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STOP INVADING MY SPACE: Encroachment Issues in Franchising

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1. Introduction and history of encroachment

Given the prevalence of disputes and litigation related to encroachment issues over the last four decades¹, it is hard to believe there was a time when federal courts held that a franchisor's attempts to provide its franchisees with exclusive territories were *per se* violations of the Sherman Act.² But they were.

It actually wasn't until 1977 when the United States Supreme Court in *Continental T.V. Inc. v. GTE Sylvania, Inc.*, held that vertical territorial restrictions no longer were *per se* violations of the Sherman Act, that encroachment claims became a viable cause of action under contract law principles.³ Not surprisingly, in the years immediately following the *GTE Sylvania* decision, there remained widespread uncertainty among practitioners regarding the legality and enforceability of exclusive territories granted to franchisees. It was not until 1984 when the United States Supreme Court expressly endorsed the lawfulness of vertical territorial restraints that encroachment claims became a staple of every franchise lawyer's practice.⁴

Since that time, franchise lawyers have worked with their clients to balance the needs of the franchisor to expand their businesses with the expectations of their franchisees to avoid intra-brand competition.

The early years of these disputes generally concerned what we now refer to as "brick-and-mortar" encroachment. The most typical type of brick-and-mortar encroachment, of course, is geographical. This type of encroachment occurs when a competing franchise or corporate-owned location operating under the same brand opens in or around an existing franchisee's geographic location.

The second most common type of brick-and-mortar encroachment is product or service encroachment. This type of encroachment occurs when a franchisor offers, through alternative methods of distribution, similar products or services under the brand to customers within the exclusive territory or geographic area of an existing franchisee's location. For example, a pizza

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¹ See generally *Bryman, et al. v. El Pollo Loco, Inc.*, Case No. MC026045 (Superior Ct. Ca. [L.A] March 14, 2017)

² See, e.g., *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967).

³ 433 U.S. 36 (1977) [*GTE Sylvania*].

⁴ *Jefferson Parish Hospital District No. 2 v. Hyde*, 466 U.S. 2 (1984).

delivery franchisor may effectively compete with its brick-and-mortar franchisees by selling the same branded frozen pizzas at grocery stores within the franchisee's exclusive territory or from locations in close proximity to the franchisee's actual location.

The final form of the brick-and-mortar encroachment is brand expansion encroachment. This type of encroachment occurs when a brand owner uses that brand to sell products or services different than the products or services for which the franchisee is licensed to use the brand. For example, this type of encroachment might occur when a franchisor that has licensed a franchisee to use the franchisor's trademark to open and operate a retail sunglasses shop, subsequently licenses another licensee to use the same trademark for eyeglasses repair shops. Although the sunglass shops may not directly compete with the eyeglass repair shops, both businesses are trading on the strength and recognition of the same brand, and they might still compete on ancillary products such as new lenses, cleaning cloths, and eyeglass cases. Moreover, if one of the businesses fails to meet customer expectations, the other business might suffer lost business because customers are likely to associate the two businesses.

Two major trends in franchising over the last 20 years have broadened the scope of potential encroachment concerns beyond mere geographical intrusion. The first is the development and commercial acceptance of marketing and sales through the internet. The second is the increased prevalence of multiple competitive brands managed and franchised by a single enterprise.

This paper will address the myriad of legal and business issues associated with the three increasingly common types of encroachment issues facing franchise counsel in 2018: brick-and-mortar encroachment, e-commerce encroachment, and cross-brand competition.

Before addressing these particulars, however, this paper will discuss the very foundation of encroachment claims, which is the formation, basis and scope of a franchisee's right to preclude the franchisor from subjecting the franchisee to competition, whether intra-brand or cross-brand.

2. Methods of creating exclusive territories

a. Contractual provisions

Many franchisors choose to grant their franchisees exclusive territorial rights, particularly in start-up contexts, or in new territories for established brands.⁵ The rationale is that a franchisor needs to give franchisees some protection from

⁵ See J. Dady and M. Giresi, *Encroachment: A Matter of Good Faith*, 1995 ABA Annual Forum on Franchising, Page 2, intro.

intra-brand competition in order to improve the value-proposition to the franchisee. The drawback for the franchisor, of course, is that the franchisor no longer will be able to sell additional franchises in certain areas, thus granting franchisees some exclusive rights to develop the business and brand in the new marketplaces.⁶

Franchisors that may try and protect their perceived unfettered right to place franchises in any location will increasingly have to take into account the impact on existing franchisees before expanding into areas that a court or arbitrator may perceive to be unfair to those franchisees.

To this end, many franchisors expressly state within their franchise agreements that they are granting the franchisee no exclusive territory or market area, and that the franchisee is receiving the right to operate its franchise only from a specific location.⁷ As will be addressed later in this paper, such provisions will not necessarily guarantee that the franchisor can place competing locations in close proximity to franchisees that have agreed to such provisions.

Franchisors often also include provisions in franchise agreements obligating a franchisee to market within a specific territory, with the caveat that such a marketing territory, delivery area, or advertising area is non-exclusive. In these cases, franchisors may also include a provision requiring the licensee to acknowledge that the license is “non-exclusive”. However, as will be addressed later in this paper, the phrase “non-exclusive” will not necessarily convince a court or arbitrator that such non-exclusivity grants the franchisor absolute discretion to place competing franchises in close proximity to the existing franchisee.

Franchisors most commonly create exclusive territories by designating a specific radius of exclusivity around the franchisee’s location. Such provisions, however, can create ambiguities, and are not as certain as provisions that more precisely describe the exclusive territories, such as those that use streets or zip codes (or postal codes) to create boundaries. Some franchisors will define their territories by using city limits or county lines. In doing so, however, franchisors must be careful, because governmental entities can change those boundaries. Accordingly, franchisors should consider stating that the boundaries for such exclusive territories are the city lines or county boundaries that exist as of the date of the agreement.

In addition to establishing whether a franchisee will receive an exclusive territory and the boundaries of that territory, franchisors will also often narrow the scope of protections provided within that so-called “exclusive” territory. For example, franchisors sometimes reserve the right to sell the very same products or services the franchisee sells through alternative distribution channels, such as the internet, smartphone applications, telephone or mail. Franchisors will often also

⁶ *Id.*

⁷ See, e.g., *Scheck v. Burger King Corp.*, 756 F.Supp.543, 549 (S.D. Fla. 1991); *Barnes v. Burger Corp.*, 932 F.Supp. 1420, 1436 (S.D. Fla. 1996).

reserve for themselves the right to develop non-traditional locations within the franchisee's "exclusive" territory,⁸ to develop or acquire competing concepts under different trademarks, to use the licensed trademarks for non-competitive concepts, and even the right to later restrict the franchisee's exclusive territory if the population within that exclusive territory increases beyond a certain number of persons.

Ultimately, many franchise agreements that appear to provide franchisees with so-called "exclusive" territories fail to provide the franchisee with much exclusivity at all. Likewise, franchise agreements that appear to provide the franchisee with no exclusivity often fail to provide the franchisor with the unfettered right to develop additional locations that the franchisor may have thought it had secured.

The recent ruling in *Bryman, et al. v. El Pollo Loco, Inc.* has, at least for now, breathed some new life into the old ghosts of *Scheck* and *Vylene*. Franchisors who want to ensure the broadest rights to develop stores will have to seriously consider whether granting franchisees exclusivity might provide the franchisor with more defensible rights to develop additional locations as compared to expressly providing the franchisee with no exclusive territory or failing to address the territorial question all together.

b. Statutorily created exclusive territories

Franchise statutes in Iowa, Indiana, and Hawaii expressly provide franchisees with certain statutory territorial protections. Section 523H.6 of the Iowa Code expressly provides franchisees with a cause of action against their franchisors for monetary damages if the franchisor develops or grants another franchisee the rights to develop a new location that "has an adverse effect on the gross sales of the existing franchisee's outlet or location." This is subject to certain enumerated exceptions, including where (1) the franchisor has offered the new location to the existing franchisee; (2) the franchisee is not eligible for an additional franchise; or (3) the franchisor has a legitimate encroachment policy.

The Indiana Franchise Act also restricts franchisor competition with Indiana franchises within a "reasonable area" around each franchise, in the event the franchise agreement does not provide the franchisee with an exclusive territory, or within the exclusive territory if one is granted.

Hawaii provides a statutory remedy for franchisees in the event that a franchisor encroaches upon a franchisee's "exclusive territory" provided under the franchise agreement. The statute deems it a deceptive and unfair trade practice

⁸ See Charles Modell, DRAFTING EXCLUSIVE TERRITORY PROVISIONS IN FRANCHISE AGREEMENTS, https://www.americanbar.org/newsletter/publications/gp_solo_magazine_home/gp_solo_magazine_index/modell.html (last visited Jan. 18, 2018).

for a franchisor to create a similar business within a contractually defined exclusive territory of an existing franchisee.⁹ Unlike the statutes in Iowa and Indiana, the Hawaii statute does not create an extra-contractual territorial right for franchisees. Rather, it provides another cause of action for the franchisee if the franchisor has encroached upon the franchisee's territory.

Although the Wisconsin Fair Dealership Law doesn't directly address territorial protection, it prohibits a franchisor or manufacturer from taking any actions that "substantially change the competitive circumstances of a dealership agreement without good cause."¹⁰ This provision, like many similar provisions in dealer statutes across the country, has been the subject of much litigation. Courts have been split on the issue of whether the phrase "substantial change of competitive circumstances" precludes a manufacturer or dealer from changing factual competitive circumstances by placing a competitor near the existing franchisee or dealer, even if there is no exclusive territory. Some courts interpreting similar statutes in other states have held that "competitive circumstances" relate only to the actual circumstances in which the franchisor or manufacturer has allowed the franchisee or dealer to operate, in which case the franchisee or dealer is likely to prevail. Meanwhile, other courts have held that the franchise agreement establishes the "competitive circumstances," and thus, if the applicable agreement provides the franchisee or dealer with no exclusive territory, the franchisor or manufacturer can authorize a new location without violating the statute.

State legislatures also have enacted statutes other than those that regulate the franchise relationship that may provide a franchisee a cause of action for encroachment even if the applicable franchise agreement provides no territorial protection. For example, all 50 states have passed deceptive and unfair trade practices acts to protect consumers from deceptive trade practices, as well as certain offensive conduct occurring in the practice of trade or commerce. Various states, such as New Jersey, have held that franchisees are "consumers" under these statutes in the context of the franchise sales process.¹¹ Other states explicitly state in their deceptive trade practices statutes that violations of Federal Trade Commission (FTC) regulations (such as the Amended FTC Franchise Rule) constitute *prima facie* violations of the state statute. Legislatures have enacted these "Little FTC Acts" to protect consumers, and to help fill the void created by Congress' failure to create a federal private cause of action for FTC violations.¹² In these cases, the threshold issue is whether that state's definition of consumer can include a person or corporate entity acquiring a franchise.

⁹ Haw. Rev. Stat. Ann. § 482E-6, subd. 2(E) (2017).

¹⁰ Wis. Stat. § 135.03 (2017).

¹¹ See, e.g., *Kavky v. Herbalife Int'l of Am.*, 820 A.2d 677 (N.J. Ct. App. 2003) (Holding that franchisees may bring suit as consumers under New Jersey's Little FTC Act, N.J. Stat. Ann. § 56:8-10, *et seq.*).

¹² Whereas the FTC Act, a result of an independent agency (the FTC), has an independent right to enforce such act. See <https://www.federalreserve.gov/boarddocs/supmanual/cch/ftca.pdf>.

Courts in some states that have extended their deceptive trade practices statutes to franchisees have found that franchisors who pit franchisees against each other implicate the “broad ethical and equitable concerns” of the state’s deceptive trade practices act.¹³ Courts in other states, however, have not recognized purchasers of franchises as consumers and have dismissed such causes of action.¹⁴

When a franchisor grants a franchisee an exclusive license to use the franchisor’s trademarks or other intellectual property, statutes regulating trademarks and unfair competition also can provide franchisees with territorial protection. If the franchisor, or another franchisee, uses the trademark of other intellectual property in that exclusive area, then the license holder can effectively argue that the use by others of that mark or intellectual property constitutes infringement or unfair competition.

3. Brick and mortar encroachment

a. What is the source of exclusivity?

The first step in analyzing whether a franchisee has a valid claim for encroachment is to determine whether the applicable franchise agreement or statute (either a franchise statute or Little FTC Act) provides the franchisee with express territorial protection. If it does, then franchise counsel can assert either a breach of contract or a statutory violation claim.

If the franchise agreement clearly defines the rights and protections of the parties with regard to the development of additional locations in the franchisee’s surrounding area, the franchise lawyer must next determine the extent to which the franchise agreement or applicable statute protects the franchisee’s territory. For example, does the franchise agreement or statute provide the franchisor free reign to place competing locations just outside the clearly defined territory, or are the franchise agreement or applicable statute silent on this issue? Does either the franchise agreement or statute always preclude the franchisor from placing competing locations within the clearly defined territory, or are there pre-conditions that allow the franchisor to do so?

b. The covenant of good faith and fair dealing

Although evaluations of a contractual or statutory exclusive territory are fairly straight forward, they are not the end of the exercise. Just as in the cases where a franchise agreement either does not address a franchisee’s territory (likely a rare occurrence in most franchise agreements drafted in the last 30 years), or expressly states that the franchisee has no exclusive territorial protection, all such situations still obligate the franchise lawyer to examine the implied covenant of

¹³ *Hanson Hams, Inc. v. HBH Franchise Co., LLC*, No. 03-61198-CIV, 2003 WL 22768687, at *2–3 (S.D. Fla. Nov. 7, 2003)

¹⁴ For example, Connecticut and Massachusetts.

good faith and fair dealing. If there is one thing that franchise lawyers have learned over the years, it's that compelling facts can provide a franchisee with territorial protections that neither the franchise agreement nor the statute expressly stipulate.

Nearly every state in the United States implies into every contract the covenant of good faith and fair dealing. Generally speaking, this covenant implies into every contract (including, of course, franchise agreements) the duty of both parties to treat each other honestly, fairly and in a commercially reasonable manner so that both parties can enjoy the reasonable benefits of the bargain. Most courts have held that this covenant does not override unambiguous provisions, but that the covenant can provide clarification for ambiguous provisions or other areas of the relationship not clearly addressed by the written agreement.

The implied covenant, obviously, can play a greater role when franchisors either fail to unambiguously address the territorial expectations of the parties, or leave certain aspects of the territorial expectations of the parties out of the agreement altogether. One example is the ability of the franchisor to develop new locations just outside the franchisee's clearly defined exclusive territory that will severely damage an existing franchisee's ability to enjoy the benefits of the bargain the franchisee made with the franchisor.

When faced with a claim for violation of the covenant of good faith and fair dealing, courts tend to consider whether the franchisor's development of the new location fits within the franchisor's development policy and other similar factors. If the franchisor's proposed new location is contrary to the franchisor's stated development policies, for example, courts may find that the franchisor's placement of the encroaching location was in bad faith. Franchisors can defend against such claims by providing evidence of impact studies that conclude that the market area at issue can easily support an additional franchise-branded unit, or that the roadways to the existing and proposed units diverge in a way that makes competition for the same customers unlikely or less impactful on the existing franchisee.

Furthermore, absent an express contractual provision granting the franchisee rights to an exclusive location, courts and arbitrators may also consider whether the covenant of good faith and fair dealing implies territorial protection. Factors that courts and arbitrators will often look to include whether the franchise agreement restricts the franchisee's ability to advertise outside a certain area or obligates the franchisee to service a certain coverage area. Barring unambiguous contractual language to the contrary, such provisions can provide a franchisee with a basis for arguing that it reasonably believed the franchise agreement provided the franchisee with territorial protection consistent with its advertising or service areas.

Perhaps the most famous (or, depending on your client's point of view, infamous) case demonstrating the impact of the implied covenant of good faith and fair dealing on encroachment was *Scheck v. Burger King Corp.* In that case, the

court held that a franchise agreement that explicitly stated the franchisee had no exclusive territory or territorial rights did not, in turn, give the franchisor the right to open additional locations wherever it pleased, as the franchise agreement did not expressly provide the franchisor with that right.¹⁵ The court held that because the franchise agreement did not address the franchisor's right to develop additional locations, the court could fairly apply the covenant of good faith and fair dealing without overriding the express language of the contract. In other words, even though the franchise agreement provided the franchisee with no exclusive territory, it also did not state that the franchisor had the unfettered right to place competing franchises in locations that would severely damage the existing franchisee's right to enjoy the benefits of its bargain with the franchisor. The court ultimately agreed that although the franchise agreement did not expressly grant the franchisee an exclusive territory, it was reasonable for the franchisee to expect the franchisor would not act to defeat the franchisee's right to enjoy the benefits of its bargain under the franchise agreement.

Likewise in *In re Vylene Enterprises, Inc.*, a court concluded that even though the franchise agreement did not provide the franchisee with an exclusive territory, the implied covenant of good faith and fair dealing prevented the franchisor from building a competing location within a mile-and-a-half from the franchisee's restaurant.¹⁶ Of course the franchisee in *Vylene* presented the court with some facts regarding bad-faith motivations of the franchisor to intentionally force the franchisee out of business.

The impact of cases such as *Scheck* and *Vylene*, however, was short lived as courts later found such reasoning unpersuasive where the franchise agreements expressly stated that a franchisee had no (or a very limited) exclusive territory.

Franchise lawyers who considered *Scheck* and *Vylene* obsolete received a bit of a shock when a California court in *Bryman v. El Pollo Loco, Inc.* concluded on March 30, 2017 that a reservation of rights in the franchise agreement expressly authorizing the franchisor to put a competing franchise wherever it wanted was unconscionable because it would permit the franchisor to "cannibalize" the business of the franchisee. The court also denied the franchisor's motion to dismiss the franchisee's claim that the franchisor's placement of two competing locations 2.5 miles and 4.2 miles away from the franchisee's location violated the covenant of good faith and fair dealing.

Armed with these rulings, the franchisee won a jury verdict on December 18, 2017 against the franchisor for violating the covenant of good faith and fair dealing, not only for the franchisor developing the two company-owned stores in close proximity to the franchisee's location, but also for the franchisor's failure to grant the franchisee the right to open one of the encroaching stores. The jury

¹⁵ *Scheck v. Burger King Corp.*, 798 F.Supp. 692 (S.D. Fla. 1992).

¹⁶ *In re Vylene Enterprises, Inc.*, 90 F.3d 1472 (9th Cir. 1996).

granted the franchisee damages for the lost sales due to the impact of the two encroaching stores, and the net income the franchisee would have generated from the store for which the franchisor should have given the franchisee the right to open.

The moral of this story is simply that at least some courts will not allow franchisors to develop franchised or company-owned stores in close proximity to franchisee locations regardless (and perhaps even because of) contractual provisions that appear unconscionable or unfair on their face.

c. Change in competitive circumstances

As mentioned above, the Wisconsin Fair Dealership Law, and many dealer protection statutes across the country, preclude franchisors or manufacturers from “substantially changing the competitive circumstances” of a franchisee or dealer without good cause. Franchisee dealer counsel routinely argue that these types of provisions preclude franchisors and manufacturers from placing potential competing franchisees and dealers in close proximity to the existing franchisees and dealers. Franchisor counsel, meanwhile, often counter with the argument that the franchise agreement itself sets the competitive circumstances of the relationship. Both sides have case law upon which they can rely.

In *Astleford Equipment Co. v. Navistar Int’l*, the Minnesota Supreme Court analyzed what it meant for a dealer to face “substantial change to the competitive circumstances of its dealership.” In analyzing this, the Minnesota Supreme Court concluded that a “substantial change in competitive circumstances is a change that has a substantially adverse - although not necessarily lethal - effect on the dealership. It is a change that is material to the continued existence of the dealership, one that significantly diminishes its viability, its ability to maintain a reasonable profit over the long term or to stay in business.”¹⁷

A Minnesota federal court earlier had reached a similar conclusion in *Midwest Great Dane Trailers, Inc. v. Great Dane Ltd. Partnership*¹⁸. The court found that a contractual right exercised by the manufacturer could still result in a violation of the Minnesota Heavy and Utility Equipment Manufacturers and Dealers Act¹⁹ that precludes substantial changes to competitive circumstances without cause.²⁰ First the court looked to the language of the statute and determined that if the intent of the legislature was to limit claims to changes in the agreement or contract, it would not have used the words “competitive circumstances.”²¹ Instead the legislature could have achieved this result by stating “substantially change a

¹⁷ 632 N.W.2d 182, 191 (Minn. 2001).

¹⁸ 977 F. Supp. 1386 (D. Minn. 1997).

¹⁹ Minn. Stat. § 325E.068.

²⁰ *Great Dane* 977 F. Supp. at 1392.

²¹ *Id.*

dealership agreement” or “substantially change the competitive circumstances in a dealership agreement,”²² rather than “of a dealership agreement.”

Using the plain meaning of “circumstance” the court held that substantial change to the “prevailing conditions, surroundings, or background of a dealership agreement” created a claim even if the change was contractually permitted.²³ As an example, the court stated that construing the statute to be limited to the terms of the contract could produce an absurd result. The court stated: “Defendant could appoint many new dealers and thus create market conditions – without actually terminating Plaintiff – that would render the dealer’s business entirely unprofitable.”²⁴ The court concluded by finding that the statute provided an extra-contractual remedy.²⁵

Other courts, including those in Wisconsin that have interpreted the Wisconsin Fair Dealership Act, have held just the opposite. In *Wisconsin Compressed Air Corp. v. Gardner Denver, Inc.*²⁶, a Wisconsin federal court held that because the dealer agreement was non-exclusive, assigning additional dealers in the area did not violate the Wisconsin Fair Dealership Law (WFDL) section 135.03, which prohibits a manufacturer from substantially changing the competitive circumstances without good cause.²⁷

But even that ruling is far from the last word on the WFDL. In *Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of America, Inc.*²⁸, the Seventh Circuit refused to “adopt an expansive reading” of *Super Valu Stores, Inc. v. D-Mart Food Stores, Inc.*²⁹, that would establish the proposition that “any action taken by a grantor that is specifically contemplated by the terms of the relevant agreement cannot be a ‘substantial change in competitive circumstance.’”³⁰ The Seventh Circuit court then went on to state that an expansive reading of *Super Valu Stores* would conflict with the liberal construction to be accorded the WFDL and the statute’s purpose of counteracting attempts to do an end run around the statutory protections by contract provisions.³¹

And in *Freightliner of Knoxville Inc. v. Daimler Chrysler Vans, LLC*³², the Sixth Circuit held that the placement by the manufacturer of another dealer close to the original dealer could not be a violation of the Tennessee Trade Practice Act’s (TTPA) prohibition of changes in competitive circumstances because the agreement was non-exclusive. The Sixth Circuit relied in part on the agreement’s

²² *Id.* (emphasis in original)

²³ *Id.*

²⁴ *Id.* at 1393.

²⁵ *Id.*

²⁶ 571 F. Supp. 2d 992 (W.D. Wis. 2008).

²⁷ *Wisconsin Compressed Air Corp.*, 571 F. Supp. 2d at 1001.

²⁸ 549 F.3d 1079 (7th Cir. 2008).

²⁹ 431 N.W.3d 721 (Wis. Ct. App. 1988).

³⁰ *Girl Scouts*, 549 F.3d at 1097.

³¹ *Girl Scouts*, 549 F.3d at 1097.

³² 484 F.3d 865 (6th Cir. 2007).

integration clause in excluding alleged pre-agreement representations to the contrary.³³

d. Litigation strategies

i. Get involved early

When contesting a franchisor's and/or manufacturer's placement of a franchise or dealership in close proximity to an existing franchisee or dealer, it is highly advantageous to get involved before the new franchisee or dealer has contractually obligated itself to the new location.

One advantage of getting involved early is that it will increase a plaintiff's chances of securing an injunction against the proposed development. Although a plaintiff might successfully secure an injunction even after the new franchisee or dealer has contractually obligated itself to the new location, a plaintiff is far more likely to get an injunction in states that differentiate between those motions that seek to maintain the status quo and those that seek to change the status quo.

A second advantage is that once the new franchisee or dealer has opened the new location, it is likely that the only remedy available to the harmed franchisee or dealer would be damages, which often are insufficient to make the harmed franchisee or dealer whole.

ii. Request the franchisor's development policy

Even when a franchise agreement provides a franchisee with no exclusive territory, the plaintiff franchisee still can establish that a franchisor breached the covenant of good faith and fair dealing by either failing to have a development policy, or failing to follow the development policy it has.

As addressed above, and as has been illuminated most recently in the *EI Pollo Loco* case, franchisors that attempt to develop new locations without taking into consideration the financial impact such new development will have on the sales and business expectations of the existing franchisees are proceeding at their peril. A key to avoiding such cases is for franchisors to develop a fair and well thought out proximity or expansion policy, and then to follow it. Such plans should include a mechanism for evaluating the effect on existing franchisee sales and an opportunity for the most closely located franchisees to contest new developments.

Finally, the franchisor should consider providing both franchisees and, prospective franchisees in FDDs, the objective criteria upon which the franchisor will rely in approving new locations

iii. Be prepared to show not only lost sales, but lost cash flows

³³ Id. at 869-70.

Franchisees contesting the placement of competing intra-brand franchise locations need to be able to establish not only the projected lost sales, but the lost incremental profits that will result from those lost sales. If an existing franchisee can show, for example, that placement of a new franchise will push the franchisee from a position where it is operating profitably to one where it no longer will operate profitably, a franchisee would be able to persuasively argue, at least in some states, that the franchisor has effectively terminated the franchise without cause in violation of the applicable franchise relationship statute in the state.

4. E-Commerce and Other Alternative Distribution Channels

The rapid growth of internet-based retail has also given rise to the advent of e-commerce--based encroachment claims. As the omni-presence of the internet has quickly expanded over the last two decades, commercial sectors have felt the impact and have been learning to adapt to the changing landscape of the market. The ubiquity of information technology and the internet has made it much easier for businesses to reach consumers and even easier for consumers to exercise their purchasing power from the click of a button at home. Traditional models of franchising have not been exempt from the rapid expansion of e-commerce. Indeed, the traditional franchise model is becoming embroiled in ambiguities and potential conflicts arising out of the spread of e-commerce and alternative distribution channels. This section explores encroachment issues arising in the franchising space in relation to e-commerce, the impact of e-commerce on the franchise relationship, and how to manage litigation risks arising from this phenomenon.

a. Why E-Commerce?

i. E-Commerce by the Numbers

Today, many products and services that were previously purchased in brick-and-mortar locations can now be more easily acquired online. It should come as no surprise that consumers that once frequented physical stores are now trading the personal service and “touch and feel” shopping experience for the ease and convenience of purchasing their products and services over the internet.

In fact, in 2016 almost 80 percent of Americans made purchases via the internet.³⁴ Statistics Canada reported that Canadian e-commerce sales were \$19.2 billion in 2016, with about 60 percent of the purchases made from domestic retailers and 40 percent from foreign retailers.³⁵ It is anticipated that 10 percent of all Canadian retail spending in 2019 will be conducted online, up from 6 percent in

³⁴ “Online Shopping and E-Commerce” *Pew Research Centre* (December 16, 2016), online: <<http://www.pewinternet.org/2016/12/19/online-shopping-and-e-commerce/>>

³⁵ Hollie Shaw, “Nearly half of online purchases in Canada made at foreign retail sites: report” *The Financial Post* (March 21, 2017), online: <http://business.financialpost.com/news/retail-marketing/nearly-half-of-online-purchases-in-canada-made-at-foreign-retail-sites-report> [“Shaw, *Online Purchases*”].

2014 and almost equivalent to—on a percentage basis—the 11 percent forecasted for the U.S. market.³⁶

With the increase in online sales, retailers are having to adapt to remain competitive. Indeed, the data illustrates that retailers are trying to offer customers easier online shopping experiences. Thirty-seven percent of Canadian retailers currently offer customers so-called “cross-channel” returns or exchanges, allowing customers to return items they purchased online to stores, while eight percent were in the process of implementing that service and 13 percent planned to do so in the next two years.³⁷ The U.S. retail market is also experiencing a growth in cross-channel commerce. US cross-channel retail sales were forecasted to reach \$1.4 trillion in 2014 and grow to \$1.8 trillion by 2018.³⁸ In fact, cross-channel retail sales are now more than four times larger than online sales in the U.S.³⁹ and by 2022, it is expected that the internet will influence 41% of in-store sales during customers' purchase journey.⁴⁰

Though businesses are seeking to meet the growing demand created by consumers for accessing goods and services online, new pressures on franchise models are also burgeoning. These are pressures that may not be contemplated by traditional franchise agreements, but now pose concerns to both franchisors and franchisees. The pressures of e-commerce have forced franchisors to rethink a myriad of issues from territorial provisions granted to protect franchisees, to goodwill associated with a brand. These issues are exacerbated, particularly in light of the “Amazon Effect”.

ii. The “Amazon Effect”

To stay competitive with the quickly evolving retail environment, franchisors increasingly need to be omni-present, requiring physical stores, an online conduit for goods, a digital presence, and compatibility with mobile apps. This phenomenon, dubbed the “Amazon Effect”⁴¹, describes 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. In order to be

³⁶ Qasim Mohammad, “After years in the slow lane, Canada’s e-commerce ecosystem is booming” *Canadian Business* (February 22, 2016), online: <<http://www.canadianbusiness.com/innovation/canada-ecommerce-innovators/>>

³⁷ Shaw, *Online Purchases*, *supra*.

³⁸ “US Cross-Channel Retail Sales Forecast: 2014 To 2018” *Forrester* (July 24, 2014), online: <<https://www.forrester.com/report/US+CrossChannel+Retail+Sales+Forecast+2014+To+2018/-/E-RES115515>>

³⁹ *Ibid.*

⁴⁰ “Digital-Influenced Retail Sales Forecast, 2017 To 2022 (US)” *Forrester* (November 14, 2017), online: <<https://www.forrester.com/report/Forrester+Data+DigitalInfluenced+Retail+Sales+Forecast+2017+To+2022+US/-/E-RES140811>>

⁴¹ Adam Hartung, “How The 'Amazon Effect' Will Change Your Life And Investments” *Forbes* (February 28, 2017), online: <<https://www.forbes.com/sites/adamhartung/2017/02/28/how-the-amazon-effect-will-change-your-life-and-investments/#69df8995e76a>>

successful in this omni-channel retail paradigm, sellers need to integrate physical stores, websites, and mobile apps, and not treat these different delivery models as different channels. The efficacy of a properly structured e-commerce strategy was demonstrated by Amazon itself: Amazon accounted for 43% of all 2016 retail sales in the U.S.⁴² In Canada, Amazon generated just over \$3.5 billion in Canadian e-commerce sales in 2016 and captured 7% of Canada's \$21.6-billion e-commerce sales in 2014.⁴³

Following Amazon's suit, businesses are increasingly realizing that a successful brick-and-mortar business must have a strong online presence in order to maintain success in the future. Franchise systems, in particular, stand to benefit from leveraging a diversified e-commerce strategy that builds a brand name online and leverages physical stores to reach online customers. This is particularly pertinent to improving the brand experience for customers, as customers have demonstrated their desire for shopping on multiple platforms at the same time. These strategies, however, may be viewed by franchisees as an attempt by the franchisor to cannibalize their revenues. Thus, franchisors wishing to capitalize on the "Amazon Effect" will need to start anticipating electronic encroachment issues arising out of the internet-based retail component of their business, rather than remaining focused on brick-and-mortar, physical encroachment issues.

b. The Impact of E-Commerce on the Franchise Relationship

Older franchise agreements may not contemplate e-commerce activities within their ambit. Accordingly, competitive concerns within franchise systems are burgeoning and may lead to unanticipated legal and business consequences. Three key issues franchisors can expect to navigate with respect to the move towards e-commerce activities are: (a) territorial encroachment; (b) brand protection; and (c) how to draft more comprehensive provisions in light of alternative distribution channels.

i. Territorial Encroachment

For franchisors, franchisee territories have the potential to create numerous legal challenges. Customarily, a franchise agreement authorizes a franchisee to use trademarks and other proprietary information in exchange for royalties, and delineates a franchisee's exclusive use in a particular location. Encroachment claims were typically based on a franchisee's assertion that it had exclusive

⁴² "Amazon accounts for 43% of US online retail sales" *Business Insider* (February 3, 2-17), online: <<http://www.businessinsider.com/amazon-accounts-for-43-of-us-online-retail-sales-2017-2>>

⁴³ Hollie Shaw, "Amazon's Prime a more 'pressing threat' for Canadian retailers than its Whole Foods acquisition: BMO" *Financial Post* (June 26, 2017), online: <http://business.financialpost.com/news/retail-marketing/amazons-prime-a-more-pressing-threat-for-canadian-retailers-than-its-whole-foods-acquisition-bmo>; Hollie Shaw, "Amazon.ca sells four times as much as its biggest online rivals in Canada" *Financial Post* (October 16, 2017), online: <<http://business.financialpost.com/news/retail-marketing/amazon-ca-sells-four-times-as-much-as-its-biggest-online-rivals-in-canada>>

territory in an area where the franchisor could not expand with brick-and-mortar units. Thus, and as discussed above, franchise territory provisions in franchise agreements historically tended to focus on defining territories by various methods including metric radius, population density, or district boundaries.

Today, e-commerce activities have blurred the line between franchise location boundaries. Even if a franchise agreement grants an exclusive territory, protocols that allow, for instance, internet sales, are not capable of being subject to those geographical boundaries delineated in a franchise agreement. In other words, it is difficult to limit the use of e-commerce to one market area only. Thus, franchisors, or even other franchisees, may be able to sell products and services within another franchisee's exclusive territory without violating the express terms of the franchise agreement. Accordingly, franchisees are no longer the only ones dealing with their customers. This gives way to a host of issues: who receives credit for internet sales – the franchisor or franchisee or should the credit be shared and, if so, how?; how do the franchisor and franchisee determine from where an online sale was made?; does the existing franchise agreement place limits on the scope of the franchisor's use of the internet?; should issues relating to internet sales or e-commerce be dealt with in the franchise agreement?

If an existing franchise agreement does contain a grant of exclusivity, it will be necessary to identify the scope of such exclusivity. In such circumstances, it is not unusual for franchise agreements to also contain a broad reservation of rights granted to the franchisor in order to shrink the scope of the franchisee's exclusive rights. For example, the franchisor may commit not to operate or grant someone else the right to operate a brick-and-mortar unit in the territory, and may reserve the right to sell the same products or services in the territory through other channels. In the online context, the central question that arises is whether the franchisor can conduct online sales and other e-commerce activities on its website without encroachment claims from the franchisee.

Provincial franchise legislation in Canada imposes a duty of fair dealing on parties whenever they are performing or enforcing the provisions of a franchise agreement.⁴⁴ Canadian courts have noted that the statutory duty of fair dealing is a codification of the common law duty of good faith that exists in the franchise relationship.⁴⁵ Under the statutory and common law duty of good faith, parties to a franchise agreement are allowed to act in their self-interest but they must have regard to the legitimate interests of the other party. Bad faith is considered conduct that is contrary to community standards of honesty, reasonableness or fairness.

⁴⁴ *Arthur Wishart Act (Franchise Disclosure)*, 2000, SO 2000, c. 3, s. 3; *Franchises Act*, RSA 2000, c. F-23, s. 7; *The Franchises Act*, SM 2010, c. 13, s. 3; *Franchises Act*, SNB 2007, c. F-23.5, s. 3; *Franchises Act*, RSPEI 1988, F-14.1, s. 3.

⁴⁵ *Lansbridge Auto Corp. v Midas Canada Inc.*, [2009] OJ No. 1279 (SCJ); *Machias v Mr. Submarine Ltd.*, 2002 CanLII 49643 (OSCJ); *1117304 Ontario Inc. v Cara Operations Ltd.*, [2008] OJ No. 4370 (SCJ).

Though there is presently no Canadian jurisprudence dealing specifically with facts relating to internet encroachment, the non-internet encroachment cases are nonetheless illuminating and may guide how the courts would grapple with e-commerce related issues in the future. In dealing with encroachment issues generally, Canadian courts seem to engage in one of two methods of analyses when resolving these disputes: (1) using a contractual interpretation of the agreement itself; or (2) applying the duty of good faith or fair dealing to the facts of the case.

In contrast to the state of the law in Canada, jurisprudence exists in the U.S. on internet encroachment. In the earlier cases reviewing potential competition through internet sales under agreements pre-dating the internet and not contemplating internet sales, decisions rested on the implied covenant of good faith and fair dealing.⁴⁶ More recent case law has addressed internet competition in the context of agreements that have an express reservation of the franchisor's rights to engage in internet sales. These cases shift the analysis to contract interpretation and generally hold that a franchisor does not breach its franchise agreements when engaging in competitive internet sales, provided it has expressly reserved the right to do so under the agreement.⁴⁷

A. Encroachment and a Contract-Based Analysis

*Metro-Pacific Cellular Inc. v. Rogers Cantel Inc.*⁴⁸ does not involve the internet but does address a franchisor's attempt to introduce a new promotion to sell over the phone. It is one of the only cases in Canada dealing with distance sales and encroachment issues in the franchise context. Because of the age of this case, there is no analysis of the breach of the duty of good faith or any consideration of the necessity of having internet or distance sales programs as part of a successful retail business. Rather, the court in *Rogers* indicated that in order for a franchisor to engage in phone sales, the franchise agreement must provide the franchisor with a clear and unambiguous reserved right to do so.

The franchise agreement in *Rogers* obligated the franchisor (Rogers) to refer all "sales leads" to the franchisee. The contract was described as being exclusive as between the franchisor and franchisee, although there could be other franchised stores in the territory. The British Columbia Supreme Court engaged in a detailed analysis of the contract and ultimately concluded that there was at least a serious issue to be tried, the plaintiff had made out a prima facie case of harm, and the balance of convenience favoured granting an injunction. Though there was never a final decision on the merits in *Rogers*, the case was described in *Shelanu Inc. v. Print Three Franchising Corp.*⁴⁹ as "the court held that [Rogers] could not

⁴⁶ See, e.g., *Emporium Drug Mart, Inc. v. Drug Emporium, Inc. of Denton*, (unreported arbitration case); see generally *Bridges*, infra note 49.

⁴⁷ See e.g., *Newspaper LLC v. Party City Corp.*, 2013 WL 5406722 (D. Minn. 2013); see generally *Bridges*, infra note 49.

⁴⁸ 1994 CarswellBC 2669 (SC [*Rogers*]).

⁴⁹ [2000] O.J. No. 4129 (SCJ).

compete directly with its non-exclusive dealer.” Although the court didn’t engage in a good faith analysis, the following has been said about *Rogers*:

While it does not specifically address internet sales, the *Rogers* case does indicate that where franchisors wish to sell into franchisee territories through some form of distance selling, both the wording of the franchise agreement and the conduct of the franchisor will be relevant considerations in any dispute. Accordingly, franchisors should ensure that their franchise agreements contain unambiguous language reserving for them the right to sell into the franchisee’s territory via the internet, by telephone or otherwise.⁵⁰(emphasis added)

Accordingly, *Rogers* engages elements of a contract-based analysis that also contains an implicit good faith analysis within its ambit. There are other decisions where courts have focused more squarely on interpreting the contractual language of the franchise agreement in making a finding on encroachment. For instance, in *Paul Sadlon Motors Inc. v. General Motors of Canada Ltd.*⁵¹, the court, in granting an injunction preventing encroachment, held that where franchisors who grant protected territories include a contractual encroachment right in their franchise agreements, they must be very careful to fully observe their own pre-conditions to encroachment, even if they are confident that no breach of their duty of good faith and fair dealing can be established. In *1117304 Ontario Inc. v. Cara Operations Ltd.*⁵², the franchisor was able to rely on clear contractual language and reasonable conduct to defend against an encroachment claim based on fair dealing. In *Cara*, the impugned new location was outside the franchisee’s protected area, and thus, not a true encroachment case. It is nonetheless illustrative of the weight that the court may place on the text of the franchise agreement in its encroachment analysis.

Finally, *Simpson v. First Choice Haircutters Ltd.*,⁵³ is also instructive regarding the importance of clear contractual language. In this case, the franchisor (Regis) acquired a competing brand of franchises (First Choice Haircutters). The First Choice franchisee sought a permanent injunction to prevent its franchisor and Regis from operating competing franchises in the franchisee’s territory. The exclusivity clause in the franchise agreement prevented the franchisor from operating “shops” anywhere in the franchisee’s territory. The parties disagreed as to whether “shops” referred only to the First Choice brand or

⁵⁰ Mike Melvin & Brad Hanna, “*Territorial Considerations in the Omni-Channel World*” presented at the Canadian Franchise Association Law Day 2016, at 34 [“Melvin & Hanna”].

⁵¹ 2011 ONSC 2628

⁵² 2008 CarswellOnt 6444 (SCJ) [*Cara*].

⁵³ 2003 CarswellOnt 5855, aff’d 2004 CanLII 10245 (ONCA)[It should be noted that Osler was counsel for the franchisor in this case]; see also *Flair Franchise Systems (1996) Ltd. v. Millebrook Investments Ltd.*, 1996 CarswellBC 2223 (SCJ).

if it referred to all competing haircutting “shops” of any brand. While the language in the franchise agreement was somewhat ambiguous, the court refused to order a permanent injunction against the franchisor. The ambiguous language of the franchise agreement did not explicitly prevent the franchisor from operating a competing brand within its franchisee’s territory.

Though the aforementioned encroachment cases do not directly deal with internet encroachment, they may serve as a guidepost for courts once they inevitably begin to address e-commerce-oriented facts. Generally speaking, the franchise agreement is a contract of adhesion, and, as a result, any ambiguity in its terms will be interpreted in favour of the franchisees.⁵⁴ Given that courts are likely to wade into the terms and language of the contract when assessing encroachment claims, clarity is key, particularly for e-commerce situations. In situations involving protected areas, for instance, franchise agreements should contain clear reservation of rights to encroach on those territories in certain circumstances (model language is provided in a section below). By extension, franchise agreements that do not contain exclusive territories should also be expressly clear on that. In situations involving a contractual right to encroachment, the pre-conditions detailed in the franchise agreement must be met.

B. Encroachment and the Duty of Good Faith and Fair Dealing

Even in circumstances where franchisors have broadly reserved their rights in the franchise agreement, courts in both the United States and Canada have demonstrated a willingness to frame non-internet encroachment issues as a potential breach of good faith and fair dealing owed by a franchisor to its franchisees.⁵⁵

*1291079 Ontario Ltd. v. Sears Canada Inc.*⁵⁶ is another case that deals with distance sales in the franchise context. One of the allegations in this case was that Sears unlawfully competed within the dealers’ market areas by shipping directly to customers and offering lower prices through direct selling channels while prohibiting dealers from matching prices. Although there has not been a decision to date on the merits in this case, the Ontario court certified the action as a class proceeding based on breach of the duty of good faith and fair dealing.⁵⁷ *Courtesy*

⁵⁴ See e.g. *1230995 Ontario Inc. v. Badger Daylighting Inc.*, 2010 ONSC 1587 [*Badger Daylighting*].

⁵⁵ Bruno Floriani & Michael K. Lindsey, “*The Continuing Impact of the Internet on International Franchising*” (2002) 1:86 Bus. L. Int’l 86 at 89 [“Floriani & Lindsey”].

⁵⁶ 2014 ONSC 5190 [*Sears*].

⁵⁷ In *Sears*, the plaintiff alleged that the Dealer Agreement did not permit Sears to compete in the dealers’ Market Areas using direct shipping through direct channels (such as internet and catalogue sales). Despite this, it is alleged that Sears actively competed by selling through direct channels and shipping directly to customers in the dealers’ Market Areas. In the alternative, in the event that the Dealer Agreement did not specifically prohibit Sears from acting in this way, the dealers alleged that Sears failed to take the dealers’ reasonable commercial interests into account or comply with the duties of good faith and fair dealing. Sears claimed that direct sales have been part of Sears’ business for many years, and there is nothing in the Dealer Agreement

*Chrysler (1987) Ltd. v. Chrysler Canada Inc.*⁵⁸ also demonstrates the important role good faith and fair dealing can play in the encroachment context. Despite a clause in the franchise agreement in *Chrysler Canada* allowing the franchisor to determine the number and location of franchises, the franchisor was not permitted, on an interlocutory basis, to encroach on the franchisee's territory as it would be a breach of the duty of good faith. In coming to its decision, the court focused on the risk to the viability of the franchisee's business posed by the new dealership, finding that the balance of convenience favored granting an injunction.

The court in *Badger Daylighting*⁵⁹ came to a similar conclusion based on a good-faith analysis. The *Badger Daylighting* case illustrates that, even where a franchisor comprehensively documents the territory rights of the parties, any lapse in the documentation will be to the franchisor's detriment. Where territory rights are vaguely defined, ambiguity will be resolved in the franchisee's favour, particularly where the franchisor is found not to have dealt fairly with the franchisee (as in *Badger Daylighting*).

In *Katotikidis v. Mr. Submarine Ltd.*⁶⁰, a pre-*Arthur Wishart Act* case, the court found that by opening a franchise in unreasonable close competitive proximity to the franchisee's exclusive territory, the franchisor breached an oral contract and the common law duty of good faith it owed to the franchisee, thus constituting encroachment.

The good faith cases in the Canadian context seem to suggest that courts are willing to look beyond the contractual language of the franchise agreement when adjudicating issues relating to encroachment. Even in cases where franchisors have expressly delineated certain rights and adhered to the black letter of the franchise agreement, a franchisor may be found to have breached the duty of good faith and fair dealing when they "substantially nullif[y] the bargained objective or [act] in a manner which is inconsistent with the reasonable expectations of the parties".⁶¹

ii. Brand Protection

Another topic triggered by the growth of e-commerce and online retailers relates to the franchise's brand, reputation, and goodwill. This is intertwined with the issue of whether franchisees have a right or entitlement to use internet systems. It is conceivable that in the interests of jumping on the "Amazon Effect" bandwagon, franchisees may seek to develop their own e-commerce strategies or to operate their own websites. In these circumstances, it is important to examine whether the franchisor can limit the franchisee's use of the internet. To

that precludes Sears from engaging in this practice. Sears argued that it provided a 4.5% commission to dealers on catalogue and internet sales shipped to their stores.

⁵⁸ 2012 ABQB 658 [*Chrysler Canada*].

⁵⁹ *Supra*.

⁶⁰ [2002] O.J. No. 1959 (Ont.S.C.J.) [*Katotikidis*].

⁶¹ *Katotikidis* at para. 74.

the extent franchisors permit their franchisees to operate their own websites, franchisors must ensure that they retain a requisite degree of control over their brand.

Typical controls in franchise agreements include restrictions on franchised marks and limits over advertising and marketing activities. This stems from the foundation of the franchise model, which is built on the consistent and uniform delivery of products and services to customers. Accordingly, franchisors have to exercise a considerable degree of control over a franchisee's operations. However, in light of the ambiguities arising from franchise agreements that do not account for e-commerce activities, franchisors may be inclined to extend their typical controls into other aspects of the franchised business. The recourse of franchisors to fall back on these archetypical provisions of the franchise agreement may be most practical in instances where franchisees begin to establish their own websites that are inconsistent with a franchisor's brand, thereby adversely affecting brand uniformity and increasing client dissatisfaction as a result of confusion.

iii. Other Alternative Distribution Channels

The questions and issues canvassed above also extend into the expansion of alternative distribution channels. Increasingly, products of franchises are being distributed to non-franchised stores, such as department stores, grocery stores, pharmacies, convenience stores, and kiosks. Similarly, franchised sales units are emerging in non-traditional or seasonal locations, such as universities, military bases, workplaces, and expositions. Unsurprisingly, these alternative distribution channels may serve as a potential source of strife between franchisors and franchisees.

It is worth reiterating that franchisees acquire only the limited right to sell and furnish the franchisors' goods or services through one or more defined distribution methods – not every imaginable distribution method developed in the future. The expansion of the franchise model to encompass alternative distribution channels illustrates the evolution of the franchise model to be more omni-present and emulate the successes of the “Amazon Effect”. Inevitably, however, other alternative distribution channels have the potential to be a source of friction between franchisors and their franchisees. Similar territorial encroachment and brand protection issues are likely to be engaged. Thus, franchisees who desire distribution rights beyond those explicitly granted under the franchise agreement should negotiate for them before the relationship develops. Additionally, it may be prudent to pre-empt this conflict altogether – as further detailed below - by broadly reserving the franchisor's rights to provide services or products also offered to the franchisee through “alternative distribution channels”. By keeping this language expansive, it provides franchisors with lee-way to develop new technology or sales methods within the ambit of the pre-existing franchise agreement.

When adjudicating issues relating to alternative distribution channels, the same considerations relating to encroachment noted above will continue to apply.

Courts will continue to look to the contractual language of the franchise agreement as well as considerations relating to the duty of good faith and fair dealing. However, the introduction of alternative distribution channels may create conflict surrounding what the franchise system actually constitutes. Certain cases on system changes have held that fundamental changes to the franchise system go beyond the intent of the parties and would require consent to a modification of the agreement to implement the change. For example, in *Restaurants Mikes Inc. v. 147564 Canada Inc.*⁶², the franchisor modified its delivery system to direct order calls to the nearest franchisee and charge them a flat rate per call redirected. These fees were not part of the franchise agreement and the Quebec Court of Appeal held that the franchisee was entitled to a return of the fees it paid the franchisor. The Court further held that fundamental changes of this kind went beyond the intent of the parties and would have required the franchisee's consent. In particular, the Court said:

“The drafting of Section XXI makes it clear that it allows the franchiser to make changes to the way that the franchise is operated, which the respondent admits. However, it does not authorize the franchiser to make changes that will result in a different contract, nor does it entitle the franchiser to increase unilaterally the level of royalties to be paid on sales or to remove the benefit of a clause providing for no payment until certain sale figures are reached. In my view, such fundamental changes to the business relationship go beyond the intent of the parties and require the specific consent of the franchisee.”⁶³ [emphasis added]

Additional cases have addressed the issue of fundamental changes through the lens of good faith and fair dealing. For instance, in *Landsbridge Auto Corp. v. Midas Canada Inc.*⁶⁴, a franchisor tried to make a unilateral change to the franchise system. Although the Ontario Superior Court found that there was no provision in the agreement that prevented a change being made, the court certified the class action on the basis of the breach of the duty of good faith. The court held that franchisors should be extremely careful when making unilateral changes to their franchise systems that could “destroy the rights of the franchisees to enjoy the fruits of [their Franchise Agreements].”⁶⁵ If customers have moved a significant amount of sales online or to an alternative channel and franchisees are suffering as a result – this might be considered a unilateral change that destroys the rights of franchisees to enjoy the fruits of their investment.

⁶² 2005 QCCA 551 [*Restaurants Mikes*].

⁶³ *Restaurants Mikes* at para. 32.

⁶⁴ 2009 CarswellOnt 1655 (S.C.J.) and 2009 CarswellOnt 6283 (S.C.J.), aff'd 2010 ONCA 478, settlement approved 2013 ONSC 5714 [*Landsbridge*].

⁶⁵ *Landsbridge* at para. 17, 2009 CarswellOnt 1655 (S.C.J.).

To guard against disputes arising from internet sales, e-commerce activities, or alternative distribution strategies, franchisors may want to consider including certain language in their franchise agreements relating to non-exclusive territories such as the language provided below:

Territory

The Franchisee expressly acknowledges and agrees that the rights granted to the Franchisee hereunder are non-exclusive and that the Franchisee shall not be granted any exclusive territory at any time during the Term of this Agreement.

Franchisors may also want to consider including a broad reservation of rights in their franchise agreements, that captures all distribution channels, generally. The language provided below may be instructive:

3.3 Rights Retained by the Franchisor

Nothing in this Agreement will preclude the Franchisor from directly or indirectly establishing, operating, distributing, selling, licensing or franchising the distribution or sale of products or services under the Trade-marks, through any distribution channel or method.

The Franchisor expressly reserves the following rights for itself and/or its Affiliates:

- (a) the right to develop, market, own, operate or participate in any other business under the Trade-marks or any other trade-marks;
- (b) the right to establish and operate or grant any other person the right to establish and operate a Franchised Business located anywhere under any terms and conditions the Franchisor deems appropriate and regardless of their proximity to the Authorized Location or their actual or threatened impact on sales of the Authorized Location;
- (c) the right to develop, use and licence the use of, at any location, proprietary marks other than the Trade-marks, in connection with the operation of a program or system which offers products or services which are the same as or similar to and which may compete with the Franchised Business;

(d) the right to develop, market, own, operate or participate in any business other than a Franchised Business under the Trade-marks or any other trade-marks;

(e) the right to acquire the assets or ownership interests of one or more businesses providing products and services similar to those provided by the Franchised Business, and franchising, licensing or creating similar arrangements with respect to such businesses once acquired, wherever these businesses (or the franchisees or licensees of these businesses) are located or operating;

(f) the right to be acquired (in whole or in part and regardless of the form of transaction), by a business providing products and services similar to those provided by the Franchised Business, or by another business, even if such business operates, franchises and/or licenses a business involved in the offer or sale of products or services which are the same as or similar to and which may compete with the Franchised Business; and

(g) the right to establish a website to promote the Franchisor and/or the Franchised Business, which website may, in the Franchisor's discretion, include a page specific to each Franchised Business.

Whether an alternative distribution channel has breached the contractual terms of the franchise agreement or the duty of good faith and fair dealing may ultimately depend on a myriad of factual considerations such as the percentage of revenue that franchisees were generating from the programs, the rate of return that franchisees generally make on their investments, the percentage of customers that buy through traditional stores versus the internet versus other accounts, as well as the intentions behind a franchisor's decision to prevent the franchisees from accessing these programs. Under the statutory and common law duty of good faith, parties are allowed to act in their self-interest but they must have regard to the legitimate interests of the other party. Bad faith is considered conduct that is contrary to community standards of honesty, reasonableness or fairness.

c. Litigation Risk

Franchisors now face uncharted territory in learning how to navigate e-commerce activities that may bring with them an onslaught of claims relating to encroachment and brand protection. In the U.S. context, Emily Bridges notes that "courts were uncertain how to address these claims, especially when franchise

agreements did not anticipate the prevalence of the Internet, and struggled with examining such claims under a theory of good faith and fair dealing.”⁶⁶ Bridges notes, however, that courts are increasingly examining electronic encroachment claims using “contract analysis and reasoning, focusing on the exact language of the franchise agreement and the territory restrictions rather than implying any type of additional duties on the franchisor or franchisee.”⁶⁷ Canadian courts have yet to explore internet encroachment specifically, so it remains to be seen whether courts will tend towards similar contract-based analysis or gravitate more toward analysing these issues through the lens of the duty of good faith and fair dealing. Current case law on encroachment, generally, suggests that Canadian courts are equipped to employ a hybrid approach, based on the facts of each particular case.

Nonetheless, the franchise agreement remains central to the franchisor and franchisee relationship. Accordingly, a prudent franchisor should properly delineate within the franchise agreement how it plans to deal with e-commerce activities, internet sales, and/or alternate channels of distribution. This can be as simple as creating a carve-out for e-commerce activities and alternative channels of distribution. Unless the reservation of rights in favour of the franchisor is explicitly worded - specifically by addressing online sales and other e-commerce activities - there is a substantial risk that franchisees will have some sort of legal claim to assert against their franchisor.

If the franchise agreement permits the franchisor to engage in e-commerce and/or other alternative distribution channels, franchisors should continue to pay heed to the covenant of good faith and fair dealing. In so doing, key considerations that the franchisor should keep in mind include: (1) whether the franchisor has taken into account its franchisees’ interests; and (2) whether the franchisee is still getting a reasonable return on its investment.

Above all, as claims involving e-commerce inevitably start to make their way through the courts, franchisors should ensure that they reserve methods of sales for themselves rather than allowing a court to interpret the provisions of a franchise agreement. The challenges to traditional franchise systems being created by e-commerce, in particular, are numerous and unpredictable. Franchisors would be wise to undertake a periodic evaluation of their standard documentation and operations manuals to ensure that they are updated to deal with continuing developments in e-commerce that affect their franchise systems. Failure to do so may ultimately result in differences of opinion, conflict, and potentially, legal issues between a franchisor and its franchisees.

5. Cross-Brand Competition

Ever since the U.S. Supreme Court in *GTE Sylvania* and *Jefferson Parish* held that restrictions that are economically useful to distribution arrangements

⁶⁶ Emily I Bridges, “Keep Off My (Virtual) Lawn: Encroachment in the Age of the Internet” (2017) 36:3 Franchise law Journal 416 at 427 [“Bridges”].

⁶⁷ *Ibid* at 427.

(such as exclusive territories and tying arrangements) were no longer *per se* violations of the antitrust laws⁶⁸, franchise models have flourished. Along with the exponential growth in franchising, the practices of companies that use the franchise model have become ever more sophisticated, including the practice of operating multiple franchise concepts under one roof. Some of the early practitioners of multi-brand operations include PepsiCo, with its ownership of three different restaurant concepts: Pizza Hut, Kentucky Fried Chicken and Taco Bell (now operated separately as YUM! Brands, after being spun off from PepsiCo). Fierce competition in the fountain beverage business with Coca-Cola drove Pepsi's desire to gain an edge by owning and franchising some of the major restaurant chains that used fountain beverages (i.e., vertical integration). In the product distribution field, automobile manufacturers, such as General Motors, identified different automobile market segments to offer cars under different brands (e.g., Cadillac, Oldsmobile, Chevrolet) through different dealer networks, even though the brands benefited from common manufacturing facilities and supply chains.

Today, the world of franchising has seen a proliferation of companies operating multiple franchise concepts within the same general industry, or even brands that are direct competitors.⁶⁹ Often a franchise company (or more likely its predecessor) will have created and built its own successful franchise program and then will use that knowledge and skill to acquire and improve the operations of a competitive chain or a chain that is in the same general field, where that knowledge and skill is transferrable. Such strategic buyers of competitive chains have been around now for many years – one need not look any further than the hotel industry. More recently, institutional investors, such as private equity companies, have discovered franchising as an attractive investment, and, applying rigorous financial analyses, aggressively acquire and consolidate multiple franchise systems within the same industries.⁷⁰ These buyers, as well as some strategic buyers, seek to maximize efficiencies (and financial returns) by pursuing an “asset light” model. In other words, buy a pure franchisor (i.e., all units are franchised, none are company owned) or convert a mixed franchise company into a pure franchisor by refranchising company-owned units (sometimes maintaining a few company-owned units to test new developments). By building an “asset light” model with multiple brands, these buyers seek to:

- reduce overhead costs (most corporate staff serve all brands – they do not have any, or very little, brand specific dedicated staff; they consolidate information technology systems; etc.);

⁶⁸ Although McDonald's ultimately prevailed, the allegations of an illegal tying arrangement in *Principe v. McDonald's Corporation*, 631 F.2d 330 (4th Cir. 1980) were an existential threat to McDonald's and the decision in *Siegal v. Chicken Delight, Inc.*, 498 F.2d 43, (9th Cir. 1971) on similar arrangements destroyed that system in the U.S. (some remnants survive in Canada, notably Manitoba).

⁶⁹ For example, Checkers and Rally's. These concepts were very similar even before they were merged together.

⁷⁰ Examples include 3G Capital (Brazil), JAB (Luxembourg) and Roark (USA).

- achieve economies of scale (enhanced buying power to gain volume purchase pricing and discounts)⁷¹;
- increase return on investment while reducing financial risk (invest only in IP rights and corporate staff; very little investment, if any, in units); and
- achieve more stabilized cash flows (royalty fee streams dampen the financial impact of economic downturns).

These strategies can have a profound impact on franchise systems, including cross-brand competition. But the effects are often a mixed bag and not just negative – any number of aspects of this approach can be positive and beneficial to franchisees. For example, franchisees may pay less for third party products and services (due to the economies of scale); they may benefit from cross-brand loyalty programs that carry a large customer base; they may benefit from more sophisticated and effective franchisor management teams; they may benefit from state-of-the-art franchisee management support systems, etc. One should not underestimate these potential benefits to franchisees – they can drive franchisee revenues and profitability. Nevertheless, management and operating systems that franchisors once dedicated to a single brand are now shared with multiple brands, some of which franchisees might perceive as competitive. As the “asset light” model succeeds and attracts more franchisees to the various systems, the singular focus management may have had when operating a single system may become diffused.

The very fact that a franchisee’s franchisor or affiliate is now operating another competitive brand may raise a number of franchisee concerns. Is a franchisee at a disadvantage in its local market area when that franchisee’s franchisor now owns and manages that other competitive brand? Franchisor’s often take the position that because the franchisee already was competing against the newly acquired system in the marketplace prior to the acquisition, that there is no real change. Franchisees, however, can reasonably believe that because their franchisor will now share the franchisees “secret sauce” with its competitor, that the competitive advantage the franchisee had enjoyed is now lost.⁷² Perhaps more troublesome is the circumstance where the franchisee had no competition from the other brand until after the acquisition. Conversely, if the franchisee has no territorial protection against expansion of its own brand, what difference does it make if the expansion is with the other brand? Are there differences in brand awareness in the local market? Are there differences in product offerings and services?

These factors may dilute the competitive threat of expansion of the other brand in comparison to expansion of the existing brand. On the other hand, if the existing brand is expanding, would the franchisee benefit in the long term from the

⁷¹ For example, a major reason for the recent merger of Starwood Hotels into Marriott International was the ability to get better pricing from the OTAs.

⁷² Assuming nothing more occurs. There is always the possibility of mischief, such as customer information sharing. Cf, *Bryman v. El Pollo Loco, Inc.*, *supra. note 1*.

increase in brand awareness in the local market, a factor clearly absent by the entry of the other brand? And does it make any difference to the franchisee that the other brand has been acquired by its franchisor or is newly conceived and developed by its franchisor? At a visceral level, there may be a significant difference.

From a legal perspective, these concerns are primarily addressed, if at all, on the basis of contractual rights and obligations, whether expressed or implied. Even Indiana and Iowa (the only two states with franchise relationship statutes that address encroachment directly) deal only with encroachment under the same brand.

If the franchisee has no territorial protection against competition from its own brand, the implied covenant of good faith and fair dealing is unlikely to have any greater impact on the franchisee's rights as a result of expansion of another affiliated brand compared to its own brand. Courts that have addressed cross-brand competition in the context of contractual protection against the same brand universally have declined to expand these covenants to inhibit competition beyond the identified brand.⁷³ In the rare circumstance where the franchise agreement protects the franchisee from franchisor competition based on the type of business (without regard to brand identification), the franchisee may fare better, with key factors being how the agreement describes this type of business and whether the competing brand bears any significant differences from that description.⁷⁴

Notwithstanding the foregoing conclusions, there inevitably will be outliers in egregious cases. For example, what if the franchisor authorizes a franchisee of the competing brand to open a location literally next door to the existing franchised unit? Depending on the magnitude of the impact on the franchisee and the surrounding circumstances of the franchisor's behavior and decision-making process, there may be a cognizable claim under the implied covenant or, in Canada, under the duty of good faith and fair dealing. Also, what is the impact when the franchisor has access to the franchisee's customer information and shares it with the competing unit (though, it is worth noting that this may be considered a misappropriation of confidential information/ unfair competition⁷⁵ matter more than a "cross brand competition" matter and could raise privacy concerns under Canadian law)? The situation where the expansion with the other brand isn't through a franchised unit but a corporate unit may also invite greater scrutiny.⁷⁶ The fundamental point is that experiencing competition from the other

⁷³ *Auto-Chlor Sys. Of Minn., Inc. v. JohnsonDiversey*, 328 F. Supp. 2d 980 (D. Minn. 2004); *Budget Rent-A-Car Sys., Inc. v. K&T Inc.*, 2008 U.S. Dist. LEXIS 73024, at *10-11 (D.N.J. Sept. 23, 2008); *Sirrah Cos., Inc. v. Budget Rent-A-Car Corp.*, 2009 U.S. Dist. LEXIS 22722, at *11-12 (W.D. Tex. Feb. 5, 2009); *Subaru Distribs. Corp. v. Subaru of Am., Inc.*, No. 03 Civ. 9608SCR, 2004 WL 32201 (S.D.N.Y. June 1, 2004); See *Daewoo Motor Am., Inc. v. Gen. Motors Corp.*, 315 B.R. 148, 155 (M.D. Fla. 2004).

⁷⁴ *G.I. McDougal, Inc. v. Mail Boxes Etc., Inc.*, No. B196029, 2008 Cal. App. Unpub. LEXIS 4275 (Ct. App. May 23, 2008).

⁷⁵ See e.g., *Bryman*, *supra* note 1.

⁷⁶ *Id.*

brand, in and of itself, is unlikely to result in a cognizable contract or implied contract claim.

Certain other legal issues beyond encroachment may arise from the operation of multiple brands, based on how the franchisor leverages its support operations and the extent of its contractual commitments to franchisees. Many franchise agreements state in their preambles that the licensed “system” (i.e., the entire method of operating the franchised business, including the brand, marketing programs, operating procedures, etc.) granted to the franchisee (and which is the perceived value of joining the network and paying the fees) is valuable and distinctive and perhaps even “unique.” What if, aside from staff functions at the corporate level (i.e., accounting, legal, IT, etc.), franchise sales and field staff are combined for multiple brands? What if research and development and product development are combined? What if the products and services of the brands evolve to become identical? What if marketing strategies or even advertising funds are combined? Do any of these consolidations driven by a desire for cost efficiency violate the express or implied terms of the franchise agreements? Do these actions render the value and distinctiveness of the system less so? And if they do, are there any cognizable damages flowing from them?

A stark example may be the Checkers/Rally’s systems. Over the course of time after Checkers acquired Rally’s, Checkers incrementally combined significant aspects of its support systems, marketing programs, menu items, and trade dress to the point where, from the public’s perspective today, the restaurants operating under the two brands became identical except for their names. This may not ultimately matter at all for the Checkers and Rally’s systems, as each of the brands covers distinct geographic areas and there is little, if any, direct competition between Checkers units and Rally’s units. Nevertheless, this raises the question: what possible adverse effect could any of this have on the franchisees? The Checkers/Rally’s example may be unique and somewhat rare. However, franchisors that operate multiple franchise systems where units are in direct competition with each other need to be mindful of the extent to which they should maintain the distinctiveness of the respective networks as they consolidate functions to achieve efficiencies. Unlike issues relating to sales impacts (which are individual to each franchisee), these matters are systemic and much more susceptible to being challenged on a system-wide basis, even if the impact is speculative or variable with each franchisee.

6. Conclusion

The rapid development of information technology coupled with convergence in the retail sector has shifted consumer purchasing patterns. Franchisors must be able to adapt quickly or otherwise risk falling behind their competitors. These adaptations can cause stress within franchise systems and, if not properly anticipated in franchise agreements, may lead to legal liability or significant difficulty implementing changes without time-consuming and unpredictable consensus building within the franchise community. In the absence of strong

contractual rights, effective communication, and unity of purpose, chains that are franchised will remain less equipped to respond to shifting consumer patterns as compared to their vertically integrated counterparts.

Examining encroachment through the lens of traditional brick-and-mortar claims, e-commerce proliferation, and cross-brand competition will prove instructive for franchisors and franchisees, particularly as courts begin to navigate more novel aspects of these issues. Nevertheless, the central importance of the franchise agreement remains clear. The franchise agreement forms the heart and the roadmap for how encroachment issues have been and will continue to be adjudicated.