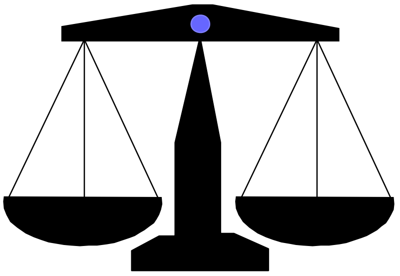

General Counsel Corner

By Peter H. Gunst, Esquire

Bringing Order Out of Chaos?
The Franchisor Encroachment Cases

One of the most confusing legal issues around today concerns the duty - if any - of a franchisor to refrain from competing unfairly with its own franchisee, where the parties' franchise agreement does not expressly give the franchisor *carte blanche* to poach on its franchisee's local marketing efforts. A brief history of some of the key court decisions shows how difficult it is to divine any definite rule.

In *Scheck v. Burger King Corp*, 756 F. Supp 543 (S.D. Fla. 1991), *on reconsideration,* 798 F. Supp. 692 (S. D. Fla. 1992), the court held that Burger King could be sued for opening a competing site just two miles away from its franchisee's location, despite the express representation in the parties' franchise that the franchisee did not possess an exclusive territory.

Citing *Scheck*, the Ninth Circuit held in *Vylene Enterprises, Inc. v. Naugles, Inc.*, 90 F.3rd 1472 (9th Cir. 1996), that a franchisor breached the implied covenant of good faith and fair dealing by opening a company-owned location less than two miles away from its financially troubled franchisee. As was true in *Scheck*, the franchise agreement at issue did not expressly permit the franchisor to encroach on its franchisee by opening a new competitive location.

In *Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp*, 139 F. 3rd 1396 (11th Cir. 1998), the Eleventh Circuit, although recognizing that *Scheck* had been criticized by later opinions, likewise held that a franchisor could not unfairly encroach upon its franchisee in the absence of express contract language providing the franchisor the discretion to do so.

But a later Eleventh Circuit decision, *Burger King Corp, v. Weaver*, 169 F.3rd 1310 (11th Cir. 1999), decided less than a year after *Camp Creek,* went the other way.

At issue in *Weaver* were encroachment claims involving two of the franchisee's locations, one governed by an agreement that was silent as to encroachment, and the second by an agreement that expressly granted the franchisor the right to open competitive locations. Surprisingly, the Eleventh Circuit held that the franchisee could not pursue an encroachment claim under *either* agreement, holding that the franchisee had no rights in the absence of an express contractual provision directly restricting the franchisor's ability to compete.

The issue raises many questions. Does the implied covenant of good faith and fair dealing limit the franchisor's freedom if the franchise agreement is silent as to encroachment? Is the implied covenant nothing more than a tool for contract interpretation, which possesses no independent vitality in the absence of an express contract provision? Is there any way to find a middle course to balance the rights and duties of franchisors and franchisees?

Two of the attorneys who litigated some of these cases, Jeffrey Selman and Robert Zarco, have recently submitted articles that attempt to answer these questions.

Mr. Selman, who was involved in the *Vylene Enterprises* litigation, would draw a line in the sand by imposing upon franchisors a "business judgment rule" analogous to the standard applicable to corporate directors. Under his analysis, a franchisor would be entitled to a presumption that it had acted in good faith. But the franchisee could attempt to prove that the franchisor had acted – not for the good of the entire franchise system – but narrowly in its own wrongful self-interest.

The problem with this analysis is that it attempts to impose what is essentially a two-party rule on a three-party relationship.

Under the standard application of the business judgment rule, the corporate director owes a single, indivisible duty to the corporation and its shareholders. There is no divergence of duty because the interest of the corporation is, by definition, that of the shareholders.

The franchise relationship is more complex. The franchisor and its decision makers must consider not only the well-being of the franchise system as a whole, but also the duty owed by the franchisor to its own shareholders.

If the franchisor can increase its internal profits to the advantage of its shareholders, but to the detriment of certain of its franchisees, how is its conduct to be measured? Are the courts equipped to balance out the franchisor's "loyalty" to its shareholders against its separate "loyalty" to the interests of the elements that comprise its overall franchise system?

Mr. Zarco, who was involved in the *Scheck* litigation, is less confident of his ability to find a satisfactory middle ground. He emphasizes that the result of any given case is dependent upon the analytical framework applied by the decision maker.

If the judge analogizes the franchise relationship to that of an at-will employment or supply relationship, he or she is unlikely to recognize an implied remedy for the franchisee. Conversely, a judge who analogizes the franchise relationship to a sort of loose business "partnership" is far more likely to impose an implied term of commercial reasonableness on the franchisor.

Mr. Zarco quotes language written over a century ago by Justice Oliver Wendell Holmes to explain why it is so difficult to find consensus in these cases:

> You can always imply a condition in a contract. But why do you imply it? It is because of some belief as to the practice of the community or of a class, or because of some opinion as to policy, or, in short, because of some attitude of yours upon a matter not capable of exact quantitative measurement,

> and therefore not capable of founding exact logical conclusions. Such matters really are battle grounds where the means do not exist for determinations that shall be good for all time, and where the decision can do no more than embody the preference of a given body in a given time and place.

The uncertainty about which Justice Holmes speaks may be disappointing, but likely is all that can be expected in uncertain world.

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