

NFC18 – LEGAL SYMPOSIUM – END OF TERM ISSUES

A Case study:

Longstanding franchisee de-badges and sells the business

Franchisor is irate!

1. In this mediation the Term had already expired, and the dispute related to the post-expiry obligations and liabilities of the franchisee.
2. The Notice of Dispute from the Franchisor read as follows:

Nature of the Dispute:

“You have pre-empted that you intend to breach several provisions of the Franchise Agreement including:

- a. Intellectual Property clause*
 - b. Franchisee Covenants clause*
 - c. Consequences of Expiry or Termination clause*
 - d. Non-compete clause.*
3. The desired outcome identified was for the dispute to be resolved, through the following action:

“You must fully comply with the provisions of the Franchise Agreement that apply at the end of the Franchise Term, and also which apply after the expiry of the Franchise Term.”
 4. In summary, the facts were as follows:

- a. *A long-term franchisee of a retail store in a large shopping centre, since 1995. The franchise agreement was due to expire in April 2015. The franchisee's option to **renew** had to be exercised three months prior to expiry.*
- b. *Franchisor initially held the lease, but its leasing company did not renew the lease in 2012, so in December 2014 the franchisee's leasing company entered into a lease extension direct with the landlord to 2020.*
- c. *The franchisor became aware of the franchisee's company obtaining a new lease. It noted that the lease contained a personal guarantee from a person other than the guarantors of the franchise agreement and enquired why. The franchisee said the person was a relative and that the leasing entity was controlled by that relative and he had been advised by his accountant to put the lease into that entity.*
- d. *By 2015 the franchisee did not want to continue the franchised business due to declining sales figures not reaching minimums for a number of years and did not exercise the option to renew.*
- e. *The franchisee informed the franchisor it was not seeking another term, and at expiry of the franchise agreement de-badged the store but continued to trade from the location.*

The February exchange

5. In February 2015 an exchange took place at the store between representatives of the franchisor and the franchisee, as follows:

Franchisor

- a. *You're intending to run the store as an independent.*

Franchisee

- b. *No I'm not.*

Franchisor

- c. *The store must be gutted. The design of the store including fit out is our intellectual property.*

Franchisee

- d. *I want to move on and not continue in the franchise network.*

Franchisor

- e. *We have great future plans and product lines.*

Franchisee

- f. *I've been here for 14 years and nothing has changed!*

Franchisor

- g. *I'll sue you! I will not allow the store to trade as an independent.*

Franchisee

- h. *I want out!*

Franchisor

- i. *You just signed a lease! Your intention is to run this store as an independent! Are you going to sell this store?*

Franchisee

- j. *"I will consult my solicitor about that".*

Franchisor

- k. *Would you agree to sell our products if you were trading as a de-branded store?*

Franchisee

l. No, who ever runs it they can put in whatever they wish.

Franchisor

m. "It's your lease, you own it"!

Franchisee

n. "Maybe it's my lease, maybe it's not. If you want me to gut the store I will do that".

Franchisor

o. "I need to look after the brand name and product in itself, and I really want to do something here (at this site)". You signed a lease here!

Franchisee

p. "How can you prove that"?

Franchisor

q. "Well, you're going to re-sign the Franchise Agreement or gut the store that's the only thing that can be done!"

Franchisee

r. I will get advice from my solicitor.

Franchisor

s. The store design and products sold are part of our intellectual property, and I will defend our intellectual property "all the way"! "I don't know why you signed a lease, obviously to run as an independent! Do you understand you are obligated to us re how to manage this?"

Franchisee

t. "How do I get out of this? When I die?"

Franchisor

u. *Everyone's got this problem (Pointing) Look at these stores! If you want to get out, you walk out!". Your intentions are to operate this as an independent! I'll find out if it's in the contract that you intend to run it as a ...*
[type of store, (let's just say, a confectionary] store...and I will prove that while you are running it as a [confectionary store] you are taking that intellectual property with you and when I find out, after 5 years of the lease it will cost you \$1Million. Your intentions are you are going to operate this as an independent! You don't know what you're getting yourself into!

Franchisee

v. *I'll speak to my solicitor.*

Franchisor

w. ***(In a surprising about face and moment of sanity...)*** "If he wants to go into mediation with me we can work around the table and see what we can do. I'm willing to do that.

x. ***(which doesn't last long...)*** But once it's with my lawyer I can't stop it"

Franchisee

y. ***(Sheepishly)...***I also don't want that.

Franchisor

z. *Well let's sit down. Let's see what we can do to exit you if that's what you want to do.*

Franchisee

aa. *(Desperate...) "I want out".*

By the time of mediation:

Business sold

6. The franchisee had sold the business to a third party, *including all plant and equipment for \$75,000*. A term of the sale contract was to transfer the lease to the purchaser.

Franchisee/guarantors not going to be involved

7. The franchisee and guarantors were not going to be involved in any way with the operation of the new business on the site and had no intention to breach the post-termination obligations of the franchise agreement.

Franchisor suspicious – franchisee passing off?

8. The **de-badged** store retained some components of the brand's image which included the store design and some specifically designed equipment. Upon closer inspection the **de-badged** store was not displaying a **trading name** of the business.
9. The franchisor was suspicious and believed this to be an **attempt to pass off** the business as still being part of the franchise, or associated with the franchise, and an attempt to conceal the identity of the true owner of the business.
10. The franchisor was **suspicious that the sale of the business was not to an independent third party** and that the guarantors intended to continue to be involved in the operation of the business from the location following the expiry of the franchise agreement.
11. The franchisor believed at the time of mediation that the franchisee had engaged in an **orchestrated attempt to mislead it** in relation to its true intentions dating back to 2012, **breached the post termination obligations** of the franchise agreement, **not acted in good faith** and engaged in passing off.

At mediation

12. The issues at mediation included:

- a. Breach of the **non-compete clause** by the franchisee by continuing to trade de-badged;
- b. The **intellectual property** of the franchisor in the remaining fittings at the store – disputed by the franchisee, who paid the franchisor for the fittings and claimed ownership of them (and ability to sell as an asset of the business);
- c. **Failure to follow** the franchise agreement **provisions re offering plant and equipment to franchisor** at depreciated value
- d. **Status of the sale of the business** by the franchisee, including transfer of the sub-lease of the premises from the franchisee's connected leasing company to the asserted unconnected third-party purchaser.

The settlement agreement

13. Agreement was reached – in exchange for a release from liability related to the 2005 franchise agreement it required the franchisee to:

- a. carry out at its expense **replacement of tiles and finishes of a different colour and texture** or paint them a different colour and texture;
- b. **remove a particular shopfront fixture** and replace it with a fitting that does not mimic or share the “visual cues” of the fitting;
- c. provide the franchisor with **design plans and specifications** and in-situ photoshop design of the new fixture to be installed and details of the supplier;
- d. **give the franchisor the opportunity to advise of any changes** it requires to the design plans and specifications for the replacement fixture;

- e. after approval by the franchisor, **submit the design and specification to the landlord;**
- f. advise the franchisee of any changes required by the landlord;
- g. in the event of default by the franchisee, pay \$100 per day (equivalent to royalties) as a **genuine pre-estimate of loss** and damage.

14. The consequences of expiry or termination clause of the franchise agreement did oblige the franchisee if directed to repaint, redesign and refurnish the premises. Hence the settlement had its genesis in the contractual provisions.

15. Was it fair for both franchisee and franchisor?

Franchisee exit

- The longstanding franchisee got to exit the franchise and was able to sell the business for valuable consideration of \$75,000, which is modest given the tenure of twenty years. But given the franchisee had effective control over the site through its leasing entity, it had goodwill to sell.

Franchisor brand and IP protected

- The franchisor enforced and protected its brand and intellectual property by ensuring the new competitor at the location could not be mistaken to be part of the network despite its longstanding presence at that location

No litigation

- Importantly the settlement was achieved without litigation over the breaches of the agreement by the franchisee – which is a better outcome than litigation for the franchisor in terms of potential brand damage and costs

16. Would clause 23 of the Code been of any use to the franchisee in this case?

- Clearly the answer to that is No – as the franchisee had NOT sought to extend the agreement, was in breach of the non-compete clause after expiry, had allegedly infringed intellectual property of the franchisor despite de-badging.
- So, the franchisor could have sought an injunction or damages for the breach of the restraint clause, and clause 23 would not have applied to make the restraint unenforceable.

17. There are **no reported cases where section 23 of the Code has been relied on** a franchisee faced with a franchisor seeking to enforce a restraint of trade clause.

18. As this case study demonstrated, there are still disputes relating to franchisees who want to exit and ignore their obligations under the franchise agreement and “take their chances” against a franchisor seeking to enforce the restraint.

- The disputes may only get to mediation.
- The franchisee here was in the good position of having effective control of the lease, and something to sell.
- The franchisor was not in as strong a position as it would have been in had it been in control of the site.

19. One final thing: the lease which the franchisee had entered into with the Landlord required a full new shopfront refurbishment *to the retailer’s latest concept* to be completed by 30 June of that year, which I thought was likely to be part of the motivation of the franchisee to exit the franchise, and plans and specifications for that were to be submitted by 1 February. This was never mentioned as the reason during the mediation!