COMMON ISSUES IN HOSPITALITY FRANCHISING

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I. SCOPE OF ARTICLE

The franchise relationship between the franchisor and franchisee revolves around and is governed primarily by a franchise agreement and applicable statutory laws. A franchise agreement is usually one-sided, favoring the franchisor, with extensive protections and rights while restricting the franchisee's entrepreneurial freedom and providing few rights and privileges. It allows one side--the franchisor--to control and set the fees to be paid by the franchisee. It allows the other side--the franchisee--to benefit from a brand name and central reservations as well as other benefits of being part of a large organized system. As such, it is crucial that a franchisee is aware of and understands the significance of every provision contained in the franchise agreement. While there are a host of different provisions contained in franchise agreements which frequently lead to disputes between a franchisor and franchisee, three of the main issues are liquidated damages, remodeling requirements and encroachment.

A liquidated damages clause provides the amount of, or formula for computing monetary damages in the event that one party breaches the contract. Typically, hotel franchisors favor the inclusion of a liquidated damages clause because they provide the exact figure which a franchisee will be required to pay to the franchisor in the event of a premature termination of the franchise agreement. Hotel franchisors also favor inclusion of the liquidated damages clause in franchise agreements in an attempt to deter franchisees from terminating their franchise agreement prior to its expiration and go join another franchise system. On the other hand, franchisees view the liquidated damages clause as a penalty because the amount of liquidated damages is in many instances not a true measure of the actual damages that a hotel franchisor suffers and results in a windfall to the franchisor.

The second common issue of dispute between hotel franchisors and franchisees is in the area of remodeling requirements. This issue is a major source of contention because the franchisor usually retains *complete discretion* when to require the franchisee to remodel and renovate the property as well as the scope and extent of the remodel. While some franchisors are willing to give the franchisee more time if requested, the decision whether to grant additional time is the franchisors, not the franchisees. If the franchisor agrees to provide additional time to complete the remodeling, it is imperative that a franchisee promptly obtain this promise, *in writing*, and preferably before the initial deadline has lapsed. The scope and extent of the remodel is extremely important. The financial burden placed on the franchisee must be related to the increased returns the franchisee is to receive from such a significant investment.

The third major concern facing hotel franchisees is the issue of encroachment. This is where a franchisor seeks to saturate a particular geographic market with its brand, to its overall benefit but to the individual franchisees' detriment by placing a new and competing business within such close proximity to an existing franchise so that the success of the existing franchise is jeopardized due to the negative impact on sales and diversion of traffic caused by the new operation. While virtually none of the hotel franchisors provide an area of protection in the language of the franchise agreement, most of them have enacted an impact policy in an attempt to afford some protection of franchisees. For example, a franchisee is provided with a specified area of protection in which the franchisor will not place a same-brand competing unit in close proximity to the existing franchisee.

This article focuses on the above three areas of major contention between hotel franchisors and franchisees from both a franchisor and franchisee perspective. A brief introduction is provided for each of these issues, and a discussion is provided as to what type of language franchisors and franchisees prefer in the franchise agreement regarding liquidated damages, remodeling and encroachment. Additionally, this article also provides franchisees with some guidelines as to how to protect themselves from disputes arising with the franchisor in these three (3) areas.

II. LIQUIDATED DAMAGES CLAUSE

A. INTRODUCTION

This portion of the article discusses the enforceability of a liquidated damages clause, which is included in virtually every hotel franchise agreement. Pursuant to the liquidated damages clause, a franchisee is required to pay to the franchisor a pre-determined sum of money should the agreement be terminated prior to the expiration of its full term. This issue arises most frequently in situations where a franchisor terminates the franchisee for some breach of the franchise agreement, whether the breach be material or non-material. It also arises in situations where a franchisee attempts to exercise its right to terminate the agreement at a designated anniversary date in order to convert to a different franchise system.

B. PURPOSE OF A LIQUIDATED DAMAGES CLAUSE

A "liquidated damages" clause provides the amount of, or formula for computing monetary damages in the event that one party breaches the contract. Instead of having a judge or jury calculate the amount of damages the injured party has suffered, the agreement itself sets forth the amount of money the breaching party must pay to the non-breaching party. In the hospitality industry, the liquidated damages are generally calculated based on the number of rooms in a property and the average amount of monthly royalty fees that a franchisee has paid during the prior two (2) to three (3) year period. Put another way, a franchisee's liability for liquidated damages proportionately increases with the number of rooms in the property.

Liquidated damages clauses vary in form and much will depend on the specific language contained in the franchise agreement. The underlying purpose of a liquidated damages clause is to prevent the franchisee from leaving the system in search of greener pastures. It may benefit both parties when it avoids the expensive process of hiring accounting and finance experts to calculate the damages caused by the contract termination. This way, each party knows up front how much it will cost to change his or her mind. Problems arise when a franchisee is *forced* to change his or her mind because of material default on the part of a franchisor, such as lack of support and services and/or shutting off the reservation system.

Many state's laws restrict the enforcement of a liquidated damages clause if it is determined by a court that the amount of liquidated damages appears to be "unconscionable" and, thus, a penalty rather than a true measure of the amount of money that a franchisor will stand to lose as a result of a premature termination of the franchise agreement. *See Howard Johnson International, Inc. v. HBS Family, Inc.*, 1998 WL 411334 (S.D. N.Y. 1998) (liquidated damages provision stricken by court where it was determined that the amount of liquidated damages was not a reasonable estimate of the potential loss likely to be suffered because it did not take into account the length of time remaining on the unexpired License Agreement at the time of default). In many of the jurisdictions where hotel franchisors are headquartered, the test for enforceability of the liquidated damages clause is solely based on the circumstances at the time the parties entered into the franchise agreement. *See Ramada Franchise System, Inc. v. Cusack Development, Inc.*, 1999 WL 165702, *8 (S.D. N.Y. 1999) (applying New York law). In other words, just because circumstances have changed so that the liquidated damages may be disproportionate at the time of breach does not matter so long as it was a fair and reasonable estimate at the time the agreement was executed.

The courts also take into account the potential difficulty of estimating the amount of actual damages suffered by the non-breaching party. If the actual amount of damages can be readily calculated at the time the agreement is entered into between the parties, then the provision may constitute a penalty and be unenforceable. In the alternative, if it is difficult to calculate the actual amount of damages suffered, then the court may enforce the liquidated damages provision. *See Shree Ganesh, Inc. v. Days Inns Worldwide, Inc.*, 192 F.Supp.2d 774 (N.D. Ohio 2002) (under New Jersey law, liquidated damages clause is valid where it constitutes a reasonable forecast of the provable injury resulting from the breach, and where harm is incapable or very difficult of accurate estimate). For example, in most states, liquidated damages clauses are only enforceable if (1) the amount of liquidated damages bears a reasonable proportion to the probable loss and (2) the amount of the actual loss is incapable or difficult of precise estimation. *Ramada Franchise Systems, Inc. v. Capitol View II Limited Partnership Venture*, 132 F.Supp.2d 358, 364 (D. Md. 2001) (applying Arizona law). If, however, the amount fixed is plainly or grossly disproportionate to the probable loss, the liquidated damages clause will be deemed a penalty and be unenforceable. Importantly, some states do not even permit the award of liquidated damages, irrespective of whether they are reasonable. *See Holiday Hosp. Franchising, Inc. v. H-5, Inc.*, 165 F.Supp.2d 937, 940 (D. Minn. 2001) (the Minnesota Franchise Act precludes the award of liquidated damages for a premature termination of the franchise agreement); *see also* Minn. Stat. §§80C.01-22.

C. SECOND LOOK APPROACH

Some states permit what is commonly known as a "second look" approach. Under the "second look" approach, a court looks at both the circumstances at the time of contracting as well as the actual damages flowing from the breach (or early termination) of the franchise agreement. *See Days Inns of America, Inc. v. P & N Enterprises, Inc.*, 164 F.Supp.2d 255 (D. Conn. 2001) (applying New Jersey law); *Shree Ganesh, Inc.*, 192 F.Supp.2d at 786 (court entered summary judgment in favor of franchisee and struck the liquidated damages clause as an unenforceable penalty under New Jersey law where the amount of damages as calculated under the liquidated damages clause were approximately five (5) times the amount that would have resulted if the calculation was based on recurring fees paid by the franchisee over the past two (2) years). Several states have not yet taken a firm position on which method to apply, while others take a "peak" at actual damages to validate their first look.

If there is any doubt as to whether a liquidated damages clause constitutes an unenforceable penalty or an appropriate and enforceable amount, many states typically require that a court rule in favor of the franchisee and declare the liquidated damages clause to be an unenforceable penalty. *See Capitol View II Limited Partnership Venture*, 132 F.Supp.2d at 364 (court denied summary judgment to franchisor where the franchisor sought liquidated damages representing over one-half of the time left to run on a twenty (20) year agreement and there was no supporting evidence to support its view that it was a reasonable forecast of just compensation). Furthermore, courts also consider the sophistication of the parties and whether each side was represented by counsel at the time of execution of the franchise agreement. For example, if a franchisee did not have an experienced franchise attorney review the franchise agreement prior to execution (as is normally the case), the franchisor would be deemed to have superior and unheralded bargaining power, thus, supporting the notion that the clause is in the nature of an unenforceable penalty.

Undoubtedly the most difficult aspect of the law on liquidated damages to understand and accept is the fact that many of the key states (i.e., California, New York) totally disregard the actual impact of the liquidated damages resulting from the formula contained in the franchise agreement. So, if *at the time of contracting*, it would be difficult to determine how much money the franchisor would lose should you decide to leave the franchise system prior to the expiration of the agreement, then the court would not consider it a penalty. *Travelodge Hotels, Inc. v. Kim Shin Hospitality, Inc.*, 27 F.Supp.2d 1377, *1382-83 (M.D. Fla. 1998) (applying

California law). The liquidated damages amount then becomes a substitute for the actual but incalculable damages the franchisor incurs. If a franchisee takes over the franchise mid-term and there is already five or ten years of historical sales figures from the previous franchisee, it may not be that hard to determine how much the franchisor would lose in royalties. But it may still be difficult to determine *at the time of contracting* how long it will take the franchisor to replace a departing franchisee with another franchisee.

D. FRANCHISOR BREACHES THE AGREEMENT FIRST

Often times, a situation arises in which the franchisor breaches the franchise agreement before the franchisee either converts to another flag or closes down prior to the expiration of the franchise agreement. For example, if a conversion or closure is due to the fact that the reservation system so critical to a franchisee's success is contributing less than five percent (5%) when a franchisee is advised that it should be in the twenty percent (20%) range and the franchisee believes that the franchisor is the cause, then the liquidated damages clause may not be enforced.

A liquidated damages clause is considered a *dependant covenant*, that is, the franchisor's ability to enforce the liquidated damages clause is dependent on its own compliance with all of the material terms of the franchise agreement. If a franchisee decides to convert to a different franchise system because the franchisor fails to provide the support and services it is obligated to provide, then the liquidated damages clause is typically unenforceable. Likewise, if the franchisor wrongfully terminates the franchise agreement without the franchisee being at fault, liquidated damages may not be awarded to the franchisor.

None of the standard hotel franchise agreements provide for an award of liquidated damages to the franchisee when the franchisor breaches. In some states this lack of "mutuality of obligation" is sufficient cause to prohibit an award of liquidated damages. Mutuality would exist, for example, where the franchise agreement included liquidated damages in favor of whichever party to the agreement did not breach or withdraw early.

If a franchisee successfully challenges a liquidated damages clause on the basis that it constitutes a penalty but the court finds that the franchisee did breach the agreement, then the court will instead require that the franchisor prove how much it was actually damaged by the breach. If the franchisor immediately replaces the brand with another franchisee in the same contracted area, then damages may be minimal. On the other hand, if the franchisor is not *able* to replace the franchisee at all, then the franchisor may be awarded the royalty stream that it would have received had the franchisee remained in the system until the expiration of the franchise agreement. Good faith efforts to avoid damages should be considered.

E. PRESENT DAY CHALLENGES TO THE LIQUIDATED DAMAGES CLAUSE

One way to challenge a liquidated damages clause is to show the length of time it takes the franchisor to signs up a replacement franchisee. For example, if a franchisee converts to a different franchise system or closes and then the ex-franchisor's flag goes up in the same area a couple of weeks later, then the full amount of liquidated damages may not be warranted as it would result in a windfall to the franchisor. If the franchisor is big enough where it has access to a large prospective franchisee pool, it is unlikely that it will be able to support a liquidated damages amount equivalent to two (2) or three (3) years' worth of royalty fees.

Most franchisees who seek to have the liquidated damages clause stricken generally argue that it is a penalty whenever the franchisor suffers little or no actual damages (and may actually profit by receiving another franchise fee from a replacement franchisee at or near the same location). Some courts have rejected this argument by pointing out the benefit of predictability (i.e., a liquidated damages clauses indicates exactly how much it will cost a franchisee to prematurely leave the system). *See Cusack Development, Inc.*, 1999 WL *8 (the court rejected the theory of mitigation of damages and repeated the rule that the court must only look at the reasonableness of the calculation as of the time of execution of the agreement). If one considers the prospect of paying the franchisor's "lost profits" for the number of years left on the contract, liquidated damages may seem more palatable – particularly where the franchisor meets or exceeds the franchisee's expectations but the franchisee just prefers a different system.

Due to the large corporate umbrellas covering several brands, many franchise agreements include choice of law clauses whereby the franchisor elects to have the agreement governed by the laws of the state where its headquarters is located. Due to the increase in the enforcement of the liquidated damages clause throughout the country, many states continue to experience an influx of litigation over this clause. Over the years, some franchisees have successfully challenged the liquidated damages clause by having it stricken as an unenforceable penalty. The law is still catching up to the magnitude of this problem and it is likely an area ripe for litigation until legislation is enacted.

III. <u>REMODELING REQUIREMENTS</u>

A. INTRODUCTION

Another issue which frequently arises in a franchisor/franchise relationship in the lodging industry is the issue of remodeling and renovations requirements. Hotel franchise agreements typically permit the franchisor to require that the franchisee complete certain franchisor-identified improvements to the property by a specified date. These improvements may be necessary because of normal wear and tear to the property, inadequate maintenance by the previous hotel owner or the effects of a natural disaster (i.e., hurricane).

This issue is a major source of contention among hotel franchisees because the franchisor usually retains *complete discretion* to the timing and extent of remodeling required by the franchisee to remodel and renovate the property. The franchisor usually dictates how much the franchisee is to spend on the remodeling. The old adage "it is easy to spend someone else's money" rings true in this issue. While some franchisors are willing to give the franchisee more time if requested, the decision whether to grant additional time is the franchisors, not the franchisees. If the franchisor agrees to provide additional time to complete the remodeling, it is imperative that a franchise promptly obtain this promise, *in writing*, and preferably before the initial deadline has lapsed. Otherwise, the franchisee typically is always at the mercy of the franchisor, and can lead to a termination of the franchise agreements as set forth below in two (2) separate incidents. *See also Ramada Franchise Systems, Inc. v. Jacobcart, Inc.*, 2001 WL 540213, *1 (N.D. Tex. 2001) (franchisor terminated franchise agreement for, among other things, franchisee's failure to improve property and bring it in conformance with franchisor's standards); *Ramada Inns, Inc. v. Gadsden Motel Co.*, 804 F.2d 1562, 1563 (11th Cir. 1986) (franchisor terminated license agreement for franchisee's failure to timely meet refurbishing requirements).

B. A FRANCHISE AGREEMENT MAY BE TERMINATED FOR FAILURE TO TIMELY REMODEL

In *P.U.D., Inc. v. Days Inn of America, Inc.*, 1999 WL 1939995 (E.D. N.C. 1999), inspectors for Days Inn provided a North Carolina franchisee with a "punch list" of improvements in order to bring the property into conformity with Days Inn's standards and set a deadline for the completion of such improvements. *Id*. at *1. If the franchisee did not have make the improvements by a specified deadline and, thus, did not have the hotel in operation, the franchise agreement was subject to termination by Days Inn without any further notice. *Id*. Approximately one (1) month prior to the expiration of the deadline, Hurricane Fran struck eastern North Carolina and significantly damaged the property. *Id*. at *2. The franchisee informed Days Inn of the damage and submitted a claim to its insurance company. *Id*. As a result of a dispute with the insurer, the franchisee was forced to temporarily close its doors and, thus, was unable to make the repairs on a timely basis. *Id*. Approximately seven (7) months later, the franchisee resolved its dispute with its insurance company and proceeded to renovate the property per Days Inn's specifications. *Id*. A few weeks after the franchisee commenced the renovations, Days Inn advised the franchisee that it was terminating the franchise agreement as a result of the franchisee's failure to timely make the improvements, which led to litigation between the parties. *Id*. at *3. In granting summary judgment in favor of Days Inn, the Court found that even though the franchisee ultimately repaired the damage to the property, Days Inn was warranted in terminating the franchise agreement as a result of the franchisee's failure to make the improvements by the specified date. *Id*.

In *Travelodge Hotels, Inc. v. Hercoules Coutoules*, 1999 WL 314166 (D. N.J. 1999), a prospective New Jersey Travelodge franchisee lacked the necessary funds to immediately make certain improvements and repairs designated by the franchisor. *Id*. at. *1. Nevertheless, the franchisor urged the franchisee to execute the franchise agreement anyway, and assured the franchisee that "as revenue was produced [defendant] could make the necessary repairs." *Id*. Moreover, Travelodge permitted the franchisee to open the hotel for business even though the repairs were not made. *Id*. Although the franchisor provided extensions of time, the franchisee never fully renovated the hotel property, thus, causing the franchisor to initiate litigation against the franchisee. *Id*. at *2. In granting the franchisor's motion for a preliminary injunction, the New Jersey court required the franchisee to promptly cease to do business under the Travelodge Hotels trademarks because, among other things, it had never made the required renovations to the property to bring the property in conformity with Travelodge's standards. *Id*. at *8.

As is evident from the above two (2) cases, the failure to remodel and renovate the property *within the time frame the franchisor has unilaterally chosen* can and does lead to a termination of the franchise agreement. As such, it is imperative that franchisees take the franchisor's remodeling requirements seriously in order to avoid a termination of their franchise rights.

C. DEFENSES TO UNREASONABLE REMODELING REQUIREMENTS

If a franchisee is put in this predicament by a franchisor with respect to making certain remodeling requirements with in a specified amount of time, it is imperative that the franchisee do his/her best to make all reasonable renovations on schedule. If the repairs cannot be made on a timely basis, whether that be because the repairs are excessive or not enough time is provided, a franchisee should always contact a franchise attorney to determine whether the reasons for the franchisee's inability to timely make the repairs are justified.

A franchisee can arguably be justified in not timely remodeling and renovating the property when a franchisor requires Hyatt Hotel quality renovations to be made to a Super 8 Motel. In other instances, a franchisee may be justified in not making all of the renovations required by the franchisor because the rate of return on the investment (i.e., higher occupancy and higher rates may not be sufficient to repay the significant investment within a reasonable period of time). For example, it is unreasonable to require a franchisee to expend one hundred thousand dollars ($100,000.00) in renovations when only two (2) years remain on the term of the franchise agreement, and only forty thousand dollars ($40,000.00) of additional gross revenues are expected to be generated by the new improvements.

In these instances, it is necessary for a franchisee to take the necessary steps to obtain a written waiver of the inappropriate and extensive remodeling requirements and/or obtain an appropriate extension of time. For example, the franchise agreement for the North Carolina Days Inn franchisee in the *P.U.D., Inc* case contained a provision allowing the franchisee six (6) additional months after "casualties" (such as Hurricane Fran) to complete repairs, but the franchisee never requested an extension on such basis assuming the franchisor would clearly understand. It is fatal to rely upon the franchisor's oral promises regarding extensions of time or other waivers of certain remodeling requirements. *See also Travelodge Hotels, Inc. v. PPS Development, Ltd.*, 2003 WL 21920104, *1 (N.D. Ill. 2003) (franchisor permitted to terminate franchise agreement for franchisee's failure to timely meet franchisor's minimum property standards; court held that franchisee could not rely on franchisor's oral promises to defer inspections until appropriate financing was obtained to perform renovations). If the franchisor does not put it in writing, it will in all likelihood be impossible for the franchisee to prove such promise as franchisors have a regular habit of conveniently forgetting about such promises.

Second, it is extremely crucial to obtain the franchisor's written detailed description of the required renovations as well as written approval of the time permitted to complete the renovations and repairs. In situations such as this, a franchisee also must be certain that the individual that the franchisee is dealing with has the proper authority to grant extensions of time and/or waive certain remodeling requirements. This is especially important because there are instances where courts have held that it is not reasonable to rely on even the written promises of representatives of the franchisor where the representative did not have the authority to make binding promises on behalf of the franchisor.

Last, it is important that the date as well as the particular renovations made to the property be well-documented to avoid any disputes with the franchisor as to which and when the repairs were made or whether they were properly made pursuant to the franchisor's specifications. Moreover, when dealing with your franchisor, especially with respect to remodeling requirements, it is crucial to keep a log documenting all the dates and contents of all communications. Do not assume that just because the franchisor failed to remind you about a remodeling deadline will mean that the franchisor will not attempt to enforce the deadline or even attempt to terminate the franchise agreement. All repair and renovation issues must be taken very seriously in order to preserve the substantial investment in the hotel.

III. <u>ENCROACHMENT: DOES THE IMPACT POLICY PROVIDE PROTECTION?</u>

A. INTRODUCTION

One of the most disputed issues within the franchise relationship is encroachment–where a franchisor seeks to saturate a particular geographic market with its brand, to its overall benefit but to the individual franchisee's detriment by placing a new and competing business within such close proximity to an existing franchise so that the success of the existing franchise is jeopardized due to the negative impact on sales and diversion of traffic caused by the new operation. The franchisee ordinarily seeks the highest possible sales and highest possible profits per unit, and has a greater stake in the success or failure of a single unit than its franchisor who regards it as "one among many"--some of which may be expected to just break even, or even operate at a loss. A mature franchise system, in particular, strives toward the ultimate goal of market saturation to increase its overall sales and royalty base, to minimize competition and increase brand recognition--and thereby, the value of its trademarks.

Although franchisors typically assert that the increased value of the trademark which market saturation produces will benefit the entire system, a franchisor's gains vastly outweigh whatever minimal return an individual franchisee may obtain. The franchisor's point of view overlooks the franchisee's justifiable expectations of success in the market and his or her enduring obligations to pay royalty fees and other fees originally agreed to in the franchise agreement for the full term of the franchise agreement regardless of any financial decline resulting from the competing franchise. Of course, the franchisor still receives royalty fees as well as other fees from each of its franchisees, and, thus, has ample incentive to saturate the market without regard for the effect on any individual franchisee.

Virtually all hotel franchise agreements contain clauses on this subject, with varying disclaimers as to the franchisee's geographic territory. In an attempt to create the perception that franchisees do, in fact, have certain geographical rights in which the franchisor will not place a competing unit, many hotel franchisors (i.e., Choice Hotels International, Inc.) have implemented an impact policy to reflect a showing of good faith on the part of the franchisor.

Notwithstanding such impact policy, it is important to note that if the express terms of a franchise agreement address a matter in dispute (i.e., territorial protection), courts are reluctant to use the implied covenant of good faith and fair dealing to disturb those express terms by implying protections, rights or duties where the contract is clear that none were intended. This, effectively, renders the impact policy as a "hollow" promise to the franchisee since the franchisee, in reality, is not being granted any rights to the extent that such terms are not expressly incorporated into the language contained in the franchise agreement. If the franchise agreement contains language which clearly and specifically sets forth that the franchisor has reserved for itself the right to place a competing unit in close proximity to an existing franchisee's location, regardless of impact, then there is substantial legal precedent to uphold the franchisor's right to encroach. *See Linquist & Craig Hotels & Resorts, Inc. v. Holiday Inns Franchising, Inc.*, CCH Bus. Fran. Guide ¶11,514 (C.D. Cal. 1998) (the court concluded that because the license agreement expressly preserved Holiday Inn's right to license franchisees "at any location," the franchisee's claim for breach of the implied covenant of good faith and fair dealing failed); *Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp.*, 139 F.3d 1396 (11th Cir. 1998) (franchisee had no claim for breach of the implied covenant of good faith and fair dealing where franchisee had no contractual right to expect franchisor to refrain from licensing the Sheraton name to additional franchises beyond the site of the subject inn); *Quality Inns Int'l, Inc. v. Dollar Inns of Amer., Inc.*, CCH Bus. Fran. Guide ¶10,007 (D. Md. 1989) (franchisor did not breach implied covenant of good faith and fair dealing by placing other franchises around franchisee where the franchise agreement was non-exclusive).

B. IMPACT POLICY: WHAT IS IT AND IS IT LEGALLY ENFORCEABLE?

Many hotel franchisors, such as Choice Hotels, have implemented an Incremental Impact Policy to assist the franchisor and its franchisees in pursuing the important mutual goals of (i) avoiding an unfair depletion of the franchisee's room revenues through same-brand competition; and (ii) expanding the various different flags of the franchisor.

Under the impact policy, a franchisee is granted an area of protection in which the franchisor will not generally grant hotel franchises for the same brand as the franchisee's brand. In addition, the franchisee is granted the right to object to (and, possibly, to exclude) same-brand franchises that are proposed to be located outside of the franchisee's area of protection, but within a specified radius from the franchisee's hotel. However, a careful review of an impact policy unquestionably reflects that a franchisee is not really being provided with any protection under impact policy it is merely a "hollow" promise.

For example, notwithstanding the fact that some hotel franchisors have an impact policy in place, the franchisor may place a same-brand hotel in the existing franchisee's area of protection if the franchisor, in its sole discretion, determines that the market containing the existing hotel is inadequately served by the franchisor's particular brand. For example, if the incremental impact study concludes that the proposed competing franchisee will not result in an incremental impact of more than a five percent (5%) reduction in the existing hotel's gross room revenues in any of the first three (3) years of operation, the franchisor can grant a proposed franchise in the existing franchisee's area of protection. While the existing franchisee has the right to select the consulting firm to perform the impact study, such consulting firm has to be selected from the franchisor's list of approved consulting firms.

In addition, the impact policy also provides existing franchisees with certain objection rights for applications of new hotels outside of the existing franchisees' area of protection. For example, under one such impact policy, the franchisor is required to notify the existing franchisee of any franchise application for a same brand hotel to be located within a specified mile radius from the hotel. Upon receiving notification, the franchisee is typically provided with two (2) different options: (i) under the first option, the franchisee may write a letter objection to the franchisor within fifteen (15) calendar days of receiving notice of the franchise application; or (ii) file a formal objection to the franchise application for the same-brand hotel by completing an incremental impact form within fifteen (15) calendar days after receiving notice of the franchise application. Under the second option, the franchisor will contact the existing franchisee to discuss the objection. If this does not resolve the objection concerns, the franchisee has the option of having an impact study conducted. Once again, while the franchisee has the option of selecting the consulting firm to conduct the impact study, such firm must be from the list of firms approved by the franchisor. The request for the impact study must be made in writing within five (5) business days after the impact discussion and also must include payment in the appropriate amount. Failure to strictly comply with these requirements will result in a loss of the right to have an impact study conducted.

Once the consulting firm is chosen, the franchisor contacts the consulting firm to discuss the study to be undertaken. At no time is the franchisee permitted to speak with the consulting firm. The consulting firm has twenty-eight (28) days to conduct the impact study, and if such time limit is not feasible, the franchisor will require the franchisee to select a new consulting firm from the list provided by the franchisor. The franchisee is provided a forty-eight (48) hours to select an alternative consulting firm. Once the study is conducted and the results are obtained, the franchisor will deny the franchise application if the proposed franchise will result in an incremental impact of more than a five percent (5%) reduction in the existing franchisee's room revenues in any of the first three (3) years of projections. If the study shows that the financial impact will be less than five percent (5%), the franchisor approves the franchise application.

Assuming the impact is greater than five percent (5%), the existing franchisee has the option to request a second incremental impact study not less than three hundred sixty five (365) days and not more than four hundred (400) days after the proposed hotel opens for business. In such scenario, the existing franchisee is given the right to terminate the franchise agreement without incurring any liability for liquidated damages provided that the second study concludes that the new hotel resulted in an incremental impact of more than a five percent (5%) reduction in the hotel's room revenues in the first year of the new hotel's operations.

In principle, the impact policy appears to be a solution to encroachment as a franchisor grants an area of protection to the franchisee in which the franchisor will not place a same brand hotel as the franchisee's brand. This prevents the franchisor from saturating the market with its product and negatively impact the sales of the existing franchisee. Notwithstanding such policy, courts do not give any legal effect to the terms contained in the various impact policies implemented by hotel franchisors. The impact policy is precisely what it appears to be--a policy which has no legal effect as it is not contractually binding on the franchisor and franchisee. Rather, it is merely a guideline which many franchisors have implemented under the disguise of attempt to afford some protection to franchisees. As a policy, not only is it not contractually binding and not legally enforceable, but the franchisor also has the unfettered and sole discretion to modify, alter, retract or withdraw the policy at any given time.

Importantly, for the impact policy to be binding, a franchisee must insist at the time of executing the franchise agreement that the terms of the impact policy be incorporated into the franchise agreement. Even then, as outlined above, the impact policy appears to be a "hollow" promise to the franchisee as the franchisee is required to clear a multitude of hurdles to even receive any protection under the terms of the policy. Assuming that the franchisee is able to jump through all of the hurdles, the best case scenario for the existing franchisee is to be able to terminate the franchise agreement without incurring the payment of any liquidated damages.

Even though many hotel franchisors use the impact policy as a selling point to franchisees in order to convey to them that the franchisor is not permitted to place any competing units in the franchisee's area of protection, franchisor's routinely place competing units in close proximity to the existing franchisee's hotel without incurring any legal liability. For example, in the case of *Pueblo Center Partners, L.L.P. v. Bass Hotels & Resorts, Inc.*, CCH Bus. Fran. Guide ¶11,927 (D.C. Ariz. 2000), a federal district court in Tucson, Arizona held that a hotel franchisor did not breach its contract with a franchisee or the implied covenant of good faith and fair dealing by granting seven (7) additional franchises in the same metropolitan area as the franchisee's hotel over the course of several years. In support of its ruling, the court noted that the franchise agreement expressly stated that the franchise license was non-exclusive, only applied to the specified location and did not limit the franchisor from licensing any business activity in any other location. Nor did the franchisor's institution of an impact policy allowing franchisees to request an impact study regarding the placement of additional franchises near their locations orally modify the agreement to add an exception of exclusivity. In short, the court found in favor of the franchisor because the impact study policy did not represent a deviation from the express terms of the franchise agreement.

C. SELF-DEFENSE AGAINST ENCROACHMENT

Before buying a franchise, a potential franchisee should seek the advice of an experienced franchise attorney to help balance the scales and to seek to implement contractual safeguards against any prospective over-reaching on the part of the franchisor. The franchisee and his/her/its counsel should evaluate the nature of the existing competition surrounding the proposed location, the franchisor's Uniform Franchise Offering Circular disclosures pertaining to any "area of protection" and the franchisor's criteria and policies and procedures for site selection.

Counsel should make every effort to reconcile the encroachment issue prior to the franchisee's execution of the franchise agreement to ensure that the franchise is fully aware of his/her/its rights under the franchise agreement. Ideally, the franchisor will grant to the franchisee an exclusive territory and waive the right to develop other competing businesses or franchise systems using the same or different proprietary marks. The latter provision will protect the franchisee in the event that the franchisor merges with or acquires a competitor and attempts to operate both systems simultaneously. In the alternative, counsel should make every effort to have the franchisor incorporate the terms of the impact policy into the language of the franchise agreement. This way, the policy is binding on both the franchisor and franchisee, and franchisor cannot retract it at any given time without being subject to any liability assuming that the franchisor has not reserved for itself the right to unilaterally modify the terms of the franchise agreement.