

CRITICIZING THE ECONOMIC ANALYSIS OF FRANCHISE  
ENCROACHMENT LAW

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ABSTRACT

One of the most vital legal debates in the field of franchise law has focused on one central question: whether encroachment—that is, the phenomenon in which the franchisor establishes a new franchise unit in unreasonable proximity to its existing franchisee—should be restricted by law. Given the centrality of the law and

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economics school of thought, it is not surprising that legal economists play a dominant role in the legal debate over encroachment legislation. Law and economics' conventional analysis contends that franchise encroachment legislation, restricting the franchisor from establishing a new unit in unreasonable proximity to its existing franchisee, is inefficient. Opposition to such legislation is based upon the belief that franchise encroachment increases consumer welfare, mainly by increasing price and service competition among neighboring franchisees.

Focusing on consumer welfare, this article argues that traditional law and economics analysis is incomplete; the conventional analysis ignores the broader and long-term negative implications that encroachment practices may have on consumer welfare. While, as legal economists suggest, encroachment may enhance consumer welfare in the short-term by increasing price and service competition, encroachment will bear a high cost for consumers in the long run.

The argument presented in this article is the following: encroachment practices are often used by franchisors in order to cause their respective franchisees' businesses to fail, thereby allowing franchisors to evade a contractual or statutory obligation to pay damages to a franchisee upon direct contract termination. Such manipulative practices therefore increase the rate of franchisee business failure in the franchise industry as a whole. The increase in the rate of franchisee business failure, as caused by encroachment practices, is likely to deter individuals considering becoming franchisees from joining the franchise industry. Deterring such individuals ultimately will reduce consumer welfare by decreasing the inherent pro-consumer efficiencies achieved by franchisees, including lower prices and product standardization.

Since an encroaching franchisor typically does not bear the entirety of the long-term social costs of her destructive strategy, yet directly benefits from such a strategy, this article ultimately calls on federal and state policy makers who are currently considering the adoption of encroachment laws to adopt such laws. Under these laws, adopted so far by a minority of states, should a franchisor encroach on a franchisee's market area, the franchisee has a cause of action for monetary damages against the franchisor. A damages regime forces the franchisor to internalize the social harm that her destructive encroachment strategy may cause in the long run.

## I. INTRODUCTION

Franchise encroachment—the phenomenon in which the franchisor establishes a new franchise unit in unreasonable proximity to its existing franchisee—is widespread.<sup>1</sup> To illustrate, a nationwide survey of 179 sandwich shop franchisees indicated that twenty-seven percent of the franchisees had suffered from encroachment by their franchisor.<sup>2</sup> Likewise, most large restaurant franchisors had been dragged into a court battle with frustrated franchisees over encroachment.<sup>3</sup> For example, McDonald's, Burger King, Subway, Taco Bell, Dunkin' Donuts, and KFC “found themselves roiled in [legal] disputes over outlets opening in close proximity to those of an existing” franchisee.<sup>4</sup> In light of the frequency of encroachment disputes, it is not surprising that “[t]he topic of encroachment has . . . received more attention in the trade press over the last several years than any other issue related to franchising.”<sup>5</sup> Naturally, one of the most vital legal debates in the field of franchise law has focused on one central question: should encroachment be restricted by law?<sup>6</sup>

Given the centrality of the law and economics school of thought, legal economists play a dominant role in the legal debate over encroachment legislation. The traditional law and economics analysis concludes that laws restricting encroachment are

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<sup>1</sup> Robert W. Emerson, *Franchise Territories: A Community Standard*, 45 WAKE FOREST L. REV. 779, 779 (2010); William Slater Vincent, *Encroachment: Legal Restrictions on Retail Franchise Expansion*, 13 J. BUS. VENTURING 29, 30 (1998); Rupert M. Barkoff, Op-Ed., *Complex Issue of Franchise Encroachment Has No Simple, One-Size-Fits-All Solution*, NATION'S RESTAURANT NEWS, June 2, 2003, at 20; see David Hess, *The Iowa Franchise Act: Towards Protecting Reasonable Expectations of Franchisees and Franchisors*, 80 IOWA L. REV. 333, 344 (1994).

<sup>2</sup> See Richard Martin, *Poll: Franchisees' Low Grades for Franchisors Even Lower Among Sandwich Shop Operators*, NATION'S RESTAURANT NEWS, Aug. 18, 2003, at 3, 8.

<sup>3</sup> See Milford Prewitt, *Encroachment 'Battlefield' Now More Peaceful*, NATION'S RESTAURANT NEWS, Feb. 24, 2003, at 1.

<sup>4</sup> *Id.*

<sup>5</sup> Arturs Kalnins, *Hamburger Prices and Spatial Econometrics*, 12 J. ECON. & MGMT. STRATEGY 591, 595 n.5 (2003).

<sup>6</sup> Emerson, *supra* note 1 (“Encroachment [is] the most debated subject in franchise law.”); Robert W. Emerson, *Franchise Encroachment*, 47 AM. BUS. L.J. 191, 193–94 (2010) (“[F]ranchisees have long considered encroachment their ‘number one problem.’ For many franchisees and their advocates, encroachment has been *the* domestic franchising problem of the past decade; and it remains, for many franchisees in particular and for numerous franchised systems as a whole, *the* issue most in need of a just resolution.”); Erik B. Wulff, *A Critical Analysis of the Small Business Franchise Act of 1998*, 18 FRANCHISE L.J. 133, 167 (1999) (“This topic of encroachment has received a great deal of attention in franchise literature in the past few years.”).

inefficient.<sup>7</sup> In brief, the economic opposition to encroachment laws is primarily based on the argument that encroachment improves consumer welfare by increasing price and service competition among neighboring franchisees.<sup>8</sup> Such opposition to encroachment laws has been of significant influence in the development of franchise encroachment law in general, as witnessed by state and federal policy-making. To date, most states have refused to adopt general laws restricting encroachment.<sup>9</sup> Similarly, at the federal level, there have been frequent federal proposals to restrict encroachment; however, all of them have been rejected.<sup>10</sup>

This article argues that traditional law and economics analysis is incomplete. It ignores the broader and long-term implications that encroachment practices may have on consumer welfare. While encroachment may enhance consumer welfare in the short-term by increasing price and service competition, the situation will bear a high cost to consumers in the long-term. I will present my argument in three stages. First, encroachment practices, which are often used by franchisors in order to cause their franchisees' businesses to fail, increase the rate of franchisee business failure in the franchise industry as a whole. Second, an increase in the franchisee business failure rate, caused by encroachment strategies, is likely to deter individuals considering becoming franchisees from joining the franchise industry. Finally, deterring individuals from becoming franchisees will reduce consumer welfare, as it will decrease the intrinsic pro-consumer efficiencies achieved by franchisees, including lower prices and product standardization.

Part II of this article will provide context by briefly reviewing the legal framework which forms the backdrop of the debate over franchise encroachment legislation. Both state and federal encroachment legislative initiatives will be presented. Part III will review the central argument underlying the traditional law and economics opposition to encroachment laws, namely that encroachment increases consumer welfare. Part IV will propose an addition to the conventional economic model. Particularly, it will reveal the broader and long-term negative implications that encroachment practices may have on consumer welfare. Part V provides a brief conclusion.

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<sup>7</sup> See Wulff, *supra* note 6, at 167–68.

<sup>8</sup> See *infra* Part III.

<sup>9</sup> See *infra* Part II.A.

<sup>10</sup> See *infra* Part II.B.

## II. FRANCHISE ENCROACHMENT—LEGAL FRAMEWORK

### A. *State Legislation*

To date, most states have refused to adopt general laws restricting encroachment. A few states, however, have enacted general franchise laws with direct or indirect anti-encroachment provisions.<sup>11</sup> The most rigorous encroachment law is found in Iowa. Iowa code prohibits the franchisor from establishing a new unit in unreasonable proximity to an established franchisee unit if the new unit has an adverse effect on the gross sales of the established franchisee unit.<sup>12</sup> If the franchisor encroaches on the franchisee's market area, the franchisee, under Iowa Code, has a cause of action for monetary damages against the franchisor.<sup>13</sup> Damages include the lost profits attributed to the opening of the new outlet.<sup>14</sup> The Indiana Code also includes anti-encroachment provisions.<sup>15</sup> It prohibits a franchisor from establishing an outlet that competes unfairly with the franchisee within an unreasonable area.<sup>16</sup>

Washington, Hawaii, and Minnesota also have laws with anti-encroachment provisions.<sup>17</sup> These provisions, however, are much less stringent than those in Iowa and Indiana. They simply reaffirm the territorial exclusivity agreed upon in the franchise contract. For example, under Washington law, if the franchise contract provides that the franchisee has an exclusive territory, the franchisor is prohibited from competing with the franchisee in said exclusive territory or from establishing competitive franchises in the exclusive territory area.<sup>18</sup> Similarly, the Hawaiian law prohibits the franchisor from establishing a new outlet within the geographical area specifically designated as an exclusive territory in the franchise contract.<sup>19</sup> Likewise, Minnesota law prohibits the

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<sup>11</sup> HAW. REV. STAT. § 482E-6 (2011); IND. CODE § 23-2-2.7-2 (2011); IOWA CODE § 537A.10 (2011); MINN. R. 2860.4400(c) (2011); WASH. REV. CODE § 19.100.180 (2011); WIS. STAT. § 135.03 (2011).

<sup>12</sup> IOWA CODE § 537A.10(6)(a).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* § 537A.10(6)(d).

<sup>15</sup> IND. CODE § 23-2-2.7-2.

<sup>16</sup> *Id.* § 23-2-2.7-2(4).

<sup>17</sup> WASH. REV. CODE § 19.100.180(2)(f); HAW. REV. STAT. § 482E-6(2)(E); MINN. R. § 2860.4400(C).

<sup>18</sup> WASH. REV. CODE § 19.100.180(2)(f).

<sup>19</sup> HAW. REV. STAT. § 482E-6(2)(E).

franchisor from competing with an existing franchisee or establishing competing franchises in the exclusive territory granted to the existing franchisee in the franchise contract.<sup>20</sup> A handful of other states have laws that indirectly address the issue of encroachment. To illustrate, Wisconsin prohibits a franchisor from changing the competitive circumstances of a franchisee absent good cause.<sup>21</sup>

In addition to the general franchise state laws that regulate encroachment, some states have industry-specific statutes that address the issue. These statutes, passed in 1963, mainly cover the automobile industry.<sup>22</sup> They are referred to as “relevant market area (RMA) laws.”<sup>23</sup> The purpose of RMA laws is twofold: first, to protect franchisees from the unequal bargaining power of franchisors;<sup>24</sup> and second, to protect existing franchisees from injury due to the establishment of encroaching franchisees.<sup>25</sup> Accordingly, these laws usually stipulate that an automobile franchisor may not appoint a new franchisee within the relevant market area of an existing franchisee without first notifying the existing franchisee.<sup>26</sup> The existing franchisee may then challenge the appointment before a state administrative board or court, which will determine whether there is “good cause” for the appointment of the new franchisee.<sup>27</sup> The factors that should be taken into account in determining whether there is such a “good cause” vary from state to state. Representative factors include: whether the establishment of the new franchisee is injurious or beneficial to the public welfare, and

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<sup>20</sup> MINN. R. § 2860.4400(C).

<sup>21</sup> WIS. STAT. § 135.03 (2011).

<sup>22</sup> For a thorough analysis of these laws, see DON T. HIBNER, JR., AM. BAR ASS'N, ANTITRUST SECTION: MONOGRAPH NO. 17, FRANCHISE PROTECTION: LAWS AGAINST TERMINATION AND THE ESTABLISHMENT OF ADDITIONAL FRANCHISES 89–101 (1990) [hereinafter MONOGRAPH NO. 17].

<sup>23</sup> *Id.* at 89.

<sup>24</sup> See *New Motor Vehicle Bd. of Cal. v. Orrin W. Fox Co.*, 439 U.S. 96, 100–01 (1978); *Am. Motors Sales Corp. v. Peters*, 317 S.E.2d 351, 357–58 (1984).

<sup>25</sup> *New Motor Vehicle Bd.*, 439 U.S. at 101–02; see also *Monmouth Chrysler-Plymouth v. Chrysler Corp.*, 509 A.2d 161, 168 (1986).

<sup>26</sup> Rupert M. Barkoff & W. Michael Garner, *Encroachment: The Thorn in Every Successful Franchisor's Side (This Town Ain't Big Enough for the Both of Us!)*, AM. BAR ASS'N FORUM ON FRANCHISING, (Dallas, TX), Oct. 20–22, 1993, at 37. The relevant market areas defined by state laws vary from 314 to 1256 square miles. See MONOGRAPH NO. 17, *supra* note 22, at 93.

<sup>27</sup> MONOGRAPH NO. 17, *supra* note 22, at 93. For illustrative anti-encroachment provisions in the automobile industry see CAL. VEH. CODE § 3062(a)(1) (West 2011); COLO. REV. STAT. § 12-6-120.3(1), (1.5) (2010); CONN. GEN. STAT. § 42-133dd(a) (2010); FLA. STAT. § 320.642(3) (2011); GA. CODE ANN. § 10-1-664(a), (b) (2011); 815 ILL. COMP. STAT. ANN. 710/4(e)(8) (2011); MASS. GEN. LAWS ANN. ch. 93b, § 6(a) (2011); MICH. COMP. LAWS § 445.1576(2), (3) (2011); TEX. OCC. CODE ANN. § 2301-652 (West 2011).

whether there is a growth or decline in the population in the relevant market area.<sup>28</sup>

### *B. Federal Legislation*

At the federal level, there have been frequent proposals over the last twenty years to restrict encroachment. For example, in 1992, former Democratic Congressman James H. Scheuer introduced a bill designed to restrict encroachment practices.<sup>29</sup> Similarly, in 1993 and 1995, former Democratic Congressman, John J. LaFalce, proposed two bills regulating encroachment.<sup>30</sup> Likewise, in 1998 and 1999, Republican Congressman Howard Coble introduced two bills addressing territorial encroachment.<sup>31</sup>

The proposed federal bills regulating encroachment were premised on four major purported findings.<sup>32</sup> First, most prospective franchisees are unfamiliar with operating a business in general, as well as “with the business being franchised and with industry practices in franchising.”<sup>33</sup> Second, given these franchisees’ lack of experience, many franchise contracts “reflect a profound imbalance of contractual power in favor of the franchisor,” allowing the latter to encroach on the franchisee’s market area.<sup>34</sup> Third, a franchisee may suffer substantial financial losses where the franchisor, in bad faith, encroaches on the franchisee’s market.<sup>35</sup> Finally, traditional common law doctrines have not evolved sufficiently to provide adequate protection to franchisees from unfair encroachment.<sup>36</sup>

Given these findings, the federal bills prohibit the franchisor from encroaching on the franchisee’s market area. Particularly, the bills prohibit the franchisor from establishing a new outlet in unreasonable proximity to an established franchised unit if the new

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<sup>28</sup> See, e.g., MICH. COMP. LAWS § 445.1576(5); see also Barkoff & Garner, *supra* note 26, at 38–39, MONOGRAPH NO. 17, *supra* note 22, at 93.

<sup>29</sup> Federal Fair Franchising Practices Act of 1992, H.R. 5961, 102d Cong. § 10 (1992).

<sup>30</sup> Federal Fair Franchise Practices Act, H.R. 1717, 104th Cong. § 8 (1995); Federal Fair Franchise Practices Act, H.R. 1316, 103d Cong. § 4 (1993).

<sup>31</sup> Small Business Franchise Act of 1999, H.R. 3308, 106th Cong. § 11 (1999); Small Business Franchise Act of 1998, H.R. 4841, 105th Cong. § 11 (1998).

<sup>32</sup> H.R. 3308 § 2(a)(3)–(a)(6); H.R. 4841 § 2(a)(3)–(a)(6); H.R. 1717 § 2(a)(3)–(a)(6); H.R. 1316 § 2(a)(3)–(a)(5).

<sup>33</sup> H.R. 3308 § 2(a)(3); H.R. 4841 § 2(a)(3); H.R. 1717 § 2(a)(3).

<sup>34</sup> H.R. 3308 § 2(a)(4); H.R. 4841 § 2(a)(4); H.R. 1717 § 2(a)(4); H.R. 1316 § 2(a)(4).

<sup>35</sup> H.R. 3308 § 2(a)(5); H.R. 4841 § 2(a)(5); H.R. 1717 § 2(a)(5); H.R. 1316 § 2(a)(5).

<sup>36</sup> H.R. 3308 § 2(a)(6); H.R. 4841 § 2(a)(6); H.R. 1717 § 2(a)(6); H.R. 1316 § 2(a)(5); see also Vincent, *supra* note 1, at 35 (“Judicial decisions concerning the encroachment issue have overwhelmingly favored the franchisor.”).

outlet is likely to reduce the gross sales of the established franchised unit.<sup>37</sup> Some of these bills state that where a franchisor has established a new outlet in an unreasonable proximity to an existing franchise, the owner of the existing franchise shall have a cause of action for monetary damages.<sup>38</sup> Similar to the Iowa state law, these damages include actual loss of income resulting from the reduction in gross sales caused by the opening of the new franchise.<sup>39</sup> However, all the federal bills attempting to regulate encroachment have failed, and currently there is no general franchise law at the federal level that addresses the issue of encroachment.<sup>40</sup>

### III. THE LAW AND ECONOMICS OF ENCROACHMENT: CONSUMER PERSPECTIVE

The need to regulate franchise encroachment has been debated for many years.<sup>41</sup> Legal economists have been playing a dominant role in the debate. The conventional law and economics approach opposes, by and large, legislation that restricts encroachment.<sup>42</sup> As was generally stated above,<sup>43</sup> the central argument that underlies

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<sup>37</sup> H.R. 3308 § 11(a)(1); H.R. 4841 § 11(a)(1); H.R. 1717 § 8(a); H.R. 1316 § 4(a); Federal Fair Franchising Practices Act of 1992, H.R. 5961, 102d Cong. § 10(a)(1) (1992).

<sup>38</sup> H.R. 1717 § 8(b); *see* H.R. 1316 § 4(b)(1).

<sup>39</sup> *See id.*

<sup>40</sup> ROGER D. BLAIR & FRANCINE LAFONTAINE, *THE ECONOMICS OF FRANCHISING* 228 (2005); Vincent, *supra* note 1, at 35.

<sup>41</sup> Jefferson I. Rust, Note, *Regulating Franchise Encroachment: An Analysis of Current and Proposed Legislative Solutions*, 19 OKLA. CITY U. L. REV. 489, 530 (1994).

<sup>42</sup> *See* BLAIR & LAFONTAINE, *supra* note 40, at 234 (arguing that consumers will pay higher prices as a result of encroachment legislation); Richard L. Smith II, *Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution*, 25 J.L. & ECON. 125, 154 (1982) (arguing that encroachment laws, covering the automobile industry, “strengthen the locational market power of dealers” causing “a significant increase in vehicle prices”); E.W. Eckard, Jr., *The Effects of State Automobile Dealer Entry Regulation on New Car Prices*, 23 ECON. INQUIRY 223, 226–27 (1985) (arguing that anti-encroachment provisions covering the automobile industry increase product prices); Robert P. Rogers, *The Effect of State Entry Regulation on Retail Automobile Markets*, BUREAU OF ECON. STAFF REP. TO THE FED. TRADE COMMISSION 97, 98 (1986) (arguing that encroachment laws dealing with the automobile industry increase the prices of products in areas with sufficiently large population growth); MONOGRAPH NO. 17, *supra* note 22, at 203 app. G. (suggesting that encroachment laws create a monopoly for existing franchise dealers and increase the price of products and services for consumers); *id.* at app. D (arguing that encroachment laws seems to “unduly restrict competition, which may result in higher prices being paid by consumers . . .”); *Report of the American Bar Association Section of Antitrust Law on Proposed Small Business Franchise Act*, 1999 A.B.A. SEC. ANTITRUST L. Rep., available at <http://www.ftc.gov/bcp/rulemaking/franchise/comments/comment025.htm>; [hereinafter *Report of the American Bar Association*] (arguing that encroachment legislation will reduce additional price competition).

<sup>43</sup> *See infra* Part I.

this position is that encroachment increases consumer welfare and that legal restrictions on encroachment serve to protect franchisees at the expense of consumers. For example, Professors Roger Blair and Francine Lafontaine argue the franchisors:

[L]ocate outlets “too close” to one another from the franchisees’ perspective . . . presumably because they do not believe that the restraints will benefit [the franchisor]. In those cases, the restraints also will not benefit consumers. . . . [I]t is troubling that courts and public policy decisions, under the notion of protecting small businesses, have sometimes favored the franchisee’s position in encroachment disputes at the expense of consumers.<sup>44</sup>

Similarly, Professor Richard L. Smith III, opposing encroachment legislation covering automobile franchises, argues that such legislation results in “a large wealth transfer from consumers to dealers.”<sup>45</sup> Furthermore, Professor E. Woodrow Eckard argues that “consumers would benefit if the various state capitals” would deregulate encroachment laws covering the automobile industry.<sup>46</sup> In the same vein, the American Bar Association’s Section of Antitrust Law stated that encroachment legislation could “reduce consumer welfare [by eliminating benefits] that may result from additional points of consumer exposure.”<sup>47</sup>

In more detail, the economic opposition to encroachment laws rests on the following analysis. Encroachment allows the establishment of additional franchised units close to an existing unit.<sup>48</sup> These additional units enhance consumer welfare.<sup>49</sup> First, these units result in price competition among the densely located units, thereby reducing the price that consumers will have to pay for their products. Second, additional franchised units will result in service competition among the close units, thereby improving the service that consumers will receive.<sup>50</sup> Third, additional franchised

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<sup>44</sup> BLAIR & LAFONTAINE, *supra* note 40, at 212.

<sup>45</sup> Smith, *supra* note 42, at 154.

<sup>46</sup> Eckard, *supra* note 42, at 240.

<sup>47</sup> *Report of the American Bar Association*, *supra* note 42, at 14; see BLAIR & LAFONTAINE, *supra* note 40, at 210–12, 234.

<sup>48</sup> BLAIR & LAFONTAINE, *supra* note 40, at 202.

<sup>49</sup> *Report of the American Bar Association*, *supra* note 42, at 14; see also BLAIR & LAFONTAINE, *supra* note 40, at 210–12, 234.

<sup>50</sup> Compare *Report of the American Bar Association*, *supra* note 42, at 14 (arguing that consumers receive fewer services as a result of encroachment legislation), with BLAIR & LAFONTAINE, *supra* note 40, at 212, 234 (arguing that encroachment legislation will reduce consumer convenience).

units will reduce consumer travel costs.<sup>51</sup> Particularly, consumers living close to the new units will be able to travel to these units in order to consume the franchisor's product instead of traveling to farther located units.<sup>52</sup> Finally and relatedly, the additional units, located close to each other, will decrease consumer search costs, namely the costs of obtaining information relevant to the purchase decision.<sup>53</sup>

#### IV. ENCROACHMENT AND CONSUMER WELFARE—A SECOND LOOK

Focusing on consumer welfare, this article argues that traditional economic analysis is imperfect in that it overlooks the broader and long-term negative effects of encroachment practices on consumer welfare.

##### A. *Encroachment Increases Franchisee Failure Rates*

An encroachment strategy is often used by franchisors in order to achieve one central hidden objective: to evade a contractual or statutory obligation to pay damages to a franchisee upon contract termination.<sup>54</sup> Instead of formally and directly terminating the franchise contract—a behavior that may expose the franchisor to an obligation to pay damages to the terminated franchisee—franchisors use an encroachment strategy.<sup>55</sup> This strategy “erode[s] [the] franchisee’s business to the extent that it is no longer viable, causing the franchisee to” surrender the business.<sup>56</sup> Thus, encroachment allows the franchisor to accomplish indirectly what it might not be able to accomplish lawfully through direct termination.<sup>57</sup>

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<sup>51</sup> BLAIR & LAFONTAINE, *supra* note 40, at 207.

<sup>52</sup> *Id.* at 206–11 (presenting a model under which consumers are worse off under an anti-encroachment legal regime because some consumers live quite far from the existing franchisee unit).

<sup>53</sup> *Cf.* Eckard, *supra* note 42, at 227–28 (arguing that encroachment legislation increases consumer search costs). *See, e.g.*, Anil Arya et al., *The Bright Side of Supplier Encroachment*, 26 *MARKETING SCI.* 651 (2007) (purporting to demonstrate other economic advantages of encroachment).

<sup>54</sup> Michael Garner, *A Termination by Any Other Name* (Feb. 14, 2008), [http://www.bluemaumau.org/a\\_termination\\_by\\_any\\_other\\_name](http://www.bluemaumau.org/a_termination_by_any_other_name). Similarly, some franchisors use an encroachment strategy in order to reduce the profitability of their franchisees' units, such that the units eventually will be less expensive for the franchisor to repurchase from the franchisee. *See, e.g.*, *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 719 (7th Cir. 1979).

<sup>55</sup> Garner, *supra* note 54.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

Given the franchisor's incentive to terminate the franchisee indirectly, by using an encroachment strategy, it is not surprising that this strategy increases franchisee failure rates in the franchise industry overall.<sup>58</sup> This failure often occurs, as indicated by empirical and anecdotal evidence, following a two-stage process.<sup>59</sup> In the first stage, the establishment of the new encroaching unit significantly reduces the revenues captured by existing franchisees.<sup>60</sup> In the second stage, the continual erosion of revenues in the existing franchisee will force it out of business.<sup>61</sup>

### 1. Encroachment Reduces the Revenues of Existing Franchisees

Encroachment practices often dramatically decrease the revenues of existing franchisees. To begin with, the encroaching unit tends to draw customers away from the existing unit.<sup>62</sup> Since the product that the encroaching unit sells is typically similar to that of the existing unit, customers often view the encroaching unit as a substitute for the existing unit.<sup>63</sup> This customer perspective allows the encroaching unit to draw customers away from the existing franchisee relatively easily by offering special sales or undercutting prices. As the experience of former Subway franchisees who owned a store in Manhattan demonstrates:

One day during lunch, a man wearing a Subway uniform began distributing flyers in front of the store. Oddly, customers speaking with the Subway coupon man would turn and walk away from the store. It turned out that the man was giving coupons advertising the "buy one, get one free" special at the Subway up the street owned by another franchisee.<sup>64</sup>

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<sup>58</sup> See *infra* Part IV.A.2.

<sup>59</sup> See *infra* notes 71, 78–79 and accompanying text.

<sup>60</sup> See *infra* Part IV.A.1.

<sup>61</sup> See *infra* Part IV.A.2.

<sup>62</sup> Rupert M. Barkoff, *Encroachment: The Nine Lives of 'Scheck'*, 224 N.Y. L.J. 5 (2000); *In re Vylene Enters., Inc.*, 105 B.R. 42, 49 (Bankr. C.D. Cal. 1989) (noting that the encroaching unit drew customers away from the existing franchisee); *Wellcraft Marine, Inc. v. Dauterive*, 482 So. 2d 1002, 1003 (La. App. 3 Cir. 1986) (describing that the existing franchisee lost a big sale to the encroaching unit); *Gerich v. Gen. Motors Corp.*, 588 S.W.2d 107, 116 (Mo. Ct. App. 1979) (explaining that the encroaching unit drew a large number of customers away from the existing franchisee).

<sup>63</sup> Kalnins, *supra* note 5, at 595.

<sup>64</sup> Paul Steinberg & Gerald Lescatre, *Beguiling Heresy: Regulating the Franchise Relationship*, 109 PENN. ST. L. REV. 105, 185 (2004); see also *Goodyear Tire & Rubber Co. v. Whiteman Tire, Inc.*, 935 P.2d 628, 631 (Wash. Ct. App. 1997) (providing another example of where the encroaching unit solicited the existing franchisee's customers).

Encroachment practices may also draw customers away from the existing unit and decrease its revenues for another reason. Since the existing unit and the encroaching unit utilize a similar trademark, customers sometimes confuse the existing unit with the encroaching unit. For example, in *Choice Hotels International, Inc. v. Okeechobee Motel Joint Venture*, the evidence suggested that customers who had reservations at the existing hotel franchisee mistakenly arrived at the encroaching unit.<sup>65</sup> Similarly, in *Robinson v. Perpetual Services Corp.*, a new encroaching unit, operating under a similar name to that of the existing franchisee, caused significant customer confusion.<sup>66</sup>

Additionally, encroachment practices often significantly decrease the revenues of existing franchisees for reasons related to personnel. When an encroaching unit opens, not only are customers from the existing unit drawn to the encroaching unit, but qualified employees may also be drawn away. For example, in *Gerich v. General Motors Corp.*, two key employees and three other experienced and valued employees quit the existing franchisee and joined the encroaching unit.<sup>67</sup> Similarly, in *In re Vylene Enterprises, Inc. v. Naugles, Inc.*, the encroaching unit hired away some employees from the existing franchisee for the encroaching unit.<sup>68</sup> Likewise, in *Re/Max of Georgia, Inc. v. Real Estate Group on Peachtree, Inc.*, a real estate franchisee allegedly had difficulty in recruiting and maintaining agents because of the establishment of an encroaching unit.<sup>69</sup>

Indeed, empirical evidence indicates that since encroachment often draws both customers and employees from the existing unit to the encroaching unit, it significantly decreases the revenue of existing franchisees.<sup>70</sup> For example, Professor Arturs Kalnins conducted an empirical study, examining the impact of

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<sup>65</sup> *Choice Hotels Int'l, Inc. v. Okeechobee Motel Joint Venture*, No. AW-95-2862, 1998 U.S. Dist. LEXIS 23570, at \*14-15 (D. Md. 1998).

<sup>66</sup> *Robinson v. Perpetual Servs. Corp.*, 412 N.W.2d 562, 564 (Iowa 1987); *see also* *Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp.*, 139 F.3d 1396, 1401 (11th Cir. 1998).

<sup>67</sup> *Gerich v. Gen. Motors Corp.*, 588 S.W.2d 107, 116 (Mo. Ct. App. 1979).

<sup>68</sup> *In re Vylene Enters., Inc. v. Naugles, Inc.*, 105 B.R. 42, 46 (Bankr. C.D. Cal. 1989).

<sup>69</sup> *Re/Max of Ga., Inc. v. Real Estate Grp. on Peachtree, Inc.*, 412 S.E.2d 543, 545 (Ga. Ct. App. 1991); *see also* *Choice Hotels Int'l, Inc. v. Okeechobee Motel Joint Venture*, No. AW-95-2862, 1998 U.S. Dist. LEXIS 23570, at \*15 (D. Md. 1998) (demonstrating that the encroaching franchisee solicited employees from the existing franchisee).

<sup>70</sup> Arturs Kalnins, *An Empirical Analysis of Territorial Encroachment Within Franchised and Company-Owned Branded Chains*, 23 MKTG. SCI. 476, 483 (2004).

encroachment on franchisee revenue.<sup>71</sup> The population in the study consisted of all hotels that were in operation in Texas at any time between 1990 and 1999.<sup>72</sup> The data included quarterly taxable revenues for each hotel, provided by the Texas Comptroller of Public Accounts.<sup>73</sup> “The data set also include[d] entry and exit dates for each” hotel franchise, owner, and location combination.<sup>74</sup> The empirical study found that revenues of existing franchisees significantly decreased when franchisors added new units in close proximity to their franchisees’ existing units.<sup>75</sup> Particularly, a new encroaching hotel “within the closest[] 10 hotels [was] associated with a loss of \$66 per room each quarter.”<sup>76</sup>

A large body of anecdotal evidence further demonstrates that encroachment significantly decreases the revenue of existing franchisees.<sup>77</sup> For example, in *McKenna-Stephens Motors, Inc. v. Nissan Motor Corp. in U.S.A.*, the California New Motor Vehicle Board, which operates in a quasi-judicial capacity to resolve disputes between franchisees and franchisors of new motor vehicles, determined that between 25% and 35% of the existing franchisee’s sales, parts, accessories, and services would be lost to an encroaching new unit.<sup>78</sup> Similarly, in *Cohn v. Taco Bell Corp.*, the encroaching unit, established no more than two miles from the existing franchisee, apparently caused a 27% to 40% reduction of sales at the existing franchisee.<sup>79</sup> Additionally, in *Gerich v. General Motors Corp.*, the jury found that an existing motor franchisee suffered substantial financial damage stemming from the

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<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 479.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *See id.* at 483 (discussing proximate same-brand unit measurements).

<sup>76</sup> *Id.*

<sup>77</sup> *See* Kalnins, *supra* note 5, at 595–96.

<sup>78</sup> *McKenna-Stephens Motors, Inc. v. Nissan Motor Corp. in U.S.A.*, No. PR-97-76, at \*7 (Cal. New Motor Vehicle Bd. 1977), [www.nmvb.ca.gov/protest/final\\_decisions/PR-97-76.PDF](http://www.nmvb.ca.gov/protest/final_decisions/PR-97-76.PDF) (last visited Sept. 22, 2011).

<sup>79</sup> *Cohn v. Taco Bell Corp.*, 147 F.R.D. 154, 160 (N.D. Ill. Jan. 12, 1993); *see also* *Robinson v. Perpetual Servs. Corp.*, 412 N.W.2d 562, 564 (Iowa 1987) (showing that an existing franchisee “produced proof indicating a drop in business volume” following the establishment of an encroaching unit); *In re Vylene Enters., Inc. v. Naugles, Inc.*, 105 B.R. 42, 46 (Bankr. C.D. Cal. 1989) (noting that a franchisee testified that an encroaching unit, established 1.4 miles from the existing unit, caused a decline of approximately 35% in the latter’s sales); *Diskin Enters., Inc. v. State Bd. of Vehicle Mfrs., Dealers & Salespersons*, Bus. Franchise Guide (CCH) ¶13,317 (Pa. Commw. Ct. 2006) (holding that increased sales at an encroaching unit, which was established in the market area of an existing franchisee, would come at the latter’s expense).

encroaching unit.<sup>80</sup> In *Photovest Corp. v. Fotomat Corp.*, following the establishment of a new encroaching unit, the existing franchisee incurred substantial economic losses.<sup>81</sup> The court in that case found that a new encroaching unit was the principal cause of the decline in the existing franchisee's sales.<sup>82</sup>

## 2. Reduced Revenues Lead to Franchisee Failure

The significant decrease in the existing franchisee's revenues, caused by new encroaching unit, often leads to the former's business failure. This is mainly because franchisees often have relatively slim profit margins. To illustrate, a typically successful fast-food franchisee may generate 15% in net profits annually.<sup>83</sup> However, since the franchisee typically pays 5% of gross sales for royalties and 2% for national advertisement to the franchisor, she will be left with an 8% net profit.<sup>84</sup> If the encroaching unit reduces more than 8% of the existing franchisee's gross sales, as is common in encroachment cases, the existing franchisee will lose money and ultimately will be forced into bankruptcy.<sup>85</sup>

The following numeric example, presented by Rupert Barkoff and Michael Garner, illustrates how encroachment may lead to eventual franchisee failure.<sup>86</sup> The example existing franchisee has annual sales of \$1,000,000, fixed costs of \$300,000, and 60% direct costs of \$600,000, resulting in the existing franchisee's operating profit of \$100,000.<sup>87</sup> When the encroaching unit is established, it achieves the same annual sales as the existing franchisee of \$1,000,000, with \$300,000 in fixed costs, \$600,000 of direct costs (60%), and \$100,000 in profit.<sup>88</sup> However, 30% of the new unit's sales constituted sales

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<sup>80</sup> *Gerich v. Gen. Motors Corp.*, 588 S.W.2d 107, 116 (Mo. Ct. App. 1979).

<sup>81</sup> *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 717 (7th Cir. 1979).

<sup>82</sup> *Id.* at 718.

<sup>83</sup> Harold Brown, *Franchising: The 20-Year Agreement*, N.Y. L.J., Oct. 22, 1992, at 3.

<sup>84</sup> *Id.*

<sup>85</sup> Marc A. Wites, *The Franchisor as Predator: Encroachment and the Implied Covenant of Good Faith*, 7 U. FLA. J.L. & PUB. POL'Y 305, 306 (1996) ("In many cases . . . the existing franchisee's decrease in sales may obliterate an already slim profit margin."); *id.* at 328 ("Encroachment provides a means for the franchisor to effectively force the franchisee to terminate the relationship because the franchisee can no longer operate the location profitably."); Rupert M. Barkoff, *Encroachment Issues Persist*, NAT'L L.J., Apr. 19, 2004, at 16, 20 (explaining that opening another franchise may put the other franchisee out of business).

<sup>86</sup> See Barkoff & Garner, *supra* note 26, at 8.

<sup>87</sup> *Id.* Notably, direct costs of 60% are reflective of the franchise fast food industry. *Id.* at 7.

<sup>88</sup> *Id.* at 8.

that would have gone to the existing franchisee, had the encroaching unit not been built.<sup>89</sup> Thus, the existing franchisee has sales of \$700,000, fixed costs of \$300,000, and direct costs of \$420,000 (\$700,000 x 60%).<sup>90</sup> As a result, the existing franchisee suffers each year a \$20,000 loss (700,000 - 300,000 - 420,000).<sup>91</sup> The bottom line is that the existing franchisee is losing money each year and will ultimately fail.

Indeed, empirical studies indicate that encroachment strategies increase franchisee failure. Professors Steven Michael and James Combs conducted an empirical study in which they examined whether franchisee failure is negatively related to exclusive territories provided by the franchisor to its franchisees.<sup>92</sup> They analyzed a sample of eighty-eight established franchisors.<sup>93</sup> They collected data on the identity of franchisors that provided exclusive territory guarantees from franchisor's Uniform Franchise Offering Circulars (UFOC).<sup>94</sup> The empirical study found that exclusive territory guarantees were negatively related to franchisee failure.<sup>95</sup> This result strongly implies that encroachment on the franchisee's territory increases franchisee failure.

Another empirical study, conducted by Professors Paul Ingram and Joel A. C. Baum, strongly indicates that franchise encroachment increases franchisee failure.<sup>96</sup> The sample used for the analysis of this study included 537 hotels that operated in Manhattan between 1898 and 1980.<sup>97</sup> The results of the study show that the failure rates of a hotel in Manhattan, affiliated with a hotel chain, increase as the number of Manhattan hotels, controlled by the chain, increases.<sup>98</sup>

A host of anecdotal evidence further suggests that encroachment increases the rate of franchisee failure. To illustrate, in *Goodyear Tire & Rubber Co. v. Whiteman Tire, Inc.*, an encroaching unit was

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<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> Steven C. Michael & James G. Combs, *Entrepreneurial Failure: The Case of Franchisees*, 46 J. SMALL BUS. MGMT. 73, 73 (2008).

<sup>93</sup> *Id.* at 80.

<sup>94</sup> These circulars "are used by franchisors to explain their business model and contract terms." *Id.* at 79.

<sup>95</sup> *Id.* at 83-84.

<sup>96</sup> See Paul Ingram & Joel A. C. Baum, *Chain Affiliation and the Failure of Manhattan Hotels, 1898-1980*, 42 ADMIN. SCI. Q. 68, 97-98 (1997).

<sup>97</sup> *Id.* at 77-78.

<sup>98</sup> *Id.* at 91, 97.

established in the market area of an existing franchisee.<sup>99</sup> Following the establishment of the new unit, the exiting franchisee no longer earned enough revenue to pay its existing obligations to the franchisor, and it ultimately filed for bankruptcy.<sup>100</sup> Equally, in *Photovest Corp. v. Fotomat Corp.*, following the establishment of encroaching units in the market area of an existing unit, the latter was valued as worthless.<sup>101</sup> Similarly, in *Diskin Enterprises v. State Board of Vehicle Manufacturers, Dealers & Salespersons*, the court concluded that the lost sales to existing franchise units, resulting from encroachment, may ultimately force the existing units out of business.<sup>102</sup> In *Super Valu Stores, Inc. v. D-Mart Food Stores, Inc.*, as well, the franchisor intended to open an encroaching unit four blocks from an existing franchise unit, while the franchisor's market survey predicted that the presence of an encroaching unit would render the existing franchisee's unit unprofitable.<sup>103</sup> In an additional example, in *RE/MAX of Georgia, Inc. v. Real Estate Group on Peachtree, Inc.*, following the establishment of an encroaching unit, the existing franchisee ceased doing business because of financial problems.<sup>104</sup> Similarly, in *Southern Implement Co. v. Deere & Co.*, an existing franchisee closed his unit due to mounting losses, following the establishment of an encroaching unit.<sup>105</sup>

*B. Increased Franchisee Risk of Failure is Likely to Deter  
Individuals from Becoming Franchisees*

An increase in the rate of franchisee business failure, caused by encroachment strategies, is likely to deter individuals considering becoming franchisees from joining the franchise industry.

Most individuals who consider becoming franchisees consider other business possibilities, such as opening an independent business or being an employee at an already established business. For example, Jeffrey Bradach and Patrick Kaufmann conducted a

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<sup>99</sup> *Goodyear Tire & Rubber Co. v. Whiteman Tire, Inc.*, 935 P.2d 628, 631 (Wash. Ct. App. 1997).

<sup>100</sup> *Id.* at 632.

<sup>101</sup> *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 717–18 (7th Cir. 1979).

<sup>102</sup> *Diskin Enters. v. State Bd of Vehicle Mfrs, Dealers & Salespersons*, Bus. Franchise Guide (CCH) ¶13,317 (Pa. Commw. Ct. 2006).

<sup>103</sup> *Super Valu Stores, Inc. v. D-Mart Food Stores, Inc.*, 431 N.W.2d 721, 728 (Wis. Ct. App. 1988) (Sundby, J., dissenting).

<sup>104</sup> *RE/MAX of Ga., Inc. v. Real Estate Grp. on Peachtree, Inc.*, 412 S.E.2d 543, 545 (Ga. Ct. App. 1991).

<sup>105</sup> *S. Implement Co. v. Deere & Co.*, 122 F.3d 503, 505–06 (8th Cir. 1997).

survey among 1418 potential franchisees who attended a franchise exposition, thus demonstrating an active interest in becoming a franchisee.<sup>106</sup> According to the survey, 84% of individuals presently considering becoming franchisees also considered opening an independent business.<sup>107</sup> Similarly, Russell Knight conducted a survey among 105 Canadian franchisees.<sup>108</sup> According to the survey, 67% of respondents had also considered starting independent businesses.<sup>109</sup>

When individuals decide whether to become franchisees or not, their decision is usually influenced by a central factor: the level of risk of franchisee failure in the franchising sector as a whole.<sup>110</sup> This assertion is supported by several empirical studies. To illustrate, Sirinimal Withane surveyed 150 Canadian franchisees through a questionnaire and follow-up interviews.<sup>111</sup> The franchisees were randomly selected from the *Annual Franchise Yearbook* (1987).<sup>112</sup> According to the study, 60% of the subjects found the franchisee risk of failure in the franchising sector as a whole, compared with the rate of failure of independent businesses, to be influential in their decision about whether to become a franchisee or not.<sup>113</sup> Similarly, Alden Peterson and Rajiv Dant conducted an empirical study among U.S. franchisees.<sup>114</sup> They analyzed seventy-four questionnaires answered by randomly selected franchisees of a major nationwide franchise system in the service industry.<sup>115</sup> The respondents were asked to provide their reasons for opting for the franchise format.<sup>116</sup> According to the

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<sup>106</sup> Jeffrey Bradach & Patrick J. Kaufmann, *Franchise or Independent Businessperson: Some Observations on the Decision Process*, in RESEARCH AT THE MARKETING/ENTREPRENEURSHIP INTERFACE: PROCEEDINGS OF THE UNIVERSITY OF ILLINOIS AT CHICAGO SYMPOSIUM ON MARKETING AND ENTREPRENEURSHIP 38, 40 (Gerald E. Hills & Raymond W. LaForge, eds. 1991).

<sup>107</sup> *Id.* at 45.

<sup>108</sup> Russell M. Knight, *Franchising from the Franchisor and Franchisee Points of View*, 24 J. SMALL BUS. MGMT. 8, 9 (1986).

<sup>109</sup> *Id.* at 10.

<sup>110</sup> Gary J. Castrogiovanni et al., *Franchise Failure Rates: An Assessment of Magnitude and Influencing Factors*, 31 J. SMALL BUS. MGMT. 105, 105 (1993).

<sup>111</sup> Sirinimal Withane, *Franchising and Franchise Behavior: An Examination of Opinions, Personal Characteristics, and Motives of Canadian Franchisee Entrepreneurs*, 29 J. SMALL BUS. MGMT. 22, 23 (1991).

<sup>112</sup> *Id.* at 23–24.

<sup>113</sup> *Id.* at 26.

<sup>114</sup> Alden Peterson & Rajiv P. Dant, *Perceived Advantages of the Franchise Option from the Franchisee Perspective: Empirical Insights from a Service Franchise*, 28 J. SMALL BUS. MGMT. 46, 46 (1990).

<sup>115</sup> *Id.* at 49.

<sup>116</sup> *Id.* at 50.

study, 71.4% of respondents agreed or strongly agreed that their decision to become franchisees was influenced by a comparison between franchisees' investment risk in the franchise sector as a whole and that of independent businesses.<sup>117</sup>

Given that an individual's decision of whether or not to become a franchisee is usually influenced by the level of risk of franchisee business failure in the franchising sector as a whole, encroachment practices are likely to deter individuals from becoming franchisees. This is mainly due to the fact that encroachment increases the rate of franchisee business failure.<sup>118</sup>

*C. Detering Individuals from Becoming Franchisees Decreases Consumer Welfare*

Encroachment's potential to deter individuals from becoming franchisees decreases consumer welfare. Specifically, it stands to reduce the inherent pro-consumer efficiencies achieved by franchisees. These efficiencies are twofold.

First, franchisees are usually able to provide consumers with the product comprising the franchisor's business format at a lower price than that of an operator of a non-franchised business.<sup>119</sup> The logic of this argument is the following: suppliers often sell the same products to multiple franchisees in the same franchise chain.<sup>120</sup> Accordingly, suppliers achieve reduced costs of production and distribution that allow them to reduce their prices to the franchisees. In addition, franchised chains can benefit from lower costs through realizing economies of scale in production, new product development, and advertising.<sup>121</sup> These buying efficiencies, in turn, allow franchisees to sell products to consumers at a lower price than that of an operator of a non-franchised business.

Franchisees provide another pro-consumer efficiency, which will be reduced if individuals are deterred from becoming franchisees.

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<sup>117</sup> *Id.* at 51–52.

<sup>118</sup> Barkoff, *supra* note 1 (“Excessive encroachment often leads to failed units, which . . . discourages prospective franchisees from buying new units.”).

<sup>119</sup> BLAIR & LAFONTAINE, *supra* note 40, at 1; Patrick J. Kaufmann & Sevgin Eroglu, *Standardization and Adaption in Business Format Franchising*, 14 J. BUS. VENTURING 69, 74 (1998); Rust, *supra* note 41, at 492 (“[F]ranchising benefits consumers by providing competitive pricing.”).

<sup>120</sup> Kaufmann & Eroglu, *supra* note 119, at 74. Similarly, franchisors act as consolidators. Namely, they bring all the necessary services together under one roof and consolidate them, achieving economies of scale. *See id.*

<sup>121</sup> BLAIR & LAFONTAINE, *supra* note 40, at 1; *see also* ANNE T. COUGHLAN ET AL., *MARKETING CHANNELS* 524 (7th ed. 2006).

One central aspect of franchising is the creation of a standardized product among franchisees.<sup>122</sup> Franchised units, owned by franchisees, generally have identifiable brand names that help to assure the consumer of uniform product quality.<sup>123</sup> Consumers therefore normally know what to expect when they patronize a franchisee's unit in a franchised chain.<sup>124</sup> Thus, by standardizing the product consumers can expect to receive at various retail locations provides valuable information to the consumer when making a choice between products.<sup>125</sup> This information is particularly valuable due to increased consumer mobility and greater time constraints.<sup>126</sup> A decrease in franchises due to destructive encroachment strategies, and their long-term deterrent effect on potential franchisees, would harm consumers in that it would reduce the availability of valuable information about products and services relevant to consumers in making purchases.

## V. CONCLUSION

Law and economics' conventional analysis contends that franchise encroachment legislation, restricting the franchisor from establishing a new unit in unreasonable proximity to its existing franchisee, is inefficient. Well rooted in traditional law and economics theories, opposition to such legislation is based upon the belief that franchise encroachment increases consumer welfare, mainly by increasing price and service competition among neighboring franchisees. As this article has demonstrated, however, the conventional analysis ignores the broader and long-term implications that encroachment practices may have on consumer welfare. While, as legal economists suggest, encroachment may enhance consumer welfare in the short-term by increasing price and service competition, these benefits will be

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<sup>122</sup> BLAIR & LAFONTAINE, *supra* note 40, at 117 ("The strength of franchise systems . . . resides largely in the capacity of the franchised chain to offer a *uniform* product."); Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J.L. & ECON. 345, 349 (1985); Rust, *supra* note 41, at 492 ("[F]ranchising benefits consumers by providing . . . consistency in the products available at various locations.").

<sup>123</sup> James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401, 403 (1987).

<sup>124</sup> BLAIR & LAFONTAINE, *supra* note 40, at 117.

<sup>125</sup> Klein & Saft, *supra* note 118.

<sup>126</sup> BLAIR & LAFONTAINE, *supra* note 40, at 1. Interestingly, Professors Blair and Lafontaine explain that "[t]he increased time constraints . . . can be traced to the increased participation of women in the labor force, and the resulting 'out-sourcing' by households, as well as the increasing complexity of products available for consumption." *Id.* at 1 n.1.

gained at the expense of consumers in the long-term.

Encroachment practices increase the rate of franchisee business failure in the franchise industry as a whole. Such increase is likely to deter individuals from joining the franchise industry, thereby reducing the inherent pro-consumer efficiencies achieved by franchisees, including lower prices and product standardization. Accordingly, if the franchisor decides to encroach on the franchisee's territory, then there is a negative long-term externality of lost benefit to consumers.

Franchisors often use a destructive encroachment strategy which causes their respective franchisees' businesses to fail.<sup>127</sup> The incentive of franchisors to use a destructive encroachment strategy may derive from two central cumulative factors: first, an encroaching franchisor directly and exclusively benefits from the destructive encroachment, since such encroachment allows the franchisor to terminate the franchisee, while evading a contractual or statutory obligation to pay damages to the franchisee upon an explicit contract termination. Instead of formally and directly terminating the franchise contract—a behavior which may expose the franchisor to an obligation to pay damages to the terminated franchisee—franchisors use a destructive encroachment strategy, which will cause the franchisee to surrender. Second, an encroaching franchisor does not bear all of the social costs of encroachment, namely the deterrence of individuals from joining the franchise industry. The franchisor bears only part of the costs, for part is borne by other franchisors and the franchise industry as a whole. When deciding to encroach, the franchisor takes into account only her own interests and not the long-term and broader costs to the franchise industry and to potential consumers, who stand to gain from the long-term continuation of the franchise format. The franchisor, therefore, may use an encroachment strategy even if long-term consumer welfare would be improved by avoiding encroachment.

The solution is to legally force the franchisor to internalize the external losses suffered. This article therefore calls on federal and state policy makers who are currently considering the adoption of encroachment laws to adopt such laws.<sup>128</sup> Under these laws,

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<sup>127</sup> See *supra* Part IV.A.

<sup>128</sup> Massachusetts, for example, has just introduced a bill prohibiting franchisor encroachment. S.1843, 187th Sess. (Mass. 2011).

adopted so far by a minority of states,<sup>129</sup> if the franchisor encroaches on the franchisee's market area, the franchisee has a cause of action for monetary damages against the franchisor.<sup>130</sup> Damages include the lost profits attributed to the opening of the encroaching outlet. Awarding such damages serves important consumer interests. On one hand, a damages regime allows the franchisor to use encroachment strategies, which can enhance consumer welfare in the short run. On the other hand, a damages regime forces the franchisor to internalize the damage that its encroachment strategy may cause in the long run. In particular, it guarantees that encroachment may take place only if it does not cause franchisee business failure and deterrence of individuals from joining the franchise industry. Ultimately, encroachment laws guarantee that consumer welfare will be enhanced, not only in the short-term, but in the long-term as well.

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<sup>129</sup> *See supra* Part II.A.

<sup>130</sup> *Id.*