

## ARTICLES

Ted P Pearce

Nexsen Pruet, Charlotte

tpearce@

nexsenpruet.com

# The orphaned unit franchisee: how to manage them after termination of a master franchise relationship

**W**hen designing an international multi-unit franchise relationship, it is beyond question that the most important factor is choosing the right international partner. Once you believe that you have found that ideal partner you will need to choose the best vehicle to structure the business relationship. The two most conventional international development structures are the area development agreement and the master franchise agreement. Under the former the franchisor maintains a direct relationship with its international partner, while under the latter, which currently is the preferred structure in international franchise relationships, the master franchisee is granted the exclusive rights to develop a designated territory primarily through a sub-franchise relationship with its unit franchisees. If the master franchise route is chosen, one issue that is given less attention is the ultimate disposition of the operating units upon the termination of the master franchise agreement. The franchisor's right to assume the sub-franchise agreement, or step-in rights, are often lost in the negotiations of initial franchise fees and royalty splits, but can greatly affect the ultimate sustainability of a franchise system's international expansion in the chosen market.

The ability of the franchisor to bring about its assumption rights in the master franchise model can be more problematic than is the case with an area development agreement. The direct relationship between the franchisor and the unit franchisee in the area development model gives the franchisor direct access to the unit businesses upon termination of the master franchise agreement without having to navigate the relationship issues between the

master franchisee and the unit franchisees. Conversely, in the master franchise relationship, with a more attenuated link to the unit franchisee, the franchisor's ability to assume the unit franchise relationship will be tempered by a number of access and relationship considerations that will be influenced by the language in the governing master franchise agreement and the individual unit franchise agreements.

Most master franchise agreements are epic in scope and attempt to address every conceivable contingency that could occur during a master franchise relationship. Deeply buried in the agreement – most likely as a sub-sub paragraph in the enforcement or remedy section – is a sentence that reads something along the lines of: 'in the event that this agreement is terminated the franchisor shall have the right to assume the unit franchise agreements as between the master franchisee and the unit franchisees.' More than likely a franchisor will attach its domestic franchise agreement as an exhibit to the master franchise agreement that is intended to be used by the master franchisee. That agreement will provide the master franchisee with a broadly worded right to assign its unit agreement to a third party. The franchisor will rely upon this language to exercise its assignment rights to the unit franchisee's agreement when the master franchisee's agreement is terminated. This non-specific language will be lost on the unit franchisee, which likely will have no understanding that this assignment language translates into a direct relationship with the franchisor. For the franchisor this general right to assignment may provide it with limited abilities to actually effectuate its access rights.

The franchisor's assignment rights are usually triggered by a material default of the master franchise agreement. Often the underlying defaults will be based either on the master franchisee's inability to meet its development schedule or a default in its financial obligations. Moreover, it is often the case that when termination becomes inevitable the master franchisee abandons its franchise relationship making the assignment of the unit franchise agreements to the franchisor problematic at best. Worse still, it is likely that the master franchisee also will be in default of its obligations to the unit franchisees. In this case not only may the unit franchisees not wish to continue a franchise relationship with the brand, but they also may harbour legal claims against the master franchisee, which may be inadvertently assumed by the franchisor when it receives an assignment of the unit franchise agreement.

So, as of the date of termination of the master franchise agreement the franchisor may be suffering from two problems:

- inability to effectuate an assignment of the unit franchise agreement from the master franchisee; and
- inadvertent assumption of a unit franchisee's claims against the master franchisee triggered by the assignment.

This quandary may leave the franchisor with the unenviable choice of whether to face a hornet's nest of unhappy franchisees or to abandon its investment in the particular market, making re-entry in the future difficult at best.

Tucked away in this conundrum is the need for the franchisor to find a means to repair the often tarnished relationship that the unit franchisees may have with the brand. A well-drafted master franchise and unit franchise agreement can provide the master franchisor with additional flexibilities that at the very least may enable it to stabilise an otherwise volatile market until re-franchising may become more viable. To accomplish this practical solution, the enforcement and remedies section of both the unit franchise and the master franchise agreement should contain language that provides the franchisor, upon termination of the master franchise agreement, the option to: (i) assume the terms of the franchisee's unit franchise agreement; or (ii) convert the unit franchise agreement to a licence agreement that would permit the franchisee to continue the operation of the business, but under a licence arrangement whereby the franchisor would

not be obligated to provide any additional services, but also where the unit franchisee would be relieved of many of its obligations under the unit franchise agreement.

Chief among the amended contract terms would be a restructuring of on-going royalties. Depending upon the situation in the market the royalty rate could be significantly reduced, or the franchisee could be given a paid-up licence, which means that for a modest one-off payment the franchisee could continue to use the franchisor's name in the continued operation of their business.

The language in the unit agreement providing for the licence relationship also would provide the franchisor with the customary trademark protection rights. This provision would also provide that if the franchisor decides to re-franchise the territory the unit franchisee would be given the option to re-enter the franchise network as a franchisee paying the required royalties and advertising contributions in exchange for receiving the same services as the other franchisees in the market. Conversely, at that time, if the unit franchisee elected not to convert their licence to a franchise they would be required to cease using any of the franchisor's trademarks. While the franchisor may also demand that the licensee stop operating a competing business, this may be problematic to enforce since it could be argued by the unit franchisee that the franchisor has abandoned its protectable interest when it converted the franchise to a licence.

In drafting the licence clause into the unit franchise agreement the franchisor should take special care to provide it with the flexibility of not having to assume any claims that the unit franchisee may have against the master franchisee. In that regard, it is best to include language disclaiming any third-party beneficiary relationship between the franchisor and the unit franchisee.

It is important that the master franchisee and the franchisor disclose the licence remedy in their respective disclosure documents to the extent that either the franchise is located in a jurisdiction that requires franchise disclosure or is located in a civil law jurisdiction requiring enhanced pre-contractual disclosures.

While the optional licence route should not be viewed as a panacea for the franchisor it will at least provide it some flexibility to salvage what could otherwise be a disastrous retreat from an international expansion initiative.