

Partner

Stewart Lloyd Germann
B.Com, LLB, FCIS, ANZIM, Notary Public

Partner

Clive Frederick Neifeld
B.Com, LLB

Ground Floor, Princes Court
2 Princes Street, PO Box 1542
Auckland, New Zealand

Telephone 0-9-308 9925
Facsimile 0-9-308 9922
email stewart@germann.co.nz
web www.germann.co.nz

TERMINATION OF MASTER FRANCHISE AGREEMENTS AND THE CONSEQUENCES

A lot of care and effort goes into drafting Master Franchise Agreements (“MFAs”) and at the outset the parties do not contemplate termination being an issue during the term of the MFAs.

Termination can be either because the term of the MFA has expired through the effluxion of time or because of default during the term. The way in which the parties must deal with termination has to be dealt with in the MFA so a lot of thought has to be given to the issues on day one when preparing the contract, or advising the prospective sub-franchisor during negotiations. The outcome of the discussions will be affected by the law in the legal territory, and to a lesser extent, by the way business is conducted in that territory.

As far as New Zealand is concerned, there are existing robust laws to deal with all aspects of termination. There are no franchising specific laws but there are various statutes and case law, and the common law has to be considered.

The issues which may arise upon termination include the following:

1. Protection of intellectual property including post-term restrictions and protection for the franchisor.
2. The circumstances in which the MFA may need to be terminated. Termination by the expiration of the term with no right of renewal, or no agreement of term to control termination by either party or as provided in the agreement or otherwise have to be considered.
3. The legal effect of such termination on the sub-franchisees and what happens to them must be dealt with. For example, do their rights continue notwithstanding the termination of the MFA? Even if that is the case, can the franchisor take over the contracts and, if so, how?

To the extent that there is experience of such termination in New Zealand, I need to consider the consequences from a business point of view for each of the franchisor and the franchisee. For example, there have been cases in the past where the franchisor has had the right to take over the franchisee network in whole or in part but where the attrition rate has reached 50 to 65%.

Termination

As I said above, termination can occur either through the effluxion of time or because of a master franchisee’s default during the term. A typical termination clause from a MFA might read as follows:

1. *“The Franchisor may terminate this Agreement forthwith by giving notice in writing to the Master Franchisee if the Master Franchisee commits or permits any one or more of the following acts, without prejudice to any remedy the Franchisor may have against the Master Franchisee, which acts shall be treated as fundamental breaches of this Agreement:*
 - (a) *the Master Franchisee at any time fails to pay within 30 days of the due date for payment, any amounts due and payable to the Franchisor on the dates on which such amounts are due for payment;*
 - (b) *the Master Franchisee fails to submit to the Franchisor in a timely manner any of the accounting or management information required to be so submitted;*
 - (c) *the Master Franchisee fails to provide the Support Services efficiently and effectively and in accordance with the Franchisor’s Operations Manual;*
 - (d) *the Master Franchisee in the reasonable opinion of the Franchisor substantially misuses or in any way impairs the goodwill associated with any of the Intellectual Property in a way that has the capacity to significantly impair the said goodwill, or takes any action to contest the validity or ownership of the Intellectual Property;*
 - (e) *the Master Franchisee purports to effect any sale, mortgage, transfer or assignment of any of the rights or licences granted other than in accordance with the terms of this Agreement;*
 - (f) *the Master Franchisee fails to obtain any prior approval or consent of the Franchisor expressly required by this Agreement;*
 - (g) *the Master Franchisee discloses or permits or suffers the disclosure of any part of the Franchisor’s Operations Manual, the Franchise Recruitment Manual or any other confidential information contrary to the terms;*
 - (h) *the Master Franchisee or any officer or employee of the Master Franchisee gives to the Franchisor any false or misleading information or makes any misrepresentation either in connection with obtaining this Agreement or at any time during the continuance of this Agreement in connection with the Business;*
 - (i) *any material change occurs in the management, ownership or control of the Master Franchisee or the business otherwise than in accordance with the provisions of this Agreement;*
 - (j) *the Master Franchisee or any of its officers or senior employees or the Guarantor is convicted of any criminal offence punishable by imprisonment which in the reasonable opinion of the Franchisor may have an adverse effect on the Franchisor, the System or the Business;*
 - (k) *the Master Franchisee ceases for 24 hours or longer to carry on the Business;*
 - (l) *the controlling shareholders of the Master Franchisee or the Guarantor becomes bankrupt or insolvent or has a receiver appointed by a court of competent jurisdiction or by way of private appointment, or suffers execution*

to be levied against any of the shares in the capital of the Master Franchisee or makes a general assignment for the benefit of creditors;

- (m) there is any change in voting control of the Master Franchisee;*
 - (n) the Master Franchisee fails to meet the minimum performance criteria as set out in the Agreement;*
 - (o) any party commences legal proceedings to enforce or foreclose any lien or mortgage over or in respect of any property of the Master Franchisee;*
 - (p) the Master Franchisee ceases or fails to comply with any statutory licensing requirement;*
 - (q) notwithstanding any of the other provisions contained within this clause, the Master Franchisee otherwise neglects or fails to perform or observe any of the provisions of this Agreement or commits any breach of its obligations, which breach if remediable is not remedied to the satisfaction of the Franchisor within 30 days of a notice in writing to the Master Franchisee requesting its remedy provided that the Franchisor shall not be obliged to give such notice in the case of a persistent breach which shall be one which has occurred more than twice in any 3 month period.*
2. *In relation to matters being the subject of this clause and which are capable of rectification, the Franchisor may not give notice unless the Master Franchisee has failed to rectify the breach within 30 days of receipt of a written notice from the Franchisor requiring the Master Franchisee to rectify that breach.*
 3. *If the events contemplated in (l) above in relation to bankruptcy or insolvency occur the Franchisor agrees to serve a written notice requiring rectification by replacement of the bankrupt or insolvent party within 60 days before exercising any right to terminate.”*

It is imperative for a franchisor to be able to protect its intellectual property after termination or expiration of the agreement. The normal type of clause might say that “the master franchisee shall execute all such documents and do all such things as are necessary to remove the name of the Master Franchisee from any register relating to business names, trade marks, and other industrial property belonging to the franchisor”. Also, there must be a covenant requiring the Master Franchisee to deliver to the franchisor “any manuals, software including updates and adjustments, instructions, notes, writings and other documents relating to the business, together with all signs, colour schemes and other features associated with the business”.

Restraint of Trade

It is essential for any master franchisee to be restrained from operating any business similar to or in competition with the franchised business during the term of the agreement. Further, after termination of the agreement the master franchisee and any guarantors must be prohibited for a period of (say) two years after termination and within the territory from being concerned or interested in or carrying on any similar business to or in competition with the franchised business without the prior written approval of the franchisor. The master franchisee must be restrained from carrying on any similar business or from directly or

indirectly being engaged, concerned or interested in whether on its or his own account as a principal, agent, partner, shareholder, investor, financier, lender, director, employee, consultant or independent contractor.

Position of Sub-Franchisees

If a master franchise agreement is terminated then the legal position of the sub-franchisees must be considered. Quite often, a MFA will contain an assignment of master franchise clause which might read as follows:

“If the franchisor requires, the master franchisee must within 7 days of the end of the agreement:

- (a) terminate any sub-franchise agreements, leases or licences to occupy that the master franchisee has entered into with its franchisees provided the franchisor or its nominee enters into a sub-franchise agreement with sub-franchisees for the unexpired portion of the terms of those sub-franchise agreements; or*
- (b) assign to the franchisor or a nominee of the franchisor any or all current sub-franchise agreements, leases and licences to occupy which the master franchisee has entered into with its franchisees, and all related documents including Deeds of Indemnity given to the master franchisee by the franchisees”.*

The protection of the sub-franchisees is of paramount importance and no franchisor will want any damage being done to the system. If a franchisor is forced to validly terminate a master franchisee pursuant to a MFA then that franchisor will want to look after the sub-franchisees of the system as much as possible. If the master franchisee had been failing in its duties then the termination of the MFA may come as no surprise to the sub-franchisees who could welcome intervention by the franchisor as a positive signal. The Sub-franchisees like any franchisees should not be underestimated and they tend to know when matters are not right. Provided the franchisor handles the situation in a professional manner and without undue delay after termination then the sub-franchisees should accept that the franchisor has been a victim of the master franchisee’s failures, and that fact should assist the franchisor’s efforts to salvage the master franchisees and attempt to keep them in the system. At that point, the sub-franchisees will have no legally binding agreement with the franchisor, and it may well be that the franchisor may choose not to offer every sub-franchisee a unit franchise agreement as the termination of the MFA will allow the franchisor to assess the value of each sub-franchisee to the system.

No Suitable Clause

If a franchisor had to terminate a MFA for default and the MFA did not contain a clause similar to the clause contained above, then the MFA would terminate and the sub-franchisees would flounder because the sub-franchise agreements would be of no legal effect. Any franchisor will want to protect the existing sub-franchisees and will attempt to enter into direct franchise agreements with them as soon as possible to preserve the goodwill of the franchisees and to secure their obligations pursuant to designated covenants. The master franchisee would have no status or standing after termination and the franchisor would have to move very quickly to secure the system. The sub-franchisees should never feel alone and must feel wanted by the franchisor should the master franchisee be terminated by the franchisor.

In conclusion, it is essential for MFAs to contain robust clauses which protect the franchisor following termination either through the effluxion of time or by default. Care must be taken in drafting the necessary clauses and to have no suitable clauses is both risky and commercially foolish in my opinion.

Stewart Germann
Stewart Germann Law Office
Auckland
New Zealand

stewart@germann.co.nz
www.germann.co.nz