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Territory - Do you Really Know What You Are Getting?

When a potential franchisee has selected a franchise which he or she wishes to pursue, then due diligence must be done. This will involve obtaining a copy of the disclosure document and franchise agreement from the franchisor. A key element in the grant of any franchise is what the territory will be.

By territory we mean a specific area within which the franchisee will be able to conduct the franchised business. If the franchisee is a shop in a shopping mall then will it be just that shopping mall? Will it be a territory covering a reasonable area which will be defined in (say) yellow on a map to be attached to the franchise agreement? Will there be a non-exclusive territory or no territory at all, and, in consequence, “a free for all” within which numerous franchisees will be conducting their own separate business with no demarcation line?

The issue of territory is a very important one for careful consideration. As franchising lawyers, we are finding clients coming to us with territorial disputes and territorial issues which stem mainly from franchisors trying to allow new franchisees to operate franchises either within what the existing franchisee thought was his own particular territory or offering the right to open a second franchise to the franchisee within the same territory because the existing franchisee is under-utilising the territory.

This article will consider various permutations of territory and will highlight the key areas to watch when a prospective franchisee is considering the franchise agreement and its ramifications.

Concise Territory

In the majority of cases, a franchisor will have divided up New Zealand or another particular country into concise and separate territories which will be allocated to each new franchisee. These territories will be carefully defined on separate maps and a typical clause in the franchise agreement may be as follows:

“The franchisor grants to the franchisee a franchise to establish and carry on a business within the territory as set out in the Schedule and delineated in red on the map attached and to carry on the business within the territory using the methods and techniques developed by the franchisor ...”

This type of clause gives certainty to a franchisee by way of a map being attached to the franchise agreement with the boundaries of the territory clearly defined. There can be no doubt as to the boundaries of the territory which a franchisee is contracting by way of execution of the franchise agreement and payment of the initial franchise fee. In our opinion,

some franchisors make the mistake in the early days of giving franchisees too big a territory which a particular franchisee does not service and exploit to its maximum potential.

There appears to be an incidence of the franchisor using the franchise agreement as a selling ploy/enticement. As we said above, if a map is attached clearly delineating the boundaries of a territory then the franchisor cannot alter that contractual arrangement without agreement by the franchisee.

Some franchisors may then wish to cover their position by reserving in the franchise agreement the right to take back part of the territory in the future (perhaps when the system has become established) by re-demarcation of the boundaries during the term. This may be framed as an absolute right or in the franchisor's discretion (reasonable or otherwise) that the territory is not being (or has become) and/or may not be capable of being serviced to its maximum potential. A franchisee should be aware of a blanket sole discretionary right which may be drafted as follows:

“The franchisor shall have the right at any time during the term to reduce the territory if in the franchisor's opinion the franchisee is not maximising or is unlikely to be able to maximise business exploitation of the territory.”

A possible way out of the above is for the franchisee's lawyer to suggest inclusion of an amendment along the following lines:

“provided that the franchisor shall not be entitled to reduce the territory to an area within a [insert number] kilometres radius from the premises.”

Exclusivity of Franchise

What a franchisee always requires in entering into a franchise arrangement is certainty. There must be certainty as to the upfront franchise fee payable, certainty as to the ongoing service fees or royalties payable together with advertising levies and, most importantly, certainty in relation to the territory. A clause which we have come across in one or two franchise agreements which gives certainty and which is clear and unequivocal is along the following lines:

“If the franchisor or the franchisee identify the opportunity to establish a further franchise in the territory (“the proposed franchise”) then the franchisee shall be considered prior to any third party as the proposed operator of the proposed franchise. The existing franchisee, subject to meeting all new franchisee criteria, shall be offered a 14 day first right of refusal”.

What can be seen from this type of clause is a clear indication that the franchisee has not been given an exclusive territory, but will be considered first and foremost should the franchisor wish to open another outlet in the territory. However, an important caveat for the franchisor is whether the existing franchisee has been operating the business in such a way that gives confidence to the franchisor that the existing franchisee will be able to manage more than one outlet in the territory. Because of this important fact, the clause quoted above usually continues and says the following:

“If the franchisor considers the franchisee is capable of operating the proposed franchise in addition to the franchisee's commitment(s) under its then existing

franchise agreement(s), it shall notify the franchisee in writing and the franchisee shall indicate its willingness to accept the proposed franchise. The final decision as to the suitability or otherwise of the franchisee to operate the proposed franchise shall rest solely with the franchisor. If the franchisee declines within 14 days to accept the proposed franchise, then the franchisor shall be free to either itself open a new store within the territory or allow a new franchisee to open a new store within the territory.”

As can be seen above, the clause is explicit, clear and unambiguous but it is essential in all cases for the proposed franchisee to have independent legal advice from a lawyer experienced in franchising.

Alternative Clause

Another way is to confirm that the franchisee has not been granted an exclusive territory but to combine that provision with a right of first refusal by a franchisee should a franchisor wish to establish another franchise outlet within the territory, and such a clause would read as follows:

“The franchisee acknowledges that it has not been granted an exclusive franchise territory but that it has been granted the right to carry on a business at the premises. The franchisor agrees that it shall give the franchisee a first right of refusal (provided the franchisee is in full compliance with all of its obligations pursuant to this agreement) to purchase another franchise it may propose to offer in respect of the establishment of another [insert brand name] outlet at a site which is within the area as specified in the Schedule (“the Territory”) on no less advantageous terms than the proposed franchise offer to any third party. The franchisee shall then have fourteen (14) days from the receipt of notice of such offer to notify the franchisor by notice in writing whether or not it wishes to accept the offer. If it wishes to accept the offer then it must agree to open the new [insert brand name] outlet within ninety (90) days of acceptance.”

Good Faith

It is important that both parties act in good faith towards each other. The subject matter of the territory, regardless of how a clause may be drafted, is always a crucial consideration and it is absolutely essential for a prospective franchisee not to enter the franchise with the wrong idea about the territory and its boundaries. A franchisor must ensure that a franchisee understands what the territory comprises and must represent the position accurately and in good faith. One franchisor for whom we act retains the right to put a second franchisee in the first franchisee’s territory should there be reasonable grounds for doing so. However, in such a case the franchisor agrees to share the initial franchise fee payable by the second franchisee on a 50/50 basis with the original franchisee. The relevant clause has been drafted to read as follows:

“The franchisor shall have the right to appoint an additional franchisee in the territory if the franchisor reasonably determines that existing demographic data or actual comparative evidence or other reasonably based financial assertions indicate that there is an opportunity for an additional franchise in the territory without detracting substantially from the business conducted by the franchisee,

in which case 50% of any upfront franchise fee received by the franchisor from the sale of such new franchise shall be paid to the franchisee.”

We assert that the main principle which should flow through the right of a franchisor to appoint an additional franchisee within the original franchisee’s territory should be one of reasonableness and fairness. It is quite wrong to punish an existing franchisee who is working extremely hard by merely saying that there is room for another franchisee in the territory.

The franchisee may also be a forward thinker and anticipate the possibility of owning more than one franchise. In this event and depending on the circumstances it may be convenient to have adjacent or neighbouring territories. In that event the franchisor may be amenable to the inclusion in the franchise agreement of an option in favour of the franchisee to take an additional territory (bounding on the original territory) on notice being given to the franchisee by the franchisor of its requirement for a new outlet to be opened in the adjacent territory and failing exercise of the option within a specific period for the franchisor itself then to be able to open the outlet in that territory or for it to offer/grant the territory to a new franchisee.

No Territory Franchises

Some franchise systems prescribe no territories whatsoever. There is a difficulty here for the initial franchisee who should be concerned about saturation of the area of the franchisee’s proposed operation – ie. how far is the franchisee going to travel to get business? This is especially relevant when in the case of a new system there are no actual (as opposed to hypothetical or anticipated) figures to justify a viable business. The logical reaction would be to request a limit on the number of franchisees to operate in the area although this can also be counterproductive because it may stultify the establishment of and/or the growing of brand awareness to the public.

Is it fair to appoint franchisees within a city area which may be divided into (say) five separate areas, and to say to 20 franchisees - “Go and conduct your business all over the city as you have no specific boundary except to ensure that any business conducted is within that city”? We consider the answer must be no. However, this would not preclude a franchisee who lives in one part of the city from servicing a customer who lives in another part of that city. Also, relatives and friends of a particular franchisee may want to be looked after by that particular person, regardless of where he might live.

In summary, territories or the lack of specific territories is a fascinating topic in franchising. We have noticed clients who are having territorial disputes with franchisors and upon reading a traditional franchise agreement there are usually grounds for franchisees to protest. A franchisor must be fair to each particular franchisee but must also abide by the provisions of the franchise agreement. Too often a franchisor in the early years has granted franchises to various franchisees who have attached to the franchise too large an area or territory. It is true in life that it is easier to give a person a limited area and later to agree to widen it if the business is succeeding than to give a person a large area and later to take it away or subdivide it if the territory is not being utilised to its maximum potential. The maxim for potential franchisees is always - know what you are getting into in relation to all aspects of the franchise agreement but particularly in relation to the territory.

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