

**CAN FRANCHISORS BE BARRED FROM CYBERSPACE?****(Internet encroachment of franchise territories)****by Kevin J. Collette and Paul Meier**

The Internet may be off-limits to franchisors with exclusive territories under a recent arbitration decision. In a 2 to 1 ruling, the arbitrators in *Emporium Drug Mart, Inc. of Shreveport and Drug Emporium, Inc.*, No. 71 114 00126 (American Arbitration Assn. 2000) pulled the plug on Drug Emporium, Inc.'s "virtual drugstore" in territories that were exclusively granted to Drug Emporium franchisees. While the precedential effect of this arbitration decision has yet to be seen, any franchisor with exclusive territories that intends to sell its products or services via the Internet needs to be aware of the possible pitfalls presented by Drug Emporium.

Alleged franchisor encroachment on the territories of franchisees has been a highly-litigated and contentious issue in recent years. Typically, the cases involve a franchisor locating a new franchise or a franchisor-owned outlet near an existing store of a franchisee due to increased customer demand. Even when exclusive territories have not been granted to franchisees, some courts have held that opening a new store next to an existing franchisee violates the implied covenant of good faith and fair dealing required under the Uniform Commercial Code.

In response to such decisions, many franchisors now expressly state in their franchise agreements that competing franchises may be established in any location, including where existing franchisees already exist. A number of courts have held that these express provisions will defeat franchisee complaints based on the implied covenant of good faith and fair dealing since the franchisees have notice that a new store may be opened in their area at any time. With the arrival of the Internet, however, an entirely new debate has begun regarding whether franchisor Internet sales constitute prohibited encroachment of a franchisee's territory. *Drug Emporium* is one of the first decisions to offer an opinion on this novel issue.

*Drug Emporium, Inc.*, a franchisor of discount drug stores since 1977, launched its *DrugEmporium.com* Internet website in 1999. Promoted by Drug Emporium as a "virtual Drug Emporium Store" and "Your neighborhood pharmacy for over 20 years," the website offered products and services similar to those of Drug Emporium's franchisees at prices that "vastly undercut" the franchisee stores. As is the case with the Internet, the *DrugEmporium.com* website was accessible to customers located anywhere, including customers located in the exclusive territories of Drug Emporium's franchisees.

Within months of the *DrugEmporium.com* website going on-line, a number of franchisees initiated an arbitration proceeding against Drug Emporium. One of the primary charges against Drug Emporium was that the franchisor's website violated Drug Emporium's franchise agreements granting franchisees the exclusive right to operate Drug Emporium stores within certain territories.

Much of the arbitration debate concerned whether the DrugEmporium.com website constituted a competing “store” within the meaning of the franchise agreements. On this issue, Drug Emporium argued that the franchise agreements intended to prohibit Drug Emporium from locating “brick-and-mortar stores” within franchisees’ protected territories and did not anticipate or apply to “virtual stores” located in cyberspace.

The arbitrators, however, dismissed Drug Emporium’s claim, stating that “It is not for this panel to divine whether a virtual reality is real or whether it is a phantom. We will take [Drug Emporium] at their word.” Since Drug Emporium had marketed its website as a “full service online drugstore” (emphasis added), reasoned the panel, Drug Emporium could not now claim that DrugEmporium.com was not a “store” within the meaning of the franchise agreements.

Having found Drug Emporium to be in violation of its franchise agreements, the arbitrators barred the DrugEmporium.com website from shipping orders to customers located within the exclusive territories of Drug Emporium’s franchisees. The website must display a notice stating such policy, and also must direct customers within an exclusive territory of a franchisee “to the nearest franchised outlet in the enjoined territory.”

It is too early to tell whether Drug Emporium will be followed by the courts and become settled law. The arbitrators did not cite a single court decision in support of their ruling. A pending lawsuit in Missouri involving the tax preparation firm H&R Block, Inc. may be one of the first cases in which a court rules on whether Internet sales by a franchisor constitute prohibited encroachment of its franchisees’ exclusive territories. In that case, *Angel v. H&R Block, Inc.*, No. 99-CV-206379 (Cir. Ct. Mo. Jackson County, filed May 25, 1999), H&R Block is accused of selling tax preparation software through its website in violation of its agreements with H&R Block franchisees. There will likely be many more cases in the near future on this new and largely unsettled area of franchise law.

Decisions such as Drug Emporium offer a warning to franchisors and their counsel that they must “expect the unexpected” when entering into agreements with franchisees. In the example of Drug Emporium, the franchise agreements failed to address the respective rights of Drug Emporium and its franchisees to engage in sales and competition through alternative means of distribution unrelated to “brick-and-mortar” stores. Drug Emporium has also been criticized for carelessly marketing its website as a “store” in light of the fact that its franchise agreements did not indicate whether franchisees’ exclusive territories only applied to “brick-and-mortar” stores, as the franchisor apparently had intended.

Even carefully-drafted agreements, however, have become outdated as a result of the sudden arrival of the Internet. Franchisors are increasingly discovering that their “brick-and-mortar” agreements of the past are ill-suited for resolving the unique issues raised by the Internet. May a franchisee register domain names using the franchisor’s trademarks? May a franchisor or franchisee advertise and make sales via the Internet? Must a franchisee website be transferred to the franchisor after a franchise relationship is terminated? All of these are important questions in our Internet age that may not be answered in franchise agreements drafted prior to the last few years.

All franchisors should review their agreements to ensure that their interests in the Internet and e-commerce are adequately protected. At a minimum, franchisors should establish a “web strategy” that sets forth the rights of and restrictions on franchisors and franchisees to register domain names, advertise and sell products or services on the Internet, and to maintain websites. Franchisors also will likely want to consider the risks and benefits of creating a centralized website for the entire franchise system or permitting competing websites among the franchisees.

Developing a comprehensive policy for the Internet, and the next new channels of distribution that undoubtedly lie in the future, is critical to franchisors. The integrity of a franchisor's trademarks, service marks, products and services, and entire franchise system may very well hang in the balance. By addressing such issues now, franchisors can help ensure that they avoid the fate of DrugEmporium.com.