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Franchisee Relationship

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A Corporate Governance Perspective on the Franchisor-Franchisee Relationship⁺

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ABSTRACT

The franchisor-franchisee relationship is unique in that it has characteristics of both an arm's length business transaction as well as an ongoing business relationship. As time goes by, however, the interests of the parties may diverge. It is in the franchisees' interest to make their individual units as profitable as possible while, conversely, franchisors also profit from the licensing of the trademark and the collection of royalties from all their franchisees. For example, an increase in the number of stores in a given market will likely benefit the franchisor, whereas the same expansion may dilute the profitability of a particular franchisee through encroachment. The parties' interests, thus, become misaligned.

We argue that that, in addition to increased disclosure under Federal Trade Commission (FTC) rules, the misalignments in the franchisor-franchisee relationship can be addressed by taking a more self-regulatory approach that recasts the duties owed among the parties. The FTC regulations focus on greater disclosure and as government regulations the rules are aimed at external incentives and protecting of the party that is perceived as having less leverage and (i.e., the franchisee). We argue for a more fiduciary duty-like relationship for franchisor-franchisee relationship and look at two somewhat related ways that the relationship is "self-regulated" by the market and, thus, the parties. We first examine the time-tested mechanism of fiduciary duties imposed by the courts as an additional balancing mechanism to supplement the mere disclosure under the FTC. Second, we examine the equitable standards applied to restrictive covenants, such as non-compete agreements and non-disclosure (confidentiality) agreements as a further reference point for how the common law can provide guidance on the boundaries of the franchisor-franchisee relationship. We conclude that this mix of court intervention to impose fiduciary duties and the existing FTC regulation is sensible because the parties are in a relatively long-term, well-defined relationship in which the initial disclosure under the FTC rules is insufficient.

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Introduction

The franchisor-franchisee relationship is unique in that it has characteristics of both an arm's length business transaction as well as an ongoing business relationship. At the beginning of the typical franchise relationship, the interests of the franchisor and the franchisee are aligned.¹ Both franchisor and franchisee are interested in entering new markets and increasing profits together in a coordinated effort.² As time goes by and as circumstances change, however, the interests of the parties may diverge. It is in the franchisee's interest to make its individual unit as profitable as possible while the franchisor also profits from the licensing of the trademark and the collection of royalties from all of its franchisees.³ For example, an increase in the number of stores in a given market—or perhaps more online sales—will likely benefit the franchisor, whereas the same expansion may dilute the profitability of a particular franchisee.⁴ The parties' interests thus become misaligned.⁵

In part to address this perceived misalignment, the Federal Trade Commission (FTC) promulgated the Amended FTC Rule of 2007 to further formalize a set of required

¹ See Robert W. Emerson, *Franchise Encroachment*, 47 AM. BUS. L.J. 191, 201-02 (2010) (“When a franchised business is in the early stages of development, the interests of franchisor and franchisee are well aligned; both seek to enter new markets and benefit from a share of the profits. As the markets mature, however, the interests of franchisors and franchisees may begin to diverge.”).

² *Id.*

³ *Id.* There are several reasons why the franchisor and franchisee's interests may start to diverge as the relationship moves forward after the agreement is struck:

Franchisors gain the capital needed to open more of their own stores or to sell to new franchisees in the most profitable markets. Moreover, franchisors may decide that they no longer need the franchisees and thus attempt to convert stores to corporate control. The idea is that a maturing business finds it easier to acquire the resources it needs to expand and therefore will, over time, seek to buy back franchised units and grow by creating company-owned units. Thus arises the issue of alleged market incursion and supposed cannibalization of the franchisees' sales, a predicament starting in the 1970s and growing increasingly prominent in recent years.

Id. (citations omitted).

⁴ *Id.* at 204-05. The antipathy the parties can feel over territorial encroachment can be mutual, for instance:

When a market reaches the saturation point, the two goals begin to conflict, with franchisors making money—a percentage of gross franchise revenue—regardless of how profitable the individual franchise was. Just as franchisees feel wronged by franchisor expansion that could reduce the sales at existing units, franchisors often battle proposed legislation that they contend unfairly expands franchisee rights and restricts franchisor conduct. The differences are exacerbated when franchisors do not see saturated markets but eye territories with growing populations and, in some instances, franchisees who even sell competing products.

Id.

⁵ This observation is consistent with the notion that franchise contracts are a prime example of incomplete contracts, where issues often arise that are unforeseeable at the time the contract is executed. See generally Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927 (1990).

material disclosures from the franchisor, including a prominent warning about the lack of territorial exclusivity, if applicable. Seemingly the FTC's goal was to use increased disclosure as a tool for greater fairness by leveling the information playing field so that prospective franchisees could know more about the relationship.⁶ The disclosures, however, are aimed at the arm's length nature of the initial decision to form a relationship by contract and fail to provide guidelines for the ongoing relationship.⁷ This failure to address the ongoing, post-sale relationship is not an oversight but a conscious choice by the FTC in promulgating the new rule.⁸

In contrast, corporate law has found ways to address the potential misalignment of corporate actors with the interests of the firm by establishing duties between the parties, via fiduciary duties to the business entity. The separation of ownership from control in the public corporation provides the opportunity for managers to act in their own self-interest to the detriment of the firm. This is sometimes called the agency problem.⁹ The common law developed throughout the years to impose fiduciary obligations on the di-

⁶ Moreover, there are costs and benefits associated with any of regulatory interventions in the franchisor-franchisee relationship. See Francine LaFontaine & Roger D. Blair, *The Evolution of Franchising and Franchise Contracts: Evidence from the United States*, 3 ENTREPRENEURIAL BUS. L.J. 381, 434 (2009) (“[It is] difficult to develop appropriate regulatory regimes to address franchisor-franchisee conflict [A] description of these relationships will permit a better assessment of the likely cost and benefit of different types of regulatory interventions across all the different types of industries where franchising exists, or in the future, may be used.”).

⁷ See Keith Girard, *Franchising Still Fraught With Pitfalls Despite New F.T.C. Rule*, N.Y. TIMES (Nov. 9, 2007), <http://www.nytimes.com/allbusiness/09girard.html?ref=smallbusiness> (“The FTC also chose to concentrate its enforcement efforts on pre-sale franchise disclosure issues, when most of the problems encountered by franchisees occur post-sale, according to Susan P. Kezios, president of the American Franchise Association, a Chicago-based group that solely represents franchisees.”).

⁸ The FTC's comments in support of the final rule makes clear that, despite calls from some franchisee advocates to regulate the post-agreement relationship, the FTC did not do so under a justification that there was an insufficient record of Unfair Acts or Practices within the FTC's mandate. Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, 72 Fed. Reg. 15444 (Mar. 30, 2007) (to be codified at 16 C.F.R. pt. 436-37).

Specifically, the FTC found that the comments on the proposed rule included “many franchisees and their advocates” who:

criticized the [proposed Amended] Rule for not going far enough [and] urged the Commission to address in this rulemaking a variety of post-sale franchise contract or “relationship” issues, including prohibiting or limiting the use of post-contract covenants not to compete, encroachment of franchisees' market territory, and restrictions on the sources of products or services. Indeed, some franchisees asserted that if the Rule cannot address post-sale relationship issues, then the Commission should abolish the Rule.

Id. at 15447.

⁹ See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (articulating an economist's view of agency costs and the opportunist managers' rent seeking at the expense of shareholders' financial interests). But see generally LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC* (2012) (asserting that the agency cost problem is wrongly the focus of corporate governance efforts and driven by a myth of shareholder dominance in firm hierarchies as a legal mandate).

rectors and officers of the firm to counter the potential misalignment of interests and alleviate the harm of potential moral hazards that put managerial interests above those of the firm. These include the duties of care and loyalty, the obligation of good faith, and the duty of candor.¹⁰

In this Article, we examine the franchisor-franchisee relationship and highlight potential lessons that may be learned from a comparison with corporate governance principles. Ideally, the franchisor-franchisee relationship should be based upon open communication and collaboration.¹¹ Both the franchisee and the franchisor must be willing to communicate openly and believe there is a degree of equity in the relationship.¹² Perhaps duties analogous to those imposed in the realm of corporate law may facilitate development of legal principles, which could support the relationship beyond mere disclosure.

Further, we argue that in addition to increased disclosure under the Amended Rule, the misalignments in the franchisor-franchisee relationship can be addressed by taking a more self-regulatory approach that recasts the duties owed among the parties. The FTC regulations focus on greater disclosure and, as government regulations, are aimed at external incentives and protecting the party that is perceived as having less leverage and expertise (i.e., the franchisee). In arguing for a more fiduciary duty-like relationship for the franchisor-franchisee relationship, we look at two somewhat related ways that the relationship is “self-regulated” by the market and, thus, by the parties.

In addition, we examine the equitable standards applied to restrictive covenants, specifically non-compete agreements, as a further reference point for how the common law can provide guidance on the boundaries of the franchisor-franchisee relationship. We conclude that a mix of court intervention to impose fiduciary duties and the existing FTC regulations is sensible because the parties are in a relatively long-term, well-defined relationship in which the initial disclosure under the FTC rules is insufficient.

I. The Misalignment Problem: The FTC Approach to Encroachment

To begin, we first look at the main misalignment in the franchise relationship: encroachment.¹³ Essentially, encroachment is “the phenomena where the franchisor has authorized a new franchise or established a company-owned unit within an existing franchisee’s market area.”¹⁴ Professor Robert Emerson describes encroachment as a perenni-

¹⁰ See, e.g., CHRISTOPHER M. FORRESTER & CELESTE S. FERBER, *FIDUCIARY DUTIES AND OTHER RESPONSIBILITIES OF CORPORATE DIRECTORS AND OFFICERS* 10 (5th ed. 2012).

¹¹ David Meretta & Eric Karp, *Regulation FD: Roadmap to Better Relations Between Franchisors and Franchisees*, 26 *FRANCHISE L.J.* 117, 117 (2007).

¹² *Id.*

¹³ See, e.g., Emerson, *supra* note 1.

¹⁴ *Id.* at 193. While territorial encroachment is the principle encroachment issue and the focus here, other forms of encroachment, including product or service encroachment and trademark encroachment, also exist. William Slater Vincent, *Encroachment: Legal Restrictions on Retail Franchise Expansion*, 13 *J. BUS. VENTURING* 29, 30 (1998).

al issue for franchisees that “remains in particular for numerous franchised systems as a whole, *the* issue most in need of a just resolution.”¹⁵ Classically, encroachment arises when, post-contract, the franchisor, either directly or through a new franchisee, sets up business in the same geographic territory as another franchisee, resulting in competition between the two franchisees to the harm of the earlier franchisee (so-called cannibalization or market incursions).¹⁶ Growing concerns include nontraditional encroachment¹⁷ and software and internet sales,¹⁸ which are part of the impetus for the FTC’s final Amended Rule and push for greater pre-sale disclosure.

At the heart of the encroachment issue are the seemingly conflicting interests between the franchisor and franchisee. The overarching aim for a franchisor is “to maximize market penetration” in order to increase awareness of its brand, maximize its revenue base, increase operations, and maximize market saturation in a particular region.¹⁹ Thus, a franchisor has a legitimate business interest in expansion, which will often include the need for additional production within particular geographic areas.²⁰ A franchisee, meanwhile, has a legitimate business interest operating in a particular geographic area without competition and will thus have concerns if a franchisor attempts to encroach within its territory.²¹ This expansion by a franchisor may have a negative impact on a particular franchisee, even though it benefits the franchise as a whole.²² Franchisor encroachment could negatively impact the bottom line of a particular franchisee, reducing sales and profitability.²³

When a franchisee asserts a legal claim of encroachment by a franchisor, the most common legal theory advanced by the franchisee is breach of the implied covenant of good faith.²⁴ The implied covenant of good faith holds that there is an implied covenant in every contract that neither party will do anything to destroy or injure the right of the other party to receive the fruits of the contract.²⁵ This definition has been expanded by the courts over the years, such that the implied covenant of good faith now prohibits one party from taking advantage of gaps or ambiguities in a contract to the detriment of

¹⁵ Emerson, *supra* note 1, at 193-94 (emphasis in original).

¹⁶ *Id.* at 236-37 (noting that territorial clause interpretation has been difficult for courts and that “contractual” ambiguities have led to many courts interpreting differing versions “of an implied covenant of good faith and fair dealing”).

¹⁷ *Id.* at 214-20.

¹⁸ *Id.* at 223-28.

¹⁹ Ronald R. Fieldstone, *Franchise Encroachment Law*, 17 *FRANCHISE L.J.* 75, 75 (1998).

²⁰ *Id.*

²¹ *Id.* 75-76.

²² *Id.*

²³ *Id.* at 76.

²⁴ Vincent, *supra* note 14, at 31.

²⁵ *Id.* (citing *Kirke La Shelle Co. v. Paul Armstrong Co.*, 188 N.E. 163, 167 (N.Y. 1933)); see also Frank J. Cavico, *The Covenant of Good Faith and Fair Dealing in the Franchise Business Relationship*, 6 *BARRY L. REV.* 61 (2006).

the other.²⁶ In addition, in the United States, the imposition of good faith is enshrined in the Uniform Commercial Code.²⁷

Yet, although the implied covenant of good faith can work to protect a vulnerable party when contractual terms are ambiguous, its scope is limited in the franchise context. Generally, for franchise encroachment issues, the contractual language in the franchise agreement governs.²⁸ Thus, although the implied covenant of good faith “protects the reasonable expectations of parties involved in a contractual relationship,” its scope is limited because the contractual language of the franchise agreement or other agreements made by the parties always supersedes it.²⁹ Consequently, the covenant of good faith will not override the express contractual terms of the franchise agreement, and franchisors are free to incorporate contractual terms that, in their absence, would violate the covenant of good faith.³⁰ For example, in *Chang v. McDonald’s Corp.* the court found that the franchisor did not breach the franchise agreement by opening new units within four miles of the franchisee’s unit because the agreement expressly precluded the franchisee from exclusivity or territorial rights.³¹ Furthermore, due to this express and unambiguous contractual language, there could be no violation of the implied covenant of good faith.³²

If, however, the contractual terms in a franchise agreement surrounding the franchisor’s ability to locate new franchises are vague, the implied covenant of good faith is given greater weight and the reasonableness of the franchisor’s actions are considered.³³ The rub is deciding what is considered vague or ambiguous language—an interpretation that has caused seemingly inconsistent results across cases. A problem also arises when

²⁶ Cavico, *supra*. 64-5 quoting *Kirke LaShelle Co. v. Paul Armstrong Co.*, 263 NY 79, 87 (N.Y. 1933)(“...the covenant [of good faith and fair dealing] means that neither party to the agreement ‘...shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.’”); *see also* *Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d. 273, 280 (7th Cir. 1992); *James v. Whirlpool Corp.*, 806 F. Supp. 835, 843 (E.D Mo. 1992).

²⁷ *See, e.g.*, Andrew Terry & Cary Di Lernia, *Franchising and the Quest for the Holy Grail: Good Faith or Good Intentions?*, 33 MELB. U. L. REV. 542, 543 (2009) (quoting U.C.C. §1-304 [(year)] on good faith in covered contracts). As Terry and De Lernia point out, “Despite its long heritage in the US, the scope of the implied covenant of good faith remains elusive.” *Id.* at 556.

²⁸ Fieldstone, *supra* note 19, at 75.

²⁹ *Id.* at 76; Vincent, *supra* note 14, at 31.

³⁰ *Id.*

³¹ Vincent, *supra* note 14, at 32 (citing *Chang v. McDonald’s Corp.*, C.A. No. 95-16012, 1996 U.S. App. LEXIS 33288 (9th Cir. Dec. 19, 1996)).

³² *But see* *Scheck v. Burger King Corp.*, 756 F. Supp. 543, 549 (S.D. Fla. 1991) (finding that a franchisor did not have a right to place other units in the area surrounding the franchisee unless the right was expressly retained in the contract).

³³ *Id.*; *see, also*, *Photovest v. Format Corp.*, 606 F.2d 704, 728 (7th Cir. 1979). In this case the court found that, in a franchisee agreement that failed to provide the franchisee with an exclusive territory and did not expressly allow the franchisor to locate new units at any location nears a franchisee, a franchisor breached the implied covenant of good faith when it encroached on a franchisee’s location because the franchisor had represented, prior to executing the agreement, that the franchisee would be free from encroachment in a two mile radius, the encroachment would preclude profitable operation of the franchisee, and the franchisor was attempting to coerce the franchisee to terminate the franchise agreement. *Id.*

the contractual language is silent on a particular issue. For example, in *Scheck v. Burger King Corp.*, a franchise agreement expressly denied the franchisee “any area, market, or territorial rights”, but did not expressly grant the franchisor unrestrained discretion in opening new units.³⁴ Rather than finding that this express language allowed the franchisor to open additional units near the franchisee, like the court found in *Chang*, the *Scheck* court found that the rights granted to Burger King were vague because the franchise agreement did not expressly allow Burger King unrestrained expansion.³⁵ As such, the court applied the implied covenant of good faith and denied summary judgment for the franchisor, reasoning that the franchisee expected that the franchisor would not “act to destroy the right of the franchisee to enjoy the fruits of the contract.”³⁶ Although *Scheck* has been criticized and rejected by many courts, the circuits are split on recognizing its validity.³⁷ Thus, because the focus is on the specific contractual language and there is no uniform guidance as to the interpretation of the contractual language, case law on the issue has been inconsistent and case specific³⁸ or varied by state.³⁹ There are “substantial gaps” regarding when contractual silence should implicate the implied covenant of good faith.⁴⁰

Rather than address the issue of good faith, however, the Amended Rule is aimed, in part, at addressing the encroachment issue through increased disclosure related to the start of the franchisor-franchisee relationship at the time the franchise agreement is signed. This rule is addressed below.

A. Franchise Disclosure Requirements

The FTC passed the Amended Rule on January 22, 2007.⁴¹ The Amended Rule increases the material disclosures that franchisors must make to potential franchisees prior to the start of any contractual relationship.

³⁴ *Scheck*, 756 F. Supp. at 549.

³⁵ *Id.*

³⁶ *Id.* The court also noted that the franchisor could have been granted summary judgment if the agreement expressly reserved in the franchisor the right to unrestrained expansion. *Id.*; see also Emerson, *supra* note 1.

³⁷ Robert Zarco & Lawrence Ashe, *The Sounds of Silence in the Franchise Agreement*, 19 FRANCHISE L.J. 1, 25 (1999).

³⁸ Susan Grueneberg & Jonathan Solish, *Franchising 101*, 19 BUS. L. TODAY 11, 14 (2010).

³⁹ For example, some states impose an implied covenant of good faith on many contracts. See, e.g., *Northwest, Inc. v. Ginsberg*, 134 S. Ct. 1422, 1432 (2014) (Minnesota’s imposition of the implied covenant of good faith in an airline frequent flier rewards program was preempted by federal law.).

⁴⁰ Zarco & Ashe, *supra* note 37.

⁴¹ 16 C.F.R. §§ 436.1-11 (2014); see also Kevin J. Moran & Max Schott, II, *The Amended FTC Franchise Rule: Much Ado About Nothing?*, 10 FRANCHISE LAW. 3, 3 (2007). The franchisors could choose to comply with the Amended Rule on July 1, 2007 but were required to have come under compliance by July 1, 2008. *Id.*

In particular, the FTC's Amended Rule requires material disclosures in five categories:

- (1) the nature of the franchisor and the franchise system;
- (2) the franchisor's financial viability;
- (3) the costs involved in purchasing and operating a franchised outlet;
- (4) the terms and conditions that govern the franchise relationship; and
- (5) the names and addresses of current franchisees, who can share their experiences within the franchise system.⁴²

The Amended Rule covers retail franchises, product/package franchises, and franchises granted to wholesalers and to manufacturers.⁴³ The nature of the relationship is analyzed when determining whether this franchise rule applies. The relevant consideration is not how the parties characterize the relationship but how the relationship operates.⁴⁴ In addition, the Amended Rule focuses solely on franchise sales. This is a change from the original Rule, which also encompassed business opportunity ventures.⁴⁵ Furthermore, compliance with the Uniform Franchise Offering Circular (UFOC) guidelines under state law is no longer sufficient for compliance with the Amended Rule.⁴⁶ Prior to the adoption of the Amended Rule, the UFOC guidelines had effectively been the national franchise disclosure standard.⁴⁷

B. Major Reforms Under the Amended Rule

There are a number of major reforms that were promulgated under the Amended Rule. Some of the major revisions include:

1. Usage of E-Disclosure: Franchisors have the option of providing the disclosure document in hard copy or electronically, including through e-mail or via a web-based download.⁴⁸ However, the franchisor has the duty to advise the franchisee of the different formats that are available to it, and the fran-

⁴² *The Franchise Rule: Hearing Before the Subcomm. on Commerce, Trade, & Consumer Prot. of the H. Comm. on Energy & Commerce*, 107th Cong. 8-9 (2002) (statement of J. Howard Beasley, Director, FTC Bureau of Consumer Protection) [hereinafter *The Franchise Rule*].

⁴³ HAROLD BROWN ET AL., *FRANCHISING: REALITIES AND REMEDIES* § 6.04 (2d. ed. 2012).

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, 71 Fed. Reg. 15444 (Mar. 30, 2007) (to be codified at 16 C.F.R. pt. 436-37).

⁴⁸ *FTC Franchise Rule Summary*, INT'L FRANCHISE ASS'N, http://www.franchise.org/uploadedFiles/Franchise_Industry/Government_Relations/Intl_Fed_State_Issues/FTC%20Franchise%20Rule%20Memo%200207.pdf {last visited May 22, 2014}.

chisee must have the ability to store and print the version that the franchisor provides.

2. Eliminates the First Personal Meeting Rule: The previous FTC rule required a personal first meeting, at which, a franchisor (or its agent) was required to provide a Disclosure Document to the potential franchisee.⁴⁹
3. Final Agreement Delivery Rule: The previous "five business day" requirement under the old FTC rule has been eliminated in the amended version. Under the old FTC rule, the franchisor and the broker were required to provide prospective franchisees with a copy of the final franchise and related agreements at least five business days before the date of execution of the agreement.⁵⁰ Under the Amended Rule, the agreement form that is attached to the disclosure document serves as the final delivered agreement. If the franchisor chooses to make unilateral changes to the agreement, then it must deliver this final edited version to the franchisee seven days prior to signing.⁵¹
4. Franchisor-initiated Litigation: Under the original Rule, only claims or counterclaims by franchisees had to be disclosed. Now, in addition, franchisor-initiated litigation against franchisees must be disclosed. "The FTC allows summary disclosure of such litigation arising in the prior year and mandates updating of such disclosures only on an annual basis rather than quarterly."⁵²
5. Disclosure of Technology: "Franchisors may provide summary disclosure about computers and technology requirements rather than the detailed disclosure required under the UFOC."⁵³
6. Limited Parent Company Disclosures: Parent company disclosures have been significantly reduced from the original Rule drafts. The parent must be identified in Item 1 and any bankruptcy information must be disclosed in Item 4. Otherwise, parent disclosures are required if the parent guarantees the performance of the franchisor or undertakes to provide post-sale services.⁵⁴
7. Required Disclosures of Franchisor: Item 12 mandates that "[i]f the franchisor does not provide any protected territory, the disclosure document must contain a warning legend about the franchisee's lack of exclusivity and the possibility of competition from other channels of distribution."⁵⁵ "The dis-

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ Item 12 of the FTC Rule concerning territorial exclusivity now goes as far as providing disclosure language related to a lack of exclusivity, as follows: "You will not receive an exclusive territory. You

closure document must contain a description of the franchisor's renewal policy and whether renewal entails a requirement that the franchisee execute a new, and possibly different, franchise agreement."⁵⁶ "The new disclosure document mandates a fully reconciled tabular summary of the inflow and outflow of franchised and company-owned outlets over the course of each year. It also establishes a separate table for transfers, which ultimately do not affect the total number of operating outlets."⁵⁷

Notably, these rules provide the *minimum* disclosure requirements. States can choose to implement more stringent regulations regarding required disclosures between franchisees and franchisors.⁵⁸ The Amended Rule, however, is not without its detractors. The next Section addresses these critiques.

C. Critiques of the Amended Rule

The Amended Rule has been criticized as "much ado about nothing."⁵⁹ Critics find that the Amended Rule does nothing to expand the original FTC Rule promulgated in 1978⁶⁰ and provides no significant impact on American franchise law. The Amended Rule focuses on providing material disclosures prior to the entering into of a franchising contract, rather than imposing any additional federal oversight into the process.⁶¹ There is also no indication of movement toward a direct governance system over the entirety of the relationship between franchisor and franchisee.⁶²

Furthermore, the Amended Rule does not address the substance of the relationship between franchisors and franchisees. The FTC apparently presumes that as long as potential franchisees are provided with full and complete disclosure regarding material information, the market will naturally take care of the rest.⁶³ Yet, the franchise relationship may remain inherently unfair with the franchisor retaining the ability to dictate the terms upon which the franchisee is allowed to conduct business.⁶⁴

may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control." See FTC, COMPLIANCE GUIDE FOR FRANCHISE RULE 16 C.F.R. PART 436, at 73 (2008).

⁵⁶ *FTC Franchise Rule Summary*, *supra* note 48.

⁵⁷ *Id.*

⁵³ Moran & Schott, *supra* note 41.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ See generally *The Franchise Rule*, *supra* note 42.

⁶⁴ See BUREAU OF CONSUMER PROT., DISCLOSURE REQUIREMENTS AND PROHIBITIONS CONCERNING FRANCHISING: STAFF REPORT TO THE FEDERAL TRADE COMMISSION AND PROPOSED REVISED TRADE REGULATION RULE 42 (2004).

Moreover, as noted by Professor Emerson, the Amended Rule does nothing to address the lack of *incentives* for the franchisor to put much effort into the ongoing relationship.⁶⁵ Similarly, Professors LaFontaine and Shaw found that “with a franchisee, the franchisor benefits from the dedication and drive of an individual who is building a business for himself. And this motivation and drive of the individual franchisee, as compared to the typical company manager, is a main reason why franchisors use franchising to begin with.”⁶⁶

Thus, the state of affairs with respect to franchise encroachment is one where the FTC’s Amended Rule focuses on increased disclosure as a way of informing a long-term contractual relationship that, in the best case, should lead to collaboration for the mutual financial benefit of both parties. The FTC, however, implicitly abdicates the responsibility to improve the often-fraught post-sale relationship of the parties that forms the bulk of the time during which the parties are bound to cooperate for their financial benefit.

As noted above, corporate governance and restrictive covenants legal concepts and approaches may provide insights for courts and state legislatures intent on curbing encroachment abuse and promoting alignment among the parties to a franchise agreement. Part II provides an overview of the fiduciary duties imposed by the corporate law to address the potential misalignment resulting from the separation of ownership from control of firms, followed, in Part III, by an analysis of the ways in which the law of restrictive covenants may be instructive in addressing the shortcomings of franchise law.

II. Corporate Law Fiduciary Duties: An Overview

An often-discussed misalignment of several parties’ interests in the corporate law context arises when the interests of managers and owners (i.e., shareholders) diverge. Throughout the modern history of corporate law, courts and legislatures have imposed fiduciary duties on the directors and officers of the firm as a way to address this problem.⁶⁷ The corporate law fiduciary duties may provide a starting point for envisioning the franchisor-franchisee relationship as a relationship that could be governed by similar duties, instead of simply by the bounds of contract law.⁶⁸

⁶⁵ See Emerson, *supra* note 1.

⁶⁶ Roger Blair & Francine LaFontaine, *Understanding the Economics of Franchising and the Laws that Regulate It*, 26 FRANCHISE L.J. 55, 62 (2007). Potential solutions have been put forth to deal with the moral hazard issue. Some have included avoiding passing strict legislation governing encroachment and the potential losses that occur with this, having regular audits to determine any losses from encroachments, and/or employing a “facts and circumstances” test. See Emerson, *supra* note 1, at 257.

⁶⁷ See, e.g., *Arnold v. Soc’y Bancorp*, 678 A.2d 533, 539 (Del. 1996) (“Fiduciary duties are owed by the directors and officers to the corporation and its stockholders.”).

⁶⁸ The common law of fiduciary duties has had a difficult time taking root in the courts, in part because of the language inserted into agreements, where “most franchise contracts stipulate that the parties have ‘no special relationship’ and are ‘dealing at arm’s length,’ and such clauses have helped to persuade

Simultaneously with the focus on increased disclosure at the point of the sale with a formal Franchise Disclosure Document, some prominent franchise law practitioners have also begun calling for more fiduciary-like treatment of the franchisor-franchisee relationship.⁶⁹ Specifically, these advocates argue for the courts to impose more good faith and fair dealing duties.⁷⁰

The most basic and essential of the fiduciary duties are the duties of care and loyalty.⁷¹ Fiduciary duties also include the obligation to act in good faith and the duty of candor. The Delaware courts consider the duty of good faith and fair dealing as a subset of the duty of loyalty.⁷² For our purposes, we will consider the duties owed by corporate directors and officers: the duties of care and loyalty, as well as the obligation of good faith and the duty of candor, embodied within that duty of loyalty.

Pursuant to the duty of care, directors and officers must, when making any decision on behalf of the firm, act as reasonably prudent persons in their positions would act.⁷³ This standard imposes the obligation of directors and officers to be fully informed and to carefully deliberate when making decisions.⁷⁴ In determining whether the standard is met, courts look to whether the directors or officers fully informed themselves of

some courts that there was no fiduciary relationship.” Robert W. Emerson, *Franchising and the Parol Evidence Rule*, 50 AM. BUS. L.J. 659, 678 (2013).

⁶⁹ See Janet Sparks, *ABA Legal Wizard Abrams Asks for Good Faith in Franchise Law Reform*, BLUE MAU MAU (Jan. 3, 2014), http://www.blumaumau.org/13438/aba_legal_wizard_abrams_asks_good_faith_franchise_law_reform (discussing comments from the former head of the ABA Franchise Law divisions calling for more court imposition of good faith and fair dealing duties, as well as a private right of action, to obviate contractual overreaching by franchisors).

⁷⁰ *Id.* Other suggested approaches to addressing the encroachment problem come from enacting anti-encroachment legislation at the state level or treating franchisees as employees. Emerson, *supra* note 1, at 281-89. Legislation addressing encroachment often sputters in state houses in part due to franchisor resistance to regulation but could be useful as a way to “introduce greater certainty to the law of encroachment, legislation could be a distinct improvement.” *Id.* at 256.

⁷¹ See, e.g., *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 264 (2d. Cir. 1984) (“A board member’s obligation to a corporation and its shareholders has two prongs, generally characterized as the duty of care and the duty of loyalty.”); Official Comm. of Unsecured Creditors of Verestar, Inc. v. Am. Tower Corp. (*In re Verestar, Inc.*), 343 B.R. 444, 472 (Bankr. S.D.N.Y. 2006) (“The fiduciary duties of directors ordinarily include the duty of care and the duty of loyalty.”).

⁷² See *Stone v. Ritter*, 911 A.2d 362, 370-71 (Del. 2006) (“...although good faith may be described colloquially as part of a “triad” of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.”) See also. *In re Verestar*, 343 B.R. at 472 (“The failure to act in good faith may result in liability because the requirement to act in good faith “is a subsidiary element . . . of the fundamental duty of loyalty.”).

⁷³ See, e.g., *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005) (“The fiduciary duty of due care requires that directors of a Delaware corporation ‘use that amount of care which ordinarily careful and prudent men would use in similar circumstances’ . . .”).

⁷⁴ See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) (finding that, in the context of mergers, the duty of care included the duty “to act in an informed and deliberate manner . . .”).

all reasonably available, material information relating to the decision.⁷⁵ A firm's directors or officers must consider both procedural issues (i.e., the completeness of the information, the time taken to review the information, and the opportunity to consult with experts about the information) and substantive issues (i.e., whether the decisions made are consistent with expert advice and are reasonable given the circumstances and alternatives).⁷⁶

Pursuant to the duty of loyalty, directors and officers must act in the best interests of the corporation when making corporate decisions.⁷⁷ Although the duty of loyalty is not breached when a director or officer profits from a decision that also profits the corporation, it requires that directors and officers, when evaluating such decisions, put the corporation's interests above their personal interests.⁷⁸ Thus, although directors and officers do not need to be completely disinterested decision makers, the duty of loyalty is breached when directors divert corporate opportunities, assets, or information away from the corporation for their own personal gain.⁷⁹ Additionally, included in the duty of loyalty is the corporate opportunity doctrine, under which a director must make a business opportunity that is related to the corporation's business available to the corporation before pursuing it for herself.⁸⁰

The duty of good faith is also an element of the duty of loyalty.⁸¹ To act in good faith, directors and officers must "act in the best interests of the corporation and its stockholders at all times."⁸² A director fails to act in good faith, then, when she does not act in the best interests of the corporation and its shareholders.⁸³ A director who violates good faith also violates the duty of loyalty because "bad faith conduct . . . would seem to be other than loyal conduct."⁸⁴

In theory, a fairness review should be applied to every alleged breach of a fiduciary duty. This requirement was set forth in *Cede & Co. v. Technicolor, Inc.*,⁸⁵ where the court found that all types of breach of fiduciary duty claims were subject to a fairness re-

⁷⁵ DLA PIPER LLP, OVERVIEW OF FIDUCIARY DUTIES OF MEMBERS OF BOARDS OF DIRECTORS OF PRIVATE CORPORATIONS, INCLUDING DESIGNEES EMPLOYED BY CORPORATE INVESTORS 1-3 (2008), available at http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=366&Itemid=93.

⁷⁶ *Id.*

⁷⁷ See, e.g., *In re Walt Disney*, 907 A.2d at 750-51 (recognizing that the duty of loyalty prohibits corporate officers and directors from using their position to further their private interests).

⁷⁸ See, e.g., FORRESTER & FERBER, *supra* note 10, at 21.

⁷⁹ See Dana M. Muir & Cindy A. Schipani, *The Challenge of Company Stock Transactions for Directors' Duties of Loyalty*, 43 HARV. J. ON LEGIS. 437, 444-57 (2006) (explaining an executive's duty of loyalty to their employer).

⁸⁰ *Id.*

⁸¹ See *supra*, 911 A.2d at 370 ("[T]he obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.").

⁸² FORRESTER & FERBER, *supra* note 10, at 36.

⁸³ *Id.*

⁸⁴ *In re ML/EQ Real Estate P'ship Litig.*, C.A. No. 15741, 1999 Del. Ch. LEXIS 238, at *15 n.20 (Dec. 20, 1999).

⁸⁵ 684 A.2d 289 (Del. 1996).

view.⁸⁶ Yet, the fairness review is typically utilized solely for duty of loyalty cases and only those which “rise to the level of self-dealing.”⁸⁷ Courts allow directors to engage in conflicted interest transactions if these transactions are pre-approved either by fully informed directors or shareholders, or if the transactions are later approved by courts.⁸⁸ When a transaction has been approved by a fully informed shareholder vote or directors’ approval, it is typically found to not rise to the level of a conflicted transaction.⁸⁹ Most states have adopted a safe harbor statute for self-dealing transactions, which effectively shields self-interested transactions from later claims of breach of fiduciary duty of loyalty when there is disinterested-director or shareholder approval after full disclosure.⁹⁰ The courts will conduct a fairness review, however, if the transaction lacks approval.⁹¹

The fairness review consists of two basic themes: fair dealing and fair price.⁹² When courts evaluate whether a transaction can be categorized as involving fair dealing, the courts look to the timing of the transaction, how it was initiated, negotiated, and organized, and the process for approval of both shareholders and directors.⁹³ The fair price review considers the relevant factors that could potentially affect the value of a company’s stock.⁹⁴ Both fair dealing and fair price are evaluated in conjunction, in order to determine whether the transaction was in fact fair.⁹⁵ This type of fairness evaluation is done on a case-by-case basis, weighing the various factors relevant to each individual transaction. If the directors demonstrate the fairness of the transaction, the courts will typically not find a breach of fiduciary duty.⁹⁶

Finally, the duty of candor, as a subset of the duty of loyalty, requires that directors and officers disclose all known, material information to the board that relates to a board decision and the board’s decision-making process.⁹⁷ Any disclosure of information

⁸⁶ Julian Velasco, *How many Fiduciary Duties are there in Corporate Law?*, 83 S. CAL. L. REV. 1231, 1233 (2010).

⁸⁷ *Id.* at 1242.

⁸⁸ *Id.* at 1241.

⁸⁹ *Id.*

⁹⁰ See William Bratton, *Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law*, 61 GEO. WASH. L. REV. 1084, 1088 (1993).

⁹¹ See, e.g., *Golden Cycle, LLC v. Allan*, C.A. No. 16301, 1998 Del. Ch. LEXIS 237, at *34-35 (Dec. 10, 1998) (finding that the entire fairness standard is implicated “where a majority of the directors approving the transaction were interested or where a majority stockholder stands on both sides of the transaction . . .”).

⁹² Velasco, *supra* note 86, at 1241.

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ See, e.g., *Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993) (“Under the entire fairness standard of judicial review, the defendant directors must establish to the court’s satisfaction that the transaction was the product of both fair dealing and fair price.”).

⁹⁷ FORRESTER & FERBER, *supra* note 10, at 30.

must be truthful, accurate, and complete.⁹⁸ The duty of disclosure appears to be an obligation of complete candor.⁹⁹

Courts have extended the duty of candor to a number of situations. For example, in *Lynch v. Vickers Energy Corporation*, the Delaware Supreme Court held that the directors of Vickers Energy breached their fiduciary duty of candor when they failed to disclose material information to minority shareholders in the context of a tender offer.¹⁰⁰ The minority shareholders of TransOcean, the target company, sued the boards of both TransOcean and Vickers Energy.¹⁰¹ Here, the court described the fiduciary duty of “complete candor” as “complete frankness . . . [under which c]ompleteness, not adequacy, is both the norm and the mandate.”¹⁰² Courts have utilized this language to identify a duty of candor or disclosure in a variety of contexts apart from similar issue patterns as those in *Lynch*.¹⁰³ *Smith v. Van Gorkom* furthered this articulation of the duty of candor, when the Supreme Court of Delaware imposed a duty of complete candor on corporate directors seeking shareholder approval of a merger transaction.¹⁰⁴

In 1992, the Delaware Supreme Court in *Stroud v. Grace*, re-characterized the duty of candor as a fiduciary duty of disclosure.¹⁰⁵ In the same year, the Delaware Chancery Court expanded the duty of disclosure in *Marhart Inc. v. CalMat Co.*, holding that directors owe a duty to disclose all material information in any public disclosure, regardless of whether any shareholder action is sought.¹⁰⁶ Then in *Pfeffer v. Redstone*, the Delaware Supreme Court affirmed that the duty of disclosure is not an independent duty but part of the duties of loyalty and care.¹⁰⁷

Further, there is a materiality standard employed in Delaware when analyzing the duty of candor. Courts determine whether a fact is material by deciding “if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”¹⁰⁸ Under this standard, proof of a substantial likelihood that disclosure of an omitted fact would have caused a reasonable shareholder to change his vote is not required.¹⁰⁹ Rather, “there must be a substantial likelihood that, under all the circum-

⁹⁸ *Id.*

⁹⁹ Shannon German, *What They Don't Know Can Hurt Them: Corporate Officers' Duty of Candor to Directors*, 34 DEL. J. CORP. L. 221, 227 (2009).

¹⁰⁰ 383 A.3d 278, 279-80 (Del. 1977).

¹⁰¹ *Id.* at 278.

¹⁰² See Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1104-12 (1996); see also German, *supra* note 99.

¹⁰³ See Hamermesh, *supra* note 102.

¹⁰⁴ 488 A.2d 858, 890 (Del. 1985).

¹⁰⁵ 606 A.2d 75, 84 (Del. 1992).

¹⁰⁶ Civ. A. No. 11,820, 1992 WL 82365, at 336 (Del. Ch. Apr. 22, 1992).

¹⁰⁷ 965 A.2d 676, 684 (Del. 2009).

¹⁰⁸ *Id.* at 684 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

¹⁰⁹ *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 945 (Del. 1985) (quoting *TSC Indus.*, 426 U.S. at 449).

stances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.”¹¹⁰

The duty of candor has sometimes, but infrequently, been analyzed through the duty of care lens due to the inherent information asymmetry between the board of directors and the shareholders. Directors have significantly more knowledge, or access to knowledge, than do common shareholders.¹¹¹ Shareholders rely upon the greater knowledge of the directors when determining how they should vote.¹¹² Here, the directors’ duty of disclosure in recommending shareholder action should mirror the directors’ duty of care. Therefore, the directors are required to exercise due care in both the collection and the presentation of information to shareholders.¹¹³

Although the courts have held that the franchise contract does not establish a fiduciary relationship among the parties, in light of the gaps that exist in the current jurisprudence governing the franchise relationship, lessons may be gleaned from these corporate law duties. Before addressing these lessons, however, the next Part provides an analysis of another area of law, that governing restrictive covenants, which may also prove helpful in resolving some of the issues related to encroachment in the franchise arena.

III. The Reasonable Geographic Scope Analysis of Restrictive Covenants

In addition to the corporate governance-related duties discussed in the previous Part, legal rules surrounding restrictive covenants is another potentially useful area of law to explicate an approach courts might take in evaluating the franchise encroachment issue. Specifically, the covenant not to compete (also known as a noncompete or CNC) is a standard contractual tool, the validity of which may be determined by its geographic scope element related to competition.¹¹⁴ Since there has been difficulty in finding a legal rule for consistently resolving encroachment issues, the geographic scope element of common law noncompete enforcement is one approach courts could borrow as a useful analytic tool for interpreting when franchisors overreach, beyond the acceptable duties discussed in the previous Part.¹¹⁵

¹¹⁰ *Id.*

¹¹¹ Hamermesh, *supra* note 102, at 1102.

¹¹² *Id.* at 1101.

¹¹³ *Id.*

¹¹⁴ The employee noncompetes discussed in this Part are related to a restriction on competition that an employee agrees to before or during employment, curtailing otherwise lawful post-employment competition. There are also CNCs related to owner’s post-sale activities related to the sale of the goodwill of a business. Both types of CNCs are evaluated with the same balancing test discussed in this Part.

¹¹⁵ Certainly noncompetes, particularly in the post-employment context, are often criticized as harmful to a variety of interests from worker freedom to innovation and economic development generally. *See generally* ORLY LOBEL, TALENT WANTS TO BE FREE: WHY WE SHOULD LEARN TO LOVE LEAKS, RAIDS,

Here we focus on the reasonableness evaluation of geographic restrictions in noncompetes, but for context, it is useful to examine the full common law balancing test used by most courts. For example in *Boulanger v. Dunkin' Donuts Inc.*, the Massachusetts Supreme Court analogized the contractual relationship of a retiring franchisee's sale of its business interest to the usual employer-employee post-employment CNC relationship.¹¹⁶ The court also took the opportunity to reiterate the standard common law test: "Non-Competition Agreements are enforceable only if they are necessary to protect a legitimate business interest, reasonably limited in time and space, and consonant with the public interest."¹¹⁷ Ultimately, the franchisor prevailed in receiving an injunction to stop its former franchisee from entering into competing businesses, as had been agreed by the parties in the initial franchise agreement.¹¹⁸

The thrust of the common law CNC test is to strike a balance between allowing competition and protecting the "legitimate interests" (also known as protectable interests) an employer or business purchaser has sought to preserve by the contract.¹¹⁹ In the case of employee post-employment noncompetes, courts hold that a protectable interest must be more than just a means to restrict competition.¹²⁰ However, in the case of the franchisor-franchisee relationship, the restriction of competition through market allocation is at the heart of the arrangement and, as such, would seemingly easily qualify as a legitimate interest to protect from the franchisor's perspective.

The public interest prong of the noncompete balancing test is often neglected or ignored as irrelevant to the court's determination.¹²¹ In any event, the public interest inquiry seems inapplicable to the franchisor-franchisee encroachment context. This is because, by its very nature, an encroachment issue that arises suggests that there is a market-need for the franchise service or product that is being addressed; the dispute occurs because the specter of increased competition is potentially harming the business interests

AND FREE RIDING (2013) (arguing for legal rules to promote labor mobility, including eliminating non-competes, as a means to spur innovation and economic development).

¹¹⁶ 815 N.E.2d 572, 577-78 (Mass. 2004) (discussing Massachusetts Supreme Court's first impression ruling on whether a non-compete agreement was enforceable in a franchisee context, where the court held in favor of the franchisor).

¹¹⁷ *Id.* at 639; *see also* *Aspect Software, Inc. v. Barnett*, 787 F. Supp. 2d 118, 125-26 (D. Mass. 2011) (applying Massachusetts choice of law and noncompete precedent to preliminarily enjoin a former executive from working for a competitor in breach of his non-compete agreement).

¹¹⁸ *See Boulanger*, 815 N.E.2d at 582.

¹¹⁹ *See generally* Norman D. Bishara, *Balancing Innovation from Employee Mobility with Legal Protection for Human Capital Investment: 50 States, Public Policy, and Covenants Not to Compete in an Information Economy*, 27 BERKELEY J. EMP. & LAB. L. 287 (2006).

¹²⁰ *See, e.g., Aspect Software*, 787 F. Supp. 2d at 128 ("Courts will not enforce non-competition agreements meant solely to protect employers from run-of-the-mill business competition[, b]ut the protection of trade secrets, other confidential information, and the good will the employer has acquired through dealings with his customers constitute legitimate business interests." (quoting *Boulanger*, 815 N.E.2d at 639)).

¹²¹ *See* Norman D. Bishara & David Orozco, *Using the Resource-Based Theory to Determine Covenant Not to Compete Legitimacy*, 87 IND. L.J. 979, 992 (2012).

of the franchisee. Yet from the franchise customer or the public's perspective, the greater competition that is inherent with franchise encroachment seems to be a positive market development. This competition presumably means greater access to more, and perhaps better, products and services, at lower prices.

The important aspect of the common law CNC enforcement evaluation as related to the encroachment question is the limited time and geographic scope prong, particularly the geographic restriction term, which is also a hallmark of franchise encroachment. Again, when looking at this important element of a non-compete agreement, a court will only allow a geographic restriction that is reasonable in light of the legitimate interest of the enforcing party (i.e., the new business owner or the former employer, depending on the circumstances).¹²² Much like how changes in the use of technology and globalization in business have complicated the ways in which franchise encroachment occurs in recent years,¹²³ the same changes have impacted how the geographic scope of noncompetes has been considered.¹²⁴

Giving courts the discretion to balance competing interests related to fiduciary duties owed to business partners—in this case franchisees—along the lines of the balancing courts already undertake to evaluate CNCs seems appropriate and even natural. Moreover, non-compete agreements, as well as confidentiality agreements, are accepted fixtures in many, if not most, franchise agreements (assuming they are allowable in the relevant jurisdiction) already.¹²⁵ This fact makes these clauses and their interpretation something that many courts are used to, even as some have pointed out that courts are unfamiliar with the intricacies of the franchisor-franchisee relationship.¹²⁶ Nonetheless courts will treat this sort of competitive restriction arising in a business relationship with less suspicion than an employee noncompete because the sale of a business arises out of a transactional relationship between parties of more equal bargaining.¹²⁷

IV. Lessons from Corporate Fiduciary Duties and the CNC Reasonableness Analysis

¹²² See, e.g., *Boulanger*, 815 N.E.2d at 580-81.

¹²³ See Emerson, *supra* note 1 (discussing how the rise of online commerce has added a new dimension to the encroachment concerns of franchisees).

¹²⁴ See, e.g., *EarthWeb, Inc. v. Schlack*, 71 F. Supp. 2d 299, 312 (S.D.N.Y. 1999) (an early application of the noncompete reasonableness test to the restrictive covenants in an online commerce context, including a finding that as knowledge becomes more quickly obsolete in an online world that the reasonableness of restrictions must be evaluated accordingly).

¹²⁵ See generally Robert W. Emerson, *Franchising Covenants Against Competition*, 80 IOWA L. REV. 1049 (1995).

¹²⁶ See, e.g., Emerson, *supra* note 1.

¹²⁷ See, e.g., *WordWave, Inc. v. Owens*, 19 Mass. L. Rep. 37, 2 (Super. Ct. 2004) (“Courts look ‘less critically’ at restrictive covenants arising from the sale of a business because, unlike employers and employees, buyers and sellers are likely to be similarly-situated, with equal bargaining power and often times the benefit of counsel.” (citing *Boulanger* 815 N.E.2d at 578)).

Drawing on the corporate law of fiduciary duties and the noncompete reasonableness analysis discussed above, we propose some lessons that can be applied to the franchise law encroachment problem and its inherent geographic concerns. The first Section below discusses how recasting the franchisor-franchisee relationship as one defined by the portfolio of fiduciary duties can be advantageous for the parties. Then, building on the first discussion, we discuss in the second Section how viewing the misalignment problem of encroachment through a noncompete reasonableness evaluation lens may also prove useful for the courts.

A. Some Lessons from Corporate Duties for the Franchisor-Franchisee Relationship

Historically, courts have generally held that there is no fiduciary duty relationship between franchisors and franchisees.¹²⁸ Instead, the relationship is considered an arm's length transaction; thus viewing the relationship as a business, rather than as one between fiduciaries.¹²⁹ In so finding, courts have pointed to the lack of control franchisors have over franchisees and the differing goals between the two. Essentially, courts view the franchisor and its franchisee as separate business entities pursuing their own business interests.¹³⁰ When franchises fail, however, franchisees often allege that the franchisor breached a fiduciary duty owed to the franchisee.¹³¹ In this situation franchisees,

claim that the franchisor (1) had a duty to disclose information when selling the franchise opportunity to the franchisee, or (2) had a duty to avoid self-dealing during the course of the franchise relationship, or (3) is liable to the franchisee for tortious breach of the franchise agreement, or (4) may not terminate the franchise relationship except for cause.¹³²

¹²⁸ See, e.g., Zachary D. Schorr, *Fading Fiduciary Duties Between Franchisors and Franchisees*, 17 BUS. TORTS J. 13, 13 (2010).

¹²⁹ See *Picture Lake Campground, Inc. v. Holiday Inns, Inc.*, 497 F. Supp. 858, 869 (E.D. Va. 1980) ("A franchise relationship is inherently a business relationship, not a fiduciary relationship."); Anne L. Austin, Comment, *When Does a Franchisor Become a Fiduciary?: Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 43 Case W. Res. 1151, 1164 (1993).

¹³⁰ See *Broussard v. Meineke Discount Muffler Shops, Inc.*, 155 F.3d 331, 338 (4th Cir. 1998).

¹³¹ For more details, see Emerson, *supra* note 125 at 1063-63, where Professor Emerson explains that:

In order for a court to find a fiduciary obligation concerning a franchise agreement, it must find each of the following characteristics: (1) The franchisee reasonably expects that it is purchasing franchisor expertise as part of the franchise; (2) the franchisor clearly dominates the franchisee with superior knowledge and bargaining power; (3) the contract clause in question is incomplete or otherwise necessitates great flexibility in its enforcement; and (4) absent some external motive, the franchisor and franchisee have the same interests.

¹³² William L. Killion, *Existence of Fiduciary Duty Between Franchisor and Franchisee*, 52 A.L.R.5th 613, § 2 (2013).

Despite these claims, in a majority of jurisdictions, courts have found that there is no fiduciary duty between a franchisor and franchisee.¹³³ In these jurisdictions, rather than finding a fiduciary relationship between a franchisor and franchisee, courts view the creation of a franchise as an arm's length, business transaction between a franchisor and franchisee.¹³⁴

Although a question of whether a fiduciary duty exists is generally a factual matter for the jury, courts have found that certain relationships in non-franchise contexts give rise to fiduciary duties as a matter of law. These relationships include the attorney-client relationship, principal-agent relationship, trustee-beneficiary relationship, and partnership relationship.¹³⁵ As discussed above, fiduciary relationships are also prevalent in corporate law. On a case-by-case basis, courts have also found a fiduciary relationship in instances where the trust and confidence given by one party to another allows for undue influence.¹³⁶

In determining whether a fiduciary relationship exists, courts typically look to

- (1) whether the activity of the parties goes beyond operating on their own behalf and constitutes acting on behalf of both of them;
- (2) whether the parties have a common interest in profiting from the activities of the other;
- (3) whether the parties repose trust and confidence in each other; and
- (4) whether one party has power to control or dominate the other.¹³⁷

The level of control of one party over the other, coupled with the trust and confidence reposed, is an especially important consideration and requires more than simply a disparity in bargaining power to give rise to a fiduciary relationship.¹³⁸ It requires that the

¹³³ See also Austin, *supra* note 129. This is the view taken in most federal jurisdictions and in at least thirty-four states. Schorr, *supra* note 128, at 13.

¹³⁴ Schorr, *supra* note 128.

¹³⁵ Harold Brown, *Franchising – A Fiduciary Relationship*, 49 TEX. L. REV. 650, 664-65 (1971).

¹³⁶ *Id.*

¹³⁷ *Id.* Similarly, “[a] claim for breach of fiduciary duty involves three elements: breach by a fiduciary of a duty owed to plaintiff; defendant's knowing participation in the breach; and damages.” *Franklin Park Lincoln Mercury, Inc. v. Ford Motor Co.*, 530 Fed. App'x 542, 546 (6th Cir. 2013). Specifically there must be a showing that:

- (1) [t]he vulnerability of one party to the other which (2) results in the empowerment of the stronger party by the weaker which (3) empowerment has been solicited or accepted by the stronger party and (4) prevents the weaker party from effectively protecting itself. Generally, where parties deal at arms-length in a commercial transaction, no relation of confidence or trust sufficient to find the existence of a fiduciary relationship will arise absent extraordinary circumstances. Nevertheless, a distributorship agreement may, in some rare instances, create a confidential relationship out of which a duty of fiduciary care arises.

Id. at 546-47 (citing *Manhattan Motorcars, Inc. v. Automobili Lamborghini, S.p.A.*, 244 F.R.D. 204, 214-15 (S.D.N.Y. 2007)).

¹³⁸ Killion, *supra* note 132, at 2.

confidence and trust that has been reposed from one party to the other gives that party “domination and influence” in the relationship.¹³⁹

Thus, because the extent of control is an important component of finding a fiduciary relationship, the level of control a franchisor exerts over a franchisee is relevant to a fiduciary determination.¹⁴⁰ In theory, this analysis would create tension for the franchisor, who may wish to exercise some control over the franchisee and yet avoid creating a fiduciary relationship. In practice, however, this tension is lessened because most courts allow a substantial amount of control to be exercised by a franchisor, without imposing a fiduciary duty, even when trust and confidence is reposed by the franchisee to the franchisor.¹⁴¹ Despite generally being a question of fact, many courts have found that a fiduciary duty is not automatically created in an arm’s length business transaction, including a franchise agreement, because the parties are considered to be pursuing their own interests.¹⁴² The characterization of a franchise relationship in terms of an arm’s length transaction then results in a finding of no fiduciary relationship as a matter of law and thus eliminates the need for courts to address the level of control exercised by the franchisor over the franchisee.

That said, some jurisdictions have recognized a fiduciary duty between a franchisor and franchisee. One much-discussed franchise case concerning fiduciary duties is *Arnott v. American Oil Co.*, where a federal district court in South Dakota found that, as a matter of law, fiduciary duties were “[i]nherent in a franchise relationship.”¹⁴³ In so finding, the court recognized that both parties had a common interest, both profited from the activities of one another, and the franchisor exercised a great amount of control over the franchisee.¹⁴⁴ Although most courts have declined to follow *Arnott*, some courts have recognized that a fiduciary duty could arise based on the nature of the relationship.¹⁴⁵ The courts recognizing the possibility of a fiduciary relationship have nonetheless struggled “to define the scope of the duty created by the [franchise] relationship.”¹⁴⁶ Due to

¹³⁹ Emerson, *supra* note 125, at 1063.

¹⁴⁰ *Id.*

¹⁴¹ Austin, *supra* note 129, at 1173.

¹⁴² See, e.g., *Happy's Pizza Franchise, LLC v. Chi. Partners #78, LLC*, No. 13-11910, 2014 U.S. Dist. LEXIS 45833, at *54 (E.D. Mich. Apr. 3., 2014) (“With one very narrow exception, that is not alleged and does not apply here Michigan does not recognize a claim for breach of an implied covenant of good faith and fair dealing.” (citing *Coyer v. HSBC Mortg. Servs.*, 701 F.3d 1104, 1108 (6th Cir. 2012))); Austin, *supra* note 129, at 1159; George Bundy Smith & Thomas J. Hall, *The Hurdle to Pleading Fiduciary Duty Claims to Arm’s Length Relations*, 243 N.Y.L.J. 32, 32 (2010).

¹⁴³ *Arnott v. American Oil Co.*, 609 F.2d 873, 881 (8th Cir. 1979).

¹⁴⁴ *Id.* at 881-82. For the control prong, the court considered the control the franchisor held over the operations of the franchisee, including the fact that the franchisor determined the hours of operation for the franchisee, hired employees for the franchisee, and conducted inspections of the franchisee. The court also considered the control the franchisor exercised regarding product advertising and pricing. *Id.*

¹⁴⁵ Austin, *supra* note 129, at 1163-64.

¹⁴⁶ *Phillips v. Chevron U.S.A., Inc.*, 792 F.2d 521, 524 (5th Cir. 1986).

this uncertainty, courts have found it difficult to “apply fiduciary law principles to aspects of the franchise relationship traditionally governed by contract law.”¹⁴⁷

The conceptual framework of the franchisor-franchisee relationship currently taken by a majority of jurisdictions is, however, limited. It fails to account for the reality that the relationship between a franchisor and franchisee is ongoing, rather than simply an arm’s length transaction. Indeed, because of this ongoing relationship, common themes can be drawn between the franchise relationship and the fiduciary relationship. For example, in a franchisor-franchisee relationship, the purpose of the relationship is the formation of a commercial venture, under which “both parties have a common interest and profit from the activities of the other.”¹⁴⁸

Interestingly, courts that have rejected the imposition of fiduciary duties in the franchise relationship have done so because the relationship involves “two business entities pursuing their own business interests, which do not always coincide.”¹⁴⁹ But courts have failed to consider that the misalignment of interests may result from the failure to impose fiduciary duties in the first place. If courts seek to erase, or at least diminish, this misalignment of interests, then it would seem appropriate to draw on analogies between the fiduciary relationship and the franchise relationship. In both relationships there are elements of control, a common purpose, and mutual profiting.

The inherent control that is both necessary and present in a franchise relationship is analogous to that typically present in a fiduciary relationship. That is, because there is some level of control in all franchise relationships, they are similar to fiduciary relationships, where the control of one party over another gives rise to fiduciary obligations.¹⁵⁰ Indeed, at the core of every franchise relationship “is the contractual control exercised by the franchisor over every aspect of the franchisee’s business.”¹⁵¹ Thus, *Arnott* remains instructive in that it found a fiduciary relationship in part because the franchisor set the hours the franchisee was to remain open, controlled product advertising and pricing, and subjected the franchise to inspections.¹⁵²

From this control stems a disparity in the position of the parties, which is why fiduciary duties are important in this type of relationship. In essence, in this type of relationship “[t]here is a marked, intentional, and constantly emphasized disparity in the positions of the parties—the franchisor combining the roles of father, teacher, and drill sergeant, with the franchisee relegated to those of son, pupil, and buck-private, respec-

¹⁴⁷ *Id.*

¹⁵⁰ Robert W. Emerson, *Franchising and the Parol Evidence Rule*, 50 AM. BUS. L.J. 659, 725 (2013) (explaining the relational nature of franchise agreements and quoting *Shell Oil Co. v. Marinello*, 294 A.2d 253, 261 (N.J. Super. Ct. Law Div. 1972).

¹⁴⁹ *Id.*

¹⁵⁰ Brown, *supra* note 135, at 650.

¹⁵¹ *Id.* at 663.

¹⁵² *Arnott v. American Oil Co.*, 609 F.2d 873, 882 (8th Cir. 1979).

tively.”¹⁵³ At all times, the franchisee is essentially “at the mercy of the franchisor.”¹⁵⁴ Fiduciary duties are often imposed when there is this type of ongoing relationship with such a distinct power disparity, as they work to mitigate and curb potential abuses that can arise due to that power disparity.¹⁵⁵ In a franchise relationship, then, fiduciary duties may be needed to enable the franchisee to succeed and protect his economic integrity.¹⁵⁶ The obligations of the franchisor in the franchise relationship can be compared to the fiduciary obligations owed by officers and directors and the potential gross disparity of power held by the directors and officers in their roles in the firm.¹⁵⁷

Additionally, like a fiduciary relationship, the franchise relationship is one ideally built on trust and confidence.¹⁵⁸ Indeed, the franchisee looks to the franchisor for guidance throughout the entirety of their relationship. Thus, the franchisee discloses to the franchisor intimate and confidential records, and the franchisor inspects those records to provide guidance, teaching, and, at times, discipline.¹⁵⁹ Fiduciary obligations are common in such arrangements, where “the relationship is so close that confidence is necessarily reposed by the one in the other.”¹⁶⁰

Furthermore, the franchise law duty of material disclosure appears to be relatively similar to the duty of candor that exists in the corporate fiduciary relationship. The requirement of material disclosure provides a franchisee with information that is essential to its decision regarding whether to enter into the franchise relationship. The required disclosure attempts to both address the “serious informational imbalance” and prevent the “serious economic harm” that could result to franchisees if the franchisors did not adequately disclose all material information.¹⁶¹ It attempts to establish some level of good faith at the onset of the relationship, even if that duty does not continue throughout the duration of the relationship.

¹⁵³ Brown, *supra* note 135, at 664.

¹⁵⁴ *Id.* at 665.

¹⁵⁵ See, e.g., *Burdett v. Miller*, 957 F.2d 1375, 1381 (7th Cir. 1992) (“The common law imposes [a fiduciary] duty when the disparity between the parties in knowledge or power relevant to the performance of an undertaking is so vast that is a reasonable inference that had the parties . . . negotiated . . . they would have agreed that the agent owed the principal [a] high duty . . . because otherwise the principle would be placing himself at the agent’s mercy.”); *Richelle L. v. Roman Catholic Archbishop*, 130 Cal. Rptr. 2d 601, 609 (2003) (“The essence of a fiduciary . . . relationship is that the parties do not deal on equal terms, because the person in whom trust and confidence is reposed and who accepts that trust and confidence is in a superior position to exert unique influence over the dependent party.”); *Mitchell v. Reynolds*, C.A. No. 1451-VCN, 2009 Del. Ch. LEXIS 3, at *37 (Jan. 7, 2009) (recognizing that fiduciary relationships are often imposed when “parties do not deal on equal terms but on one side there is an overmastering influence or on the other weakness . . .”).

¹⁵⁶ Brown, *supra* note 135, at 650.

¹⁵⁷ *Id.* at 665.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 674.

¹⁶¹ *Id.*

Finally, encroachment is another area that raises fiduciary-like concerns. At the beginning of any franchise relationship, the interests of the franchisor and the franchisee line up with one another.¹⁶² Both franchisor and franchisee are typically looking to enter new markets and increase their profits.¹⁶³ As circumstances change, the interests of the two may diverge. On one hand, franchisees may look to make their individual units as profitable as possible, while, on the other hand, franchisors profit from the licensing of the trademark and the collection of royalties from all their franchisees.¹⁶⁴ When the market is saturated, the two goals conflict because the franchisors continue to make money regardless of the amount of profit to each individual franchise unit.¹⁶⁵ Without corporate fiduciary duties, each entity is incentivized to act in its self-interest at the expense of the business partnership. This misalignment of interests demonstrates the need for reforming the law applicable to the franchise relationship.

Thus, although a majority of jurisdictions reject the idea of a fiduciary relationship in the franchise context,¹⁶⁶ strong analogies between a fiduciary relationship and the franchise relationship can be drawn. Furthermore, even though some courts conceptualize the franchise relationship as an arm's length, business transaction, pursuant to which separate business entities are pursuing separate goals,¹⁶⁷ other courts have concluded that with a franchise relationship, the parties are bound together for an ongoing period of time, during which there is a large power disparity while both parties pursue a largely common purpose.¹⁶⁸ It thus seems appropriate to cast the franchise relationship as a fiduciary one.

B. The CNC Reasonableness Evaluation and the Franchise Encroachment Problem

If, as we argue in the previous Section, applying the well-developed law of corporate fiduciary duties to the franchisor-franchisee relationship is an important way to address the misalignment of interests that arises post-sale, there remains the issue of how to address encroachment. One approach is to evaluate complaints of encroachment using the reasonableness evaluation courts have long applied to the geographic scope element of non-compete agreements.

¹⁶² Emerson, *supra* note 1, at 201.

¹⁶³ *Id.*

¹⁶⁴ *Id.* at 204.

¹⁶⁵ *Id.*

¹⁶⁶ Austin, *supra* note 129.

¹⁶⁷ See, e.g., *Broussard v. Meineke Discount Muffler Shops Inc.*, 155 F.3d 331, 348 (4th Cir. 1998) ("The near-universal rejection of imposing fiduciary duties in the franchise setting reflects a recognition that these obligations are out of place in a relationship involving two business entities pursuing their own business interests, which of course do not always coincide.").

¹⁶⁸ See, e.g., *Arnott v. American Oil Co.*, 609 F.2d 873, 881 (8th Cir. 1979) (finding that a fiduciary relationship is inherent in a franchise relationship because "both parties have a common interest and profit from the activities of one another").

The courts have consistently used the reasonableness analysis to balance the parties' interests and to evaluate whether the geographic restriction in a non-compete agreement is broader than necessary to protect the legitimate interests.¹⁶⁹ This approach is an attractive way to address franchise encroachment for two reasons. First, it recognizes that the parties have a legitimate, albeit limited, interest to protect, which involves a restriction on otherwise unfettered competition in the absence of the agreement. Second, the evaluation works as a check on the overreaching tendency associated with the dominant party in the contractual relationship¹⁷⁰ (in this case, the franchisor). While noncompetes have been criticized as being similar to contracts of adhesion that are unfair to employees lacking sufficient leverage challenge the restrictions,¹⁷¹ franchise agreements suffer less from this concern because they arise in the context of a business sale, where the franchisee has an array of investment choices.

As is with the case of applying corporate fiduciary duties to managers, other employees, and directors, courts in most states are already relatively comfortable with the reasonableness test for interpreting the permissible geographic scope of a non-compete agreement. There is also an intuitive fairness adjudication and equitable element to evaluating geographic scope that courts already undertake regularly with CNC evaluations,¹⁷² which should translate well to reviewing claims of impermissible franchise encroachment using a similar balancing test.

Conclusion

In advocating for the application of both fiduciary duties and a geographic reasonableness evaluation to the franchise context, and particularly to encroachment, we acknowledge that these suggestions for greater judicial involvement are not meant to supplant the existing regulation and disclosure mandated by the FTC. The Amended Rule's emphasis on disclosure in the initial stages of the relationship, pre-sale, is important; however, imposing greater and reciprocal duties on the parties will serve to em-

¹⁶⁹ See, e.g., *EarthWeb, Inc. v. Schlack*, 71 F. Supp. 2d 299, 312 (S.D.N.Y. 1999) (judging the worldwide restriction on a former employee's competition in light of the rapid growth of the globalized online sales sector).

¹⁷⁰ See generally Norman D. Bishara & Michelle Westermann-Behaylo, *The Law and Ethics of Restrictions on an Employee's Post-Employment Mobility*, 49 AM. BUS. L.J. 1 (2012).

¹⁷¹ See, e.g., Rachel S. Arnov-Richman, *Bargaining for Loyalty in the Information Age: A Reconsideration of the Role of Substantive Fairness in Enforcing Employee Noncompetes*, 80 OR. L. REV. 1163, 1214-15 (2001) (discussing the bargaining power disparity when employers requested a noncompete agreement at the start of the employment relationship); see also Cynthia L. Estlund, *Between Rights and Contract: Arbitration Agreements and Non-Compete Covenants as a Hybrid Form of Employment Law*, 155 U. PA. L. REV. 379, 384-85 (2006) (discussing some courts' skepticism about employee bargaining power in the employment relationship).

¹⁷² See generally T. Leigh Anenson, *The Role of Equity in Employment Noncompetition Cases*, 42 AM. BUS. L.J. 1, 54 (2005).

phasize the post-sale collaboration that is essential to the ongoing success of a particular franchise system. Leaving the parties to negotiate, pre-sale, the parameters of a long-term business relationship with high switching costs has not worked thus far, and solutions to address the encroachment issue will likely be welcomed by conscientious franchisors and franchisees, and their respective advocates.

Furthermore, addressing misalignment through a mix of court, imposed fiduciary duties, and enforcement of the existing FTC disclosure regulation is sensible because the parties are in a relatively long-term, well-defined relationship, in which the initial disclosure under the FTC rules is insufficient. To date, franchise misalignment and encroachment have been generally relegated to the realm of contract interpretation at the start of the relationship. Our suggestions provide additional options for the courts and policy makers to consider in light of the conclusion that merely increasing mandated disclosure at the inception of the franchise relationship and relying on a mantra of “franchisee beware” will not address the long-term issues.