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Territorial Disputes Over Internet May Arise at Franchises

BY BARRY KURTZ

Many retail franchise companies may soon find themselves in conflict with their franchisees over the enticing opportunities offered up by the internet.

The potential for conflict stems from the "exclusive territory" provisions in many older franchise agreements, including a number due to come up for renewal in Southern California over the next few years. These provisions may not permit franchisors to engage in electronic commerce, with the result that, just as many of them face limits on growth in a faltering economy, they also risk trouble with their franchisees if they try unilaterally to expand into e-commerce.

The solution, however, is not for franchisors to try to block franchisees from engaging in e-commerce altogether -- for example by requiring them to sign one-sided agreements benefiting only the franchisors when existing agreements come up for renewal, or perhaps before.

Instead, franchisors should step carefully to ensure that they share the opportunities of e-commerce with their franchisees, putting the promise of internet business within the reach of both parties.

Like many other old-economy industries, franchisors sought to grasp the potential of the internet to revolutionize retailing in the mid-1990s. Many franchisors of retail goods, however, found that their plans conflicted with existing agreements giving their franchisees exclusive rights to operate within specific territories, thus shielding them from competition not only from other franchisees but also from their own franchisors.

Geography is crucial to franchise retailers of perishables such as pizzas and hamburgers, which must locate near their potential customers to do business. It is less important to retailers of nonperishable products such as books, CDs, computers, electronic supplies, and the like, which can locate wherever they have access to good transportation.

The "exclusive territory" provisions in many older agreements, signed before the ad-

vent of e-commerce, commonly prevent franchisors of both perishable and nonperishable goods from competing against their franchisees in their protected territories at all. But most existing agreements either do not make it clear which party has the right to sell over the internet or, because they say nothing on the subject, may lead franchisors to think that they can do so, even in competition with their franchisees.

If they want to continue doing business together, the parties to these agreements must decide whether one or the other will have the exclusive right to engage in e-commerce or whether they will share the opportunity, and if so, under what terms. The alternative is to allow the legal system to decide for them, very possibly with unhappy consequences to

both parties. In one recent legal ruling, for example, the decision went entirely in favor of the franchisor, freeing it up to engage in e-commerce. Another protected the exclusive territories of franchisees by permitting the franchisor to sell in protected areas via the internet only if it funneled all orders through local franchisees.

There are probably hundreds of older, often vague agreements now in force in Southern California and very possibly more. These agreements cover a wide variety of franchise businesses ranging from gift retailers to pet suppliers, and the parties to these agreements must work carefully through a number of difficult issues if they want to continue doing business together.

As a rule franchisors do not leave franchisees much room to negotiate the terms of their agreements upon renewal. In fact, most can require franchisees to accept the terms of the franchisor's "then current" agreements upon renewal -- meaning the agreements used by the franchisor when signing up new franchisees.

In essence, this can make renewing a franchise agreement a take-it-or-leave-it proposition for franchisees. For franchisors, it may constitute a temptation to take advantage of their strength by reserving for themselves the right exclusively to engage in e-commerce.

State law in California contains many pro-

visions protecting franchisees, but not when it comes to sharing the promise of e-commerce. For example, California requires that franchisors get the approval of the state Department of Corporations for any uniform franchise offering circulars they propose to use in this state. California law also requires that franchisors get the department's approval for any "material modifications" to existing agreements before presenting them to franchisees. These may include new provisions reducing or enlarging the rights or obligations of either franchisor or franchisee, including new or increased royalties or fees or, to be sure, rights to engage in internet commerce.

For the most part, however, these are bureaucratic burdens; the Department of Corporations seeks to police aggressive franchisors, but it typically does not withhold approval. It does require that franchisors clearly disclose the impact of any material changes so that franchisees understand them.

Even so, franchisors often have the upper hand when renewing existing agreements. Most require franchisees to show that any leaseholds material to their franchise operations run concurrently with the agreement, which can last as long as 20 years. Many require retail franchisees to refurbish their outlets as a condition of renewal, making them look new-built, and to undergo training to keep up with current business practices. Many reduce the exclusive territory available to the franchisee or increase the royalties or fees payable to the franchisor; some require the payment of a renewal franchise fee.

Because these requirements can involve big financial outlays, they may provoke disputes that can threaten the relationship between franchisor and franchisee. Indeed, in the franchise business as in any other, financial disputes between the parties can wreck any undertaking, particularly when the parties both seek to pursue the benefits of e-commerce.

Many such disputes loom in the near future as the franchise industry adjusts to e-commerce. Clearly, franchisors and franchisees must avoid trampling on each other -- because it is in the interest of each that the other prosper.

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