FRANCHISE INDIA
Your growth is our business

How to part ways with a shake hand

January 18, 2014

Liberalization of the Indian economy has attracted many foreign franchisees to India, as a part of their expansion strategy. Pizza hut, Subway, and fashion retail brands like Mango are some such international names. Simultaneously, indigenous home grown brands such as Jumbo Vada Pav, Reliance Fresh, Metro, Archie's, Pantaloons etc have also benefitted, both in terms of reach and revenue.
KPMG's 2013 report predicts India's franchising industry to quadruple in volume in the next five years, accounting for almost 4% of India's gross domestic product (GDP) in 2017.
Franchising allows franchisors to expand their reach and earn handsomely through franchise fees and royalties. Franchisees benefit by getting the flexibility to do their own business while using a known brand name. Thus, franchising creates a win-win situation for all.
It is true for all businesses that parties seldom worry about a break up and consequences at inception stage. However, things become tricky when the eventualities upon termination are not discussed beforehand and relations turn sour.Franchise, being a creation of contract, is usually for a limited term as may be agreed between the parties. Typically, franchise agreements have an option for renewal, but renewal terms are usually heavily negotiated between the parties.

Some of the reasons why franchise arrangements terminate:

- Parties find it difficult to do business together due to commercial or other reasons;
- Franchisor may want to appoint a new franchisee to give a new and fresh start to his business;
- Franchisee may want to exit the franchise arrangement or may not want to renew the franchise arrangement due to inflation, increase in franchise fee or royalties, low profitability, increasing competition from competitors or opening up of competing franchise outlets in the same locality etc.

In this article, we have discussed certain interesting scenarios related to termination which can be considered at the time of entering into a franchise relationship.

Property Leases

Location of the franchise outlet plays a strategic role in the business growth and thus, the franchisors usually lay a lot of stress on choosing the right location for the outlet. In fact, occupancy of the premises post termination of the franchise arrangement becomes a bone of contention for both parties.
While property leases for running franchise business are usually undertaken by the franchisee or a sub-franchisee, it is not uncommon for franchisors to insist on a tri-partite lease arrangement with an understanding that the premises will be leased in favor of the franchisor upon termination of the franchise relationship. At the same time, the franchisee may also want to retain the right to use the premises due to the strategic advantages of the place / location.
Therefore, clauses in relation to the physical place of business for the franchise should be negotiated beforehand so as to avoid any disputes and also ensure a smooth transition for the parties.
However, this option is not available when the foreign franchisor directly grants a franchise to Indian franchisee as foreign franchisor will not be able to obtain lease in India without having an entity in India.

Stock

Post termination, the franchisor should either allow the franchisee to dispose off the existing stock of goods within the identified time period or buy the goods at a predetermined price, so that the question of franchisee misusing / making unauthorized use of the goods does not arise. At times, the franchisee may also put an obligation on the franchisor to buy the inventory upon termination,

at a pre-agreed cost.

Assignment of Sub – Franchise Agreements

In many franchise arrangements, there is an involvement of sub-franchisees whose functioning is supervised by the master franchisee. In the event of discontinuance of the relationship between the franchisor and master franchisee, the franchisor may require the sub-franchise agreements to be transferred to the new master franchisee or the franchisor directly.

Since the concept of third party beneficiary is not well recognized in India, automatic assignment or novation clauses in favor of the franchisor should be clearly articulated in franchisor - franchisee as well as the franchisee - sub-franchisees agreements.

Non-Compete Covenants

Another issue that could arise is the enforcement of non-compete covenants post termination / discontinuance of the franchise business. In the landmark case of Gujarat Bottling Co. Ltd. and others v. Coca Cola Co. and others[1], Coca Cola Co. had imposed a restriction on Gujarat Bottling Co. Ltd from entering into an agreement with any other beverage manufacturing company during the term of their contract.

When the case came up before the Supreme Court as being in restraint of trade, the Court held the following:

"There is a growing trend to regulate distribution of goods and services through franchise agreements providing for grant of franchise by the franchisor on certain terms and conditions to the franchisee. Such agreements often incorporate a condition that the franchisee shall not deal with competing goods. Such a condition restricting the right of the franchisee to deal with competing goods is for facilitating the distribution of the goods of the franchisor and it cannot be regarded as in restraint of trade."

The Court, therefore, held that a negative agreement restraining the franchisee from manufacturing, bottling, selling, dealing or otherwise being concerned with the products or beverages of any other brands or trademarks /trade names during the subsistence of a franchise agreement was enforceable. However, the Court did not address the issue of a negative covenant post-termination of the agreement.

Therefore, the parties should take into consideration the law of the land as well as judicial precedents while drafting a restrictive or negative covenant in a franchise agreement.

Selling the Franchise Business as a Going Concern

At the end of a franchise relationship, franchisees are typically required to wind up the franchise business. When the network established is mainly of the sub-franchisees, it is fairly easy for the franchisor to continue the business as is, by simply assigning the sub-franchise agreements to the new franchisee(s) or to itself. However, if franchise stores are owned and operated by the franchisee itself, then the franchisor would be required to rebuild the entire franchise network through a new franchisee. On the other hand, all the efforts put in by the franchisee to build the franchise network would also be lost.

Assuming that the franchise arrangement lasted for a considerable term, there would be significant value identifiable with the franchise business and such value may not be foreseen or identified at the inception of the relationship.

Therefore, one of the options which can be evaluated is the selling of the franchise business (in a situation where most of the business is owned and operated by the franchisee) as a going concern to franchisor or to a new franchisee.

The benefits of selling a franchise business as a going concern are –

- The franchisor continues to receive royalty from the new franchisee;
- The brand of the franchisor continues to remain in existence and develops greater visibility;
- The franchisee gets a fair market price for the efforts expended by him over the years to develop the franchise business.

If the above option is exercised, the franchisor may be given the first right to buy the franchise business at a value which is agreeable to both parties or as determined by a third party valuer based on current market standards.

Thus, sale of business by franchisee to franchisor as a going concern can be a good and commercially feasible option for both parties.

To conclude, while disputes are inevitable and may arise in any form, negotiating the abovementioned clauses at the time of entering into the contract itself, may just help in parting ways with a hand shake (and no heartaches!).

Contributed by - Nishith Desai Associates, a leading international law firm with offices in India, Singapore, Palo Alto (US) and Munich.

Copyright © 2009 - 2014 Franchise India Holdings Ltd.