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ADRS
ALTERNATIVE DISPUTE RESOLUTION SOCIETY

NATIONAL MEDIATION COMPETITION

27TH - 29TH MARCH, 2020

GENERAL INFORMATION

QUARTER-FINAL

"CAN A LOT HAPPEN OVER A COFFEE?"

Incredible Hospitality Pvt. Ltd. (a franchiser) is based in New Delhi and is in the business of running chain of cafés and restaurants in India under various brand names. In South India, it has brands in almost all major cities. Hyderabad remains relatively unexplored and has had only one of its franchised outlets, which was run by Lifestyle Hospitality. Lifestyle Hospitality (a franchisee) is a registered partnership firm, having its office in Jubilee Hills, Hyderabad. Lifestyle is led by Dave McNeil, who is a fresh entrepreneur and recent BBA graduate. Primarily focused in the entertainment and hospitality industry, Dave dreams to make a name for himself in Hyderabad.

Lifestyle Hospitality and Incredible Hospitality have had a business relationship for several years, starting from year 2015 when Lifestyle Hospitality first became a franchisee of Incredible Hospitality running a Café cum Restaurant Bar at Banjara Hills, Hyderabad. Though it was not a successful venture and had to be ended in 2017, both parties built on their trust and executed a new agreement, i.e. Franchise Agreement dated 31.01.2018. Dave thought everybody deserved a second chance and refused to join hands with various other franchisers who were keen on giving their franchise to Dave. The new outlet in Jubilee Hills is called Café Heights. With open to sky seating surrounded by green, and brilliantly designed interiors, Café Heights exudes the elegance of another era. Its one-of-a-kind lounges with a well-thought menu, make it ideal for both post-work drinks during the week and leisurely rounds on weekends. The property is owned by Lifestyle Hospitality and is undoubtedly one of the best places in Jubilee Hills.

After the new Franchise Agreement was executed, the outlet in Jubilee Hills started operations in February 2018. Through the period of operation, Dave made best efforts giving his optimum to generate maximum Net Revenue, but more importantly to generate Net Profits. This was important because under the Franchise Agreement the franchisee was bound to pay 10% of the Net Revenue per month to the franchiser as the franchise fee (royalty) for using Incredible Hospitality's brand and franchise system. However, Lifestyle Hospitality started suffering severe issues with respect to the outlet and could make no payment March 2018 onwards. These issues were primarily concerning kitchen, food costing, deputed managerial staff, and service. March 2018 onwards, the outlet started receiving bad reviews and critiques which were connected to the managerial staff, service, and food and kitchen. These had become a cause for the degrading popularity and recognition of the outlet. After all, a franchise business or any café, bar, or restaurant works on the fundamental principle of good experience with ambience, food, service, kitchen, and the behavior or conduct of the managerial staff.

As per the Franchise Agreement, the managerial staff (Manager, Asst. Manager, and Head Chef) was deputed by Incredible Hospitality. These personnel were employed, trained, and specifically placed at the outlet by Incredible Hospitality. According to the Franchise Agreement, Lifestyle Hospitality could play no role in these matters. The purpose was simple: Incredible Hospitality, being the owner and promoter of the brand name, required full control over the franchise, as a way to meet its own specifications, market standards, reputation, service, and system and style working. Therefore, the Franchise Agreement gives major control over the staff, system, and standards of the outlet to the franchiser. Almost no part of the franchise was under the control of Lifestyle Hospitality, except dealing with investments, finances, payments, management of the outlet, and some promotional activities for the outlet.

The problems faced by the outlet continued and escalated. There were some antagonistic situations where Dave had conflicts with the working of the managerial staff. He was unhappy with their unprofessionalism. The managerial staff was under no obligation to answer to Dave and only answered to the franchiser, but their salaries were paid by the franchisee, i.e. Lifestyle Hospitality, which he considered was affecting the work culture of the outlet. Tensions between Dave and the managerial staff kept recurring. These issues were reported to Incredible Hospitality and their intervention was often sought; however, a proper solution or support could not be found by Incredible Hospitality (even though they had full rights to intervene and implement changes). On the other hand, an issue that persisted since the commencement was the high food costing, which was regulated by Incredible Hospitality. In any restaurant, food costing directly impacts sales and Net Profits. Even in the present case, the sales of the outlet were severely affected due to high food costing. Even after repeatedly notifying to Incredible Hospitality, the issue was ignored.

Thus, since the commencement of the outlet, Lifestyle Hospitality kept incurring immense losses. The overall expenditure for running the outlet were many times higher than the Net Revenue (which made it worse). Unable to keep up with the losses and degrading business, on 01.11.2018, Lifestyle Hospitality terminated the Franchise Agreement. Dave decided that he would keep away from any franchise business. Since January 2019, Dave is the owner of "Coffee and Conversations" – after shutting down Café Heights in November 2018 and starting Coffee and Conversations at the same venue. Many in the industry think that this will again be a loss-making venture – Dave's reputation is such in the market; they say he is a rookie, lacking management experience in restaurant business.

This termination came as a shock to Incredible Hospitality and it refused to treat the termination letter as valid. On 15.11.2018, Don Radulovic (COO) and Franco Gevaerd (CFO) both flew down to Hyderabad to meet with Dave and talk about the situation.

Don and Franco wanted Dave's cooperation and collaboration. They discussed several options as the way forward, particularly, with respect to the payment of franchise fee (royalty) which has been due since March 2018. Incredible Hospitality suggested that Dave either continued together with a considerably reduced franchise fee (to be applied retrospectively) or discontinue the contractual relationship and go separate ways. Dave took the latter option, pursuant to which the Incredible Hospitality requested that the Lifestyle Hospitality pull down the branding and shut the operations with immediate effect.

On 15.01.2019, Incredible Hospitality sent a notice through its Advocates, demanding the entire franchise fee from Lifestyle Hospitality at 10%, amounting to INR 50 lakhs. Lifestyle Hospitality disputed the demand the next day and Incredible Hospitality invoked the arbitration clause in the Franchise Agreement. Incredible Hospitality has claimed INR 50 lakhs (plus 24% interest) as expectation damages for Lifestyle's breach of non-payment of franchise fee. The arbitration proceedings have been going on since May 2019 in New Delhi and the case has reached its final stages: the evidentiary hearings are complete, and the final arguments have been scheduled for April 2019. At the arbitration, Lifestyle has counterclaimed INR 1.54 crores as reliance damages for breach of contract, in failing to perform its obligations under the Franchise Agreement, which led to Lifestyle's financial losses and inability to perform its obligation to pay the franchise fee.

At the evidentiary hearings in New Delhi, Dave met Don and Franco for the first time since 15.11.2018. The conversations led to Dave inviting Don and Franco over to Hyderabad, to interest them in a tour of his outlet (Coffee and Conversations) and have settlement talks through mediation (as suggested by his arbitration counsel). Dave and Franco have agreed and have promised that either one of them will be there at the mediation session with their legal representative.

Annexure 1:

FRANCHISE AGREEMENT [Extracted and Summarized]

1. General Information:

1.1. The “Date of Commencement” of the Franchise Agreement was 31.01.2018.

1.2. “Net Revenue” means the gross revenues arising directly and indirectly from the conduct of the business, i.e. the Franchised Outlet.

1.3. The Franchise Agreement was executed for a “Term” of 3 years from the Date of Commencement.

1.4. The Franchisee was to commence operation of the Franchised Outlet within three months from the Date of Commencement.

[...]

3. Scope of Franchiser’s Obligations:

3.1. The various obligation of the Franchiser:

3.1.1. To provide initial training and on-going training to Franchisee’s principals.

3.1.2. To license the use of appropriate software for the Franchised Outlet to record transactions, while license fees and incidental costs were to be borne by the Franchisee.

3.1.3. To provide a record-keeping system for the business for efficient administration of business, the cost of which was to be borne by the Franchisee.

3.1.4. To depute to the Franchisee, an Outlet Manager, Asst. Outlet Manager, and an Outlet Head Chef, to manage the operations of the outlet. The salary, PF, ESIC, accommodation, and travel expenses of such personnel was to be borne by the Franchisee. Note, the Franchisee has no right to select hire or terminate the services of these personnel.

3.1.5. To provide such marketing, merchandising, advertising, research data, and advice as may from time to time be developed, which would be helpful or necessary for the operation of the Franchised Outlet.

3.1.6. To provide benefits of its contracts with strategic partners; benefits of negotiated vendor prices; list of preferred vendors for strategic partners.

3.1.7. To involve the Franchisee in promotional schemes entered into by the Franchiser and pass on the benefits accrued to the Franchisee thereof.

[...]

14. Scope of Franchisee's Obligations:

14.1. The overall scope of the Franchisee's obligation was the setting up, operating, and running of Franchised Outlet under the Franchiser's terms and conditions of the Franchise Agreement. The Franchisee was obligated:

14.1.1. To attend initial training at Franchiser's fifteen-day orientation program. Note, the Franchiser may conduct a personnel audit, and if the Franchiser feels that further training is required then the Franchiser is obligated to ensure that his employees have completed the requisite training.

14.1.2. To follow all directions in all aspects of the business made by the Franchiser in order to maintain and preserve the Franchiser's rights, goodwill, and reputation in the business and the Franchised Mark. Moreover, the Franchisee was obligated to follow all the specifications given by the Franchiser with respect to furnishings, handouts, menus, crockery, cutlery, etc.

14.1.3. To participate fully and without exception in all marketing programs, sales promotions and services of Franchiser as Franchiser determines to be necessary and desirable for the Franchise Outlet from time to time.

14.1.4. To allow the Franchiser conduct inspections and investigations to determine that the activities of the Franchisee and the Franchised Outlet meet the standards set forth in the Rules and Regulations and the Franchise Operations Manual, and with the obligations of the Franchise Agreement.

14.1.5. To purchase the raw materials for preparation of food and beverages at the Franchised Outlet from the Franchiser's approval list of vendors/ suppliers' only.

14.2. In addition to the general obligations described above, the fees and payment obligations of the Franchisee were:

14.2.1. To pay INR 15,00,000.00, as a one-time non-refundable royalty fee (inclusive of taxes). The fee payable is payable towards the consultancy and guidance provided by the Franchiser in setting up the outlet.

14.2.2. To pay a Franchise Fee (fortnightly) at the rate of 10% of the fortnightly Net Revenue, exclusive of taxes, of the Franchised Outlet.

15. Breach, Remedy, and Termination

15.1. The Franchiser is obligated to give a written notice of any failure to comply with the standards established pursuant to the Franchise Agreement with respect to the operation of the Franchised Outlet. If within the 15 days from such notice the objectionable item or activity has not been satisfactorily remedied, the Franchiser shall have the right to remedy it.

15.2. In the event the Franchisee fails to cure a breach within a period of 30 days from the receipt of a written notice (from the Franchiser) to cure such breach, then the Franchise Agreement shall automatically come to an end at the end of the period of 30 days.

15.3. The Franchise Agreement provides for the Franchiser's right to terminate the agreement (either with opportunity to cure or without it).

15.4. The termination of the Franchise Agreement triggers various rights and obligations upon the Franchisee. These include, ceasing the use of the Franchised Mark and operating the Franchised Outlet under the system and Franchised Mark.