff and Giresi 1996].

This formal procedure grants Burger King Corporation the authority to approve the location of new outlets. However, if there is an unreasonable negative impact on existing outlets, the Burger King Corporation will compensate the adversely affected franchisee on a formula basis [Barkoff and Giresi 1996].

As a result, instead of the franchisee having to go to court and prove that the franchisor cannot legally impact an existing outlet, which has been violated, all the franchisee now must prove is that there is an actual adverse impact on his franchised outlet; that the new outlet caused the adverse impact; and that the level of impact was unreasonable under the circumstances.

Burger King must notify each "Potentially Affected Franchisee" of a proposed new outlet. If the franchisee files an objection to a proposed outlet, the franchisee and Burger King must submit to mandatory mediation. If the mandatory mediation fails, the franchisee has the right either to litigate or go to binding arbitration.

Burger King Corporation and its franchisees realized they shared the common goal of maximizing the market potential of its brand by developing new outlets as quickly as possible in order to secure the best locations. This procedure could not have been developed through the courts or legislated on a federal or state level since it is unique to the Burger King system. As a result, the focus of attention is on determining the extent of damages, rather than the legal duties of the parties.

# CHAPTER 5
# CONCLUSION

As new distribution channels, such as the internet, open up to more and more franchise networks, the problems of NEC will certainly increase (Barkoff & Garner 1993).

Franchise networks must grow to remain competitive. Increases in brand name awareness comes from expanding market coverage, which then has positive effects on both the franchisor and its existing franchisees (Kaufmann 1997). At the same time, franchisees are determined to protect their investments, not having their financial stability and profits negatively impacted by their own franchisor.

The real issues then are how these decisions on expansion are made; how they should be made; how the costs of expansion should be borne, and how the benefits of such expansion should be shared (Coldwell 1996).

Experience has shown that issues of NEC cannot be resolved in the courtroom or through legislative or regulatory means. NEC issues in franchises vary considerably industry to industry. Standards set by either legislature or regulatory agencies that work well for some franchise networks could have devastating effects on others. Moreover, since courts must apply laws that vary from state to state to determine their decisions, it is most improbable that a coherent and consistent national standard can be developed.

It is incumbent for each franchisor, with input and participation from its franchisees, to establish a system of addressing NEC issues, and to develop policies and procedures that would be most effective for its network. These policies should adequately address the objectives and needs of both the franchisor and franchisees, creating a win-win situation.

A franchise network that develops an effective NEC policy is more likely to maintain a positive franchise relationship. When the franchisor and franchisee(s) work together to expand the chain, “spreading the costs” if any existing franchisee is adversely affected, the entire chain will be better situated to expand. Prospective franchisees will receive favorable comments from existing franchisees, and the entire network will move towards its common goals and objectives.

Conversely, franchisors that seed to expand without any concern for the impact on their existing franchisees; that insist on their contractual rights to expand wherever and however they want, and who allow their franchisees no input into the expansion process are likely to suffer from poor franchise relationships. Their network’s growth will become more difficult.

Few franchisors would adopt this approach today. Each franchise network, if it wishes and hopes to grow and mature, must develop a workable, continuing solution to NEC.

A critical challenge exists today and into the 21st century. Franchisors must continue to find and utilize ways to mature and grow, while limiting and controlling any conflicts that might arise with their franchisees through expansion.

Franchisors able to find an equitable balance, through NEC policies, between the competing interests of their franchisees and themselves will continue to prosper. Those who do not are likely to encounter more and more difficulties along the way!