THE CLUB PHYSICAL CASE

Background

1. On 24 November 2009 a Franchise Agreement was executed in relation to Club Physical Botany and the franchisee purchased an existing business from Newman Investments Limited. The term was for 9 years expiring on 24 November 2018. The franchisee was Colven Group New Zealand Limited which on 5 December 2011 changed its name to Colven Botany Limited.

2. On 3 December 2010 a Franchise Agreement was executed in relation to Club Physical Three Kings and the franchisee purchased an existing business from Club Physical Three Kings Limited. The term was for 9 years expiring on 3 December 2019. The franchisee was Colven Three Kings Limited.

3. On 8 June 2011 a Franchise Agreement was executed in relation to Club Physical Westgate and the franchisee purchased an existing business from E-Motion 2010 Limited. The term was for 9 years expiring on 8 June 2020. The franchisee was Colven Westgate Limited.

4. In relation to all three franchises the Franchisor was Health Club Brands Limited. The franchisee advised that there were ten clubs at the time and the franchisee owned three of those clubs. The five other clubs were located at Birkenhead, New Lynn, K' Road, Queen Street and Kaitaia. The remaining two clubs were located at Te Atatu and Albany and were owned by the franchisor. My client franchisee further advised that since 2011 three clubs had gone out of business and in the franchisee's opinion the franchise was in steep decline.

5. The franchisor was not and is not a member of the Franchise Association of New Zealand and therefore it did not have to comply with the Franchising Code of Practice and the Code of Ethics. The franchisor did not have to supply a Disclosure Document in relation to the appointment of new franchisees. The franchisee confirmed that it did not receive any Disclosure Document when it purchased the three franchises.

Leases

6. The franchisee was provided with copies of the lease documentation. In relation to the Botany premises, the lessee is Colven Botany Limited and the lessor is Etcart Holdings Limited. That lease should have been renewed on 25 April 2012 and although it may have been, the franchisee did not provide a copy of the Deed of Renewal. Pursuant to a document dated 27 January 2009 and called Agreement Recording a Rent Review and Other Matters the annual rental was $249,362.00 plus GST.

7. In relation to the Three Kings premises, the lessee was Colven Three Kings Limited with the sole director being Stuart Holder and the lessor was

Antipodean Properties Limited. The term of the lease had been extended until 11 March 2022 and the annual rental was $200,000.00 plus GST.

8. In relation to the Westgate premises, the lessee was Colven Westgate Limited and the lessor was Westgate Properties Limited. The current lease was due to expire on 19 December 2018 and the current rental was $233,168.79 including opex but excluding GST.

9. In all three cases the companies which were the franchisee in relation to the respective locations were also the lessee in terms of the lease of premises and Stuart Holder was the guarantor of the respective leases.

10. The three Franchise Agreements appeared to be identical. They were executed in 2009, 2010 and 2011 respectively and were legally binding upon the three franchisee companies. Stuart Holder was the sole guarantor which meant that should any franchisee company fail then Mr Holder would be personally liable for all debts and any outstanding obligations.

Current Issues and Concerns

11. The franchisee confirmed that it had received no training before entering the Club Physical system and that no written manuals had ever been provided. The franchisee described the current position as very serious and there had been a recent decline in the number of franchisees. The franchisee also provided examples of misleading advertising which was of concern.

12. The fact that no product had ever been supplied by the franchisor and no information had been made available to the franchisee on any research undertaken in relation to the gyms was a major omission in my opinion.

Options of the Franchisee

13. The franchisee's respective companies were the franchisees in relation to the Botany franchise, Three Kings franchise and the Westgate franchise. The franchisee executed legally binding franchise agreements that ran for a considerable number of years in the future. The franchisee considered it untenable to carry on as it had lost confidence in the franchisor and Paul Richards in particular and the franchisee felt strongly that its considerable financial investment was in decline and would diminish further.

14. There had been gross breaches of the Franchise Agreements by the franchisor and those breaches were continuing. The franchisee could **either** take the soft approach, allege breaches and allow the franchisor to remedy the breaches (if that was possible) **or** take the hard approach.

15. **Option 1** was for the franchisee to carry on its businesses into the future and work with the franchisor. However, based upon what the franchisee advised it was thought that this was not a tenable option.

16. **Option 2** was for the franchisee to put one or more of its businesses on the market for sale. However, it seemed that the franchisee enjoyed what it was doing and wanted to carry on but it was frustrated by Mr Richards.

17. **Option 3** involved using the Contractual Remedies Act 1979. The franchisee may have had sufficient grounds to cancel all three Franchise Agreements, de-brand and carry on from the same premises which the franchisee controlled under another name. The franchisee would have to hand back all of the intellectual property of the franchisor. There was an inherent risk in the above approach in that the franchisor might attack the franchisee legally and may try to obtain an injunction and close its three businesses down.

18. The franchisee was advised that if it felt that termination was a risky way to go then **Option 4** would be to invoke Dispute Resolution which would mean a mediation to try to negotiate an exit position for the franchisee. However, the Franchise Agreement contained no Dispute Resolution clause which was bad. If there was a dispute and both parties agreed to go to mediation in an attempt to resolve a dispute then mediation could happen.

Additional Facts

19. Not every breach of contract can justify cancellation of the contract and the primary remedy for breach is a claim for damages leaving the contract remaining. However, where there is a breach of an essential term, or the breach is substantial, then the party may be entitled to cancel the contract.

20. Section 7(4)(b) defines a substantial breach as one where the effect of the breach is to:

    (i) substantially reduce the benefit of the contract to the cancelling party; or

    (ii) substantially increase the burden of a cancelling party under the contract; or

    (iii) in relation to the cancelling party, to make the benefit or burden of the contract substantially different from that represented or contracted for.

21. The question of whether a breach is substantial according to these tests is primarily one of fact and the Courts have avoided formulating any guidelines. However, past cases are helpful in this area. For example, *Brown v Langwoods*

Photo Stores Limited [1991] 1 NZLR 173 (CA) where it was held that a franchisor's failure to apply funds from a marketing levy of 3% on gross turnover constituted a substantial breach justifying the franchisee cancelling the agreement.

22. In the Club Physical case the real complaint by the franchisee was that it had lost faith in the franchisor's system because of various marketing blunders made by the franchisor.

23. When all the facts were put together I concluded that there was significant risk that the cancellation argument would succeed should the matter ever progress to a trial.

24. The three Franchise Agreements were cancelled and thereby terminated on Friday 8 February 2013. Normally a franchisor would pursue matters quietly and confidentially. However, in this case the franchisor chose to initially use social media to its best advantage and comments were made on the franchisor's Facebook page on Friday night and all over the weekend. By Monday morning the franchisor had contacted Campbell Live and the New Zealand Herald and the media was relentless.

25. The franchisor brought an application for an interim injunction which was heard at the Auckland High Court on 26 February 2013 before Justice Winkelmann. In the Judgment at paragraph 46 the Judge concluded that there was a serious question to be tried:

> *"(a) That the franchise agreements contained a provision restraining the defendants from operating a health and fitness business from the relevant business premises following termination, probably for a period of two years. In respect of the Three Kings franchise, there is also an arguable case that a five-kilometre restraint of trade applies.*
>
> *(b) That those restraints are reasonable because they are designed to protect Health Club Brand's legitimate interest in the goodwill developed through association with the 'Club Physical' brand.*
>
> *(c) That although the restraints would not survive termination by breach on the part of Health Club Brands, the defendants' termination of the agreements was unjustified and a repudiation of the agreements. The restraints remain enforceable."*

26. The Judge then looked at the balance of convenience argument and at paragraph 51 the Judge said:

> *"It is true that granting injunctions sought is likely to have a catastrophic effect on the defendants' businesses. Nevertheless I have concluded that the overall*

justice of the case favours the grant of an injunction restraining the defendants from operating gym businesses from any of the business premises, and further, in the case of the Three Kings gym, within five kilometres of the business premises, until further order of the Court."

27. At paragraph 52 the Judge said that:

"There will undoubtedly be harsh consequences for the defendants which flow from the issue of this injunction. However, given the relative strength of each party's case, this consideration does not outweigh those which tend to support the grant of an injunction."

28. The Judge then granted an interim injunction restraining the defendants from operating a health and fitness business but slightly modified because of the particular wording in the restraint of trade clause. However, at the time of granting the injunction the Judge did not think of the immediate consequences on the parties because the franchisor did not want all three gyms to be closed and the customers locked out and left in the cold. Therefore, there were numerous applications by the defendants to the Judge for Variation of the Orders which were granted by consent and over a two week period the parties got together through their lawyers and agreed on the form of settlement.

29. In this particular case the franchisor won. However, there are no hard and fast rules and each case will turn on the facts. The decision is good for franchisors as it shows that without legal justification franchise agreements cannot be terminated by franchisees.