

Franchising and E-Commerce

the e-lephant in the room

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For many premises-based, consumer facing brands (particularly those in the retail sector) which have used franchising as a tool to expand their business, the traditional approach has been to recruit experienced and well-capitalised local operators and grant them rights to open outlets in an allocated territory. Alternatively, brands which operate a centralised international e-commerce platform may use that to test the market before deciding to open outlets through a franchise model. Either way, the grant of franchise rights has tended to be on a "pure-play" basis – i.e. a franchisee is granted the right to open and operate branded physical premises to sell products and services in an allocated territory, with the franchisor reserving its rights in respect of other channels, such as wholesale distribution, e-commerce and other forms of distance selling.

From a legal point of view, the reservation of channels such as e-commerce will only work in jurisdictions where the local competition authorities do not view these restrictions and prohibitions as having a problematic effect on competition.

From a commercial point of view, this model is becoming increasingly outdated on two fronts:

- the rise of the tech-savvy, "global consumer" which has disrupted the traditional buying cycle, meaning that now, more than ever before, the success of a brand will depend upon its ability to create a consistent brand experience across all of the retail channels in which it operates, regardless of whether it uses third party relationships to exploit a particular channel; and
- increasing levels of friction in the commercial relationship between a franchisor and its franchisees, in franchise systems where the franchisee remains pigeon-holed in the traditional "bricks and mortar" channel whilst its franchisor or its nominee sells the same products and services to consumers located in its allocated territory, but through a reserved channel, such as e-commerce.

In this article, we will consider the various options for bringing e-commerce into the franchise system, the legal and commercial challenges and how brands can develop and implement a strategy for e-commerce and franchising which creates a genuine "win/win" for them, their franchisees and their customers.

What are the basic options?

Whether a brand is looking at franchising for the first time or has already established a network of franchisees, the basic options are as follows:

- i. the franchisor follows the traditional pure-play model of only using franchising for the bricks and mortar channel and reserving some or all of the other channels to the franchisor or its nominees;
- ii. the franchisor compensates the franchisee from the revenue generated by the franchisor's direct sales of products and services through its centralised e-commerce platform to customers in the franchisee's allocated territory. This is a variation on option 1, in which the franchisor recognises the

importance of the physical premises in driving brand awareness and goodwill;

- iii. the franchisor retains the direct selling relationship with a customer of its centralised e-commerce platform who is located in the franchisee's territory, but the franchisee is involved in local fulfilment and customer service and is compensated accordingly;
- iv. the franchisee is permitted to operate its own transactional website targeting consumers in their contractual territory, which could be either a constituent page on the franchisor's global platform or a stand-alone website. The franchisee would take on more, if not all, of the burden of investing in infrastructure to support the online business and would pay the franchisor a fee, which, depending upon the preferred model, may be a "cost-plus" arrangement on the products ordered from the franchisor for online sales or a royalty, based on the additional turnover generated through online sales.

What are the commercial challenges?

Some of the key commercial factors which will impact upon which option is most appropriate include:

- the maturity and potential of the allocated territory for online sales;
- seasonality and localisation of the product ranges;
- the franchisee's capability and desire to play a part in online sales;
- the ease (or difficulty) of selling via e-commerce into the allocated territory – the size of the market, import tariffs, post and packing costs, availability of international credit and debit card payment systems;
- how to manage product returns and the provision of an effective customer service in the local language which is attuned to local customs;
- the need for consistency of brand experience and associated marketing and promotion.

Option 1 is favourable from a control perspective, but it does not look like a sustainable long term strategy for the reasons given in the introduction. Whilst Option 1 means that a brand retains control over e-commerce, it comes at the cost of having to make the capital investments to build and sustain a logistical and operational infrastructure which can service consumers located in the franchisee's allocated territory, costs which may become prohibitive the further the customer is from the brand's central e-commerce operation. There is also a risk of a disconnect between the channels which can erode trust between the consumer and the brand and the brand and its franchisee – if a franchisor's online prices undercut its franchisee's brick and mortar retail price, this will inevitably lead to increasing friction in the relationship. Equally, if the online offering is inconsistent with the local bricks and mortar offering (particularly in markets that have a level of localisation and seasonality in the product mix) or the two channels are not joined up in other respects, the reputation and goodwill associated with the brand will be diminished.

Option 2 retains control for the brand but may address relational issues with its franchisee which would otherwise arise under Option 1. Option 2 is viable for easily accessible markets which are close to and/or culturally and economically similar to the franchisor's home market but this becomes increasingly more difficult to manage in more remote and challenging markets. In any event, perhaps the greatest disadvantage of Option 2 is the potential for inconsistency across the retail channels which may arise if the franchisee is not engaged at any level regarding local fulfilment and customer service for online sales.

Option 3 sees the brand relinquish some control, but in return it can start to shift some of the investment and operational burden onto the franchisee and improve the consumer's brand experience.

Option 4 comprises two possible scenarios - the brand allows for either local, franchisee-operated pages on its global platform or stand-alone, local, franchisee-operated web stores. If it chooses the former, the brand will need to make a significant investment in the appropriate technology platform, but in any event Option 4 requires a carefully structured legal framework which will sit alongside the existing franchise agreement, together with additional training and support. Option 4 optimizes the consumer experience as it brings together the bricks and mortar and the e-commerce channels in the allocated territory.

What are the legal challenges?

The preferred commercial model needs to be tested against the applicable legal environment in the allocated territory before implementation and the key area of law which is likely to impact on online sales is competition law.

From a European perspective, a franchising agreement is at risk of infringing EU competition law (Article 101(1) of the Treaty on the Functioning of the European Union) if it has the object or effect of restricting competition and is capable of affecting trade within the European economic area (EEA). Each member state has equivalent national competition rules which apply if trade in that market is (or is capable of being) affected by the agreement in question. An infringement of competition law can lead to substantial fines on the parties concerned. The non-financial implications are equally severe, including damage to business reputation, the unenforceability of contracts, the risk of third party damages actions and even personal sanctions (fines, director disqualification and imprisonment) imposed on executives of the parties concerned.

There has been a long-standing and pervading sense of false security about the actual risk of non-compliance with EU competition law, particularly among consumer brands which fall into the "SME" category. The attention of the European Commission (EC) and the national competition authorities may well have been focussed primarily on investigating cartels between multi-national corporations and abuses of dominant market positions. However, that risk assessment is now more dangerous than ever - recent case law has shown that the EC and its national agencies are scrutinising the activities of brands which

operate franchise networks within the EU, irrespective of their market shares and geographic scope. Furthermore, the EC has recently commenced an investigation into e-commerce with a view to identifying and eliminating the various barriers which exist online to the free movement of products within the EEA.

The basic challenge posed by European competition law to the use of e-commerce in franchise systems is that the EC considers online sales as a form of "passive" selling, as opposed to "active" selling. Outright bans on online sales and most other restrictions on passive selling contravene EU competition law. The EC takes a hard line on these abuses, deeming them to be "hardcore" restrictions by object as opposed to considering whether the restriction has an anti-competitive effect. Such restrictions are almost always prohibited and are the kind of restriction that commonly leads to substantial fines. Inclusion of hardcore restrictions in franchising agreements can also complicate their enforcement, enabling franchisees who are in breach of unrelated provisions to mount a "Euro-defence" based on competition law and seek to have the whole agreement declared void and unenforceable.

Hardcore restrictions include:

- charging franchisees different wholesale prices for the same product, depending upon the channel through which the franchisee will sell the product to a consumer;
- geo-blocking i.e. practices which prevent a consumer located outside of a franchisee's allocated territory from visiting that franchisee's website;
- diverting traffic from the franchisee's website by automatically re-routing a consumer to the franchisor's website;
- preventing a franchisee from displaying prices in different currencies or using different languages on their website;
- (arguably) preventing a franchisee from purchasing search engine adwords.

A franchisor can, however, impose a number of controls on a franchisee's use of the internet, including:

- preventing sales through third party platforms such as Amazon and eBay, although this restriction needs to be looked at carefully in each EU jurisdiction, as the interpretation of the law is not consistent;
- withholding the right to use a domain name featuring the trade mark;
- imposing the same level of quality standards on the franchisee's webstore that the franchisor requires for physical stores;
- preventing a franchisee from actively selling into territories exclusively allocated to another franchisee or reserved to the franchisor (although the boundary between legitimate restrictions on active online selling and illegitimate restrictions on passive online selling is unclear and needs careful consideration to implement in practice);

- requiring a franchisee to operate at least one physical store before it starts selling online.

For all non-European jurisdictions, franchisors should check whether there is a similar competition law regime which will apply to the chosen model.

Other legal challenges include restrictions on a consumer's ability to access international credit or debit cards or ability to make payments to foreign entities, customs duties on imports and requirements on brands to have a local presence for fulfilment.

Implementing the Strategy

The franchise agreement needs to reflect the framework of the franchisor's chosen model for e-commerce. The reservation of rights needs to be carefully worded, with clear parameters on what the franchisee is and is not allowed to do and what the triggers might be for the exercise of those rights. It is becoming increasingly difficult for franchisors to simply ignore the issue of e-commerce for its franchisees.

Where a franchisee is granted multi-channel rights, new sections will need to be developed in the manual. It is advisable to express the multi-channel rights in the franchise agreement as a contractual option or right of first refusal, which is subject to certain conditions, and require the franchisee to enter into a separate ecommerce agreement upon the exercise of the option.

The ecommerce agreement will set out the terms and conditions which will govern the establishment and operation of a transactional webstore and refer back to the new provisions in the manual, in the same way as the franchise agreement does for physical stores. Key terms and conditions include:

- a licence of the relevant domain name and other intellectual property rights, including those which subsist in the design and content of the webstore (including source and object codes and the user interface itself);
- approval rights over content which is not sourced from the brand;
- the interplay with the franchisee's obligations to market and promote the business, including on social media platforms;
- handling of customer data collected online;
- service levels and expectations on the provision of the customer service;
- training and support for the customer service and technical support;

- financial obligations, both in terms of investment and the ongoing fee which the franchisee will pay to the franchisor (this could be a percentage of turnover generated through online sales).

Conclusion

The key take-away is that there is no "one size fits all" solution for the use of e-commerce within a franchise network. Different approaches will be required for different markets and different partners, so it is imperative that brands devise a strategy which can be flexible and works from a legal and commercial perspective.

Franchise agreements and the accompanying e-commerce agreements must be carefully drafted and regularly reviewed by an experienced lawyer to ensure they adhere to competition law. It is equally important for franchisors to put in place (and keep under regular review) a system of policies, procedures and training to enable their own employees and franchisees to be aware of and avoid potentially anti-competitive practices in their day-to-day dealings.

The end-game for brands is to ensure that they are continually satisfying the consumer's shifting demands and expectations, whilst at the same time safeguarding the reputation and goodwill associated with their brand and products and maintaining strong and collaborative relationships with their franchise partners – it all sounds so easy!

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