FRANCHISING - CANADA

Franchisor caught between rock and hard place: importance of clear exclusivity clauses

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AUTHORS

Bruno Floriani

Marissa Carnevale

Tanya Nakhoul

Introduction

Franchise arrangements often involve a three-way relationship whereby franchisors enter into commercial leases with landlords and then sublease the rented premises to franchisees. Such commercial leases often contain an exclusivity clause limiting the landlord's ability to lease nearby commercial space to competitors of the franchise network.

In *Second Cup Ltd v 8702934 Canada Inc (Café Vasanti)*, the Superior Court of Quebec's decision revolved around the interpretation of an exclusivity clause contained in both:

- a commercial lease between The Second Cup Ltd and 8407304 Canada Inc (the landlord); and
- a sublease between Second Cup and its franchisee Café Darmel Inc (the franchisee).

The exclusivity clause prevented the landlord from leasing premises in proximity to the leased premises to other tenants whose principal business involved the sale of specialty coffees and espresso-based drinks. According to the franchisee, the landlord breached the exclusivity clause by leasing space to Café Vasanti, which offered certain coffee beverages and food products similar to those sold by the franchisee as part of the Second Cup franchise system. With a view to exercising its rights under the head lease (and thereby attempting to protect the viability of the franchised business in question), Second Cup applied to the Superior Court of Quebec seeking injunctive relief against the landlord and Café Vasanti.

Since the court came to the conclusion that the sale of coffee was secondary to Café Vasanti's main business as a cafeteria-style restaurant, it ruled in favour of the landlord and Café Vasanti and held that they had not contravened their contractual obligations as to the use of premises leased nearby Second Cup's leased unit.

In rendering its decision, the court confirmed that exclusivity clauses must be interpreted and applied restrictively so as not to unduly interfere with the parties' freedom of contract.(1)

Facts

In November 2012 Second Cup entered into a franchise agreement with the franchisee to operate a Second Cup franchise in the shopping centre owned by the landlord.(2) In September 2013, after several months of negotiations, Second Cup and the landlord signed a head lease, which included the following exclusivity clause:

> *For so long as The Second Cup Ltd.... is the tenant of and is occupying the Premises for the purpose of operating a coffee shop selling gourmet coffees and espresso from the whole of the Premises and provided that the Tenant is not in default of its obligations to Landlord under this*

> *lease beyond the applicable cure period, Landlord shall not lease or permit the operation of any premises in the Commercial Area, in whole or in part, to any tenant or occupant who will use the premises* ***for the principal business of a specialty coffee shop selling coffees, specialty coffees and espresso-based drinks, such as, by way of example, a Starbucks, Tim Horton's, Dunkin Donuts, Café Dépôt, and AL Van Houtte***.(3) (Emphasis added.)

Shortly thereafter, Second Cup subleased the premises to the franchisee, which began operating its franchise in November 2013.

In early 2014 the landlord entered into a commercial lease with Café Vasanti, which referred to Second Cup's exclusive right to sell gourmet coffee and espresso in the shopping centre. Following the opening of Café Vasanti in February 2015, the franchisee experienced a significant decrease in its sales. It wrote to Second Cup, claiming that:

- Café Vasanti's main operations focused on the sale of coffee and that the landlord and Café Vasanti had, in effect, breached the exclusivity clause; and
- its sales had suffered as a consequence.

Accordingly, the franchisee urged Second Cup to take legal action against the landlord and Café Vasanti to cause such breach to cease. In light of the franchisee's allegations, Second Cup promptly notified the landlord that it must cease engaging in any activities violating its contractual obligations towards Second Cup.(4)

The franchisee's business operations continued to falter and in March 2015 it sent a notice of default to Second Cup, insisting that the franchisor seek injunctive relief against the landlord and Café Vasanti. Second Cup responded that upon further investigation, it had concluded that the exclusivity clause had not been breached and that the chances of success of any legal action against the landlord and Café Vasanti were tenuous. At this point in time, the franchisee had already ceased making its rental payments under its sublease with Second Cup.(5)

In August 2015 the franchisee instituted legal proceedings against Second Cup to terminate its sublease and franchise agreements, alleging that Second Cup had refused to enforce the exclusivity clause under the head lease and protect its rights; this action is still pending. In a separate instance, the landlord sued Second Cup for the Franchisee's unpaid rent arrears.

Subsequently, in September 2015 Second Cup sought injunctive relief against the landlord and Café Vasanti alleging that, upon the discovery of new information, it had concluded that the exclusivity clause had indeed been breached. The Superior Court denied Second Cup's motion for an interlocutory injunction in January 2016.(6)

The landlord's claim for unpaid arrears and Second Cup's claim for permanent injunction were consolidated before being heard on the merits.

Decision

In assessing whether the exclusivity clause had been breached, the Superior Court of Quebec began its analysis by comparing the products and services provided by Second Cup and Café Vasanti, as well as the physical spaces of both shops. On the one hand, the court considered that Second Cup offered a fixed menu which included a selection of ground coffee beverages, as well as sandwiches and pastries delivered by suppliers. In addition, the design, layout and floor plan of the franchisee's Second Cup shop was standardised and looked no different to any other Second Cup location. On the other hand, the court found that Café Vasanti did not have the physical appearance of a coffee shop. It offered a variety of hot meals prepared on site, a salad bar and a self-serve coffee station with six different types of coffee. Also, unlike Second Cup, Café Vasanti did not include a seating area.(7)

The court then endeavoured to determine the meaning that should be given to 'speciality coffee shop', given its finding that the exclusivity clause was ambiguous and that the various agreements entered into between the parties provided no guidance in this regard. Second Cup argued that Café Vasanti qualified as a specialty coffee shop, as it presented itself as a coffee shop on its website and

offered six different types of coffee, while Café Vasanti asserted that the sale of coffee was ancillary to its main business as a "take-out delicatessen and a buffet style restaurant". The notion of 'principal business' was not defined in the agreements either.(8)

The court observed that the exclusivity clause prohibited:

- a type of establishment ("specialty coffee shop");
- a list of beverages ("coffees, speciality coffees and espresso based drinks"); and
- a business model analogous to Second Cup's ("Starbucks, Tim Horton's, Dunkin Donuts").

However, the absence of any definition of 'principal business' or 'specialty coffee shop', combined with the fact that businesses such as Starbucks and Tim Horton's were used to exemplify these notions (with only the former being equipped with an espresso machine at the time), prompted the court to conclude that the deciding factor was whether Café Vasanti was a type of establishment whose general appearance was comparable to that of a Second Cup coffee shop.(9)

The court was not convinced that Café Vasanti gave the impression of being a speciality coffee shop akin to, for example, Second Cup or Starbucks: while Café Vasanti served coffee, this was ancillary to its principal business as a cafeteria-style restaurant; as such, its activities were not prohibited by the exclusivity clause and the court concluded that no breach had occurred.

Given the court's finding that the exclusivity clause had not been violated, it granted the landlord's claim for unpaid rent arrears against Second Cup.(10)

Comment

This decision is yet another example of the importance of drafting exclusivity clauses in commercial leases with clearly defined terms. As evidenced by the franchisee's experience in the above case, the breadth and scope of an exclusivity clause can be determining factors in the success or failure of a franchisee's business. When entering into commercial leases, franchisors should strive to ensure that their franchisee's operations are protected from competitors that have business activities similar to theirs, whether in a principal or ancillary manner.

The court also emphasised that exclusivity clauses must be interpreted narrowly because such clauses limit the parties' freedom of contract; when in doubt, the courts will construe an ambiguous exclusivity clause in favour of the party whose rights are being restricted.

Further, the duty of contracting parties to act in good faith under Quebec law should be noted, as it pertains to the franchisor's actions in this case. With regard specifically to franchise agreements, recent decisions have arguably extended the implied duty of good faith owed by a franchisor to a franchisee in Quebec. In order to fulfil its obligations, a franchisor must:

- act in good faith throughout the franchise relationship;
- respond promptly and effectively to its franchisees' concerns regarding competitive threats; and
- generally take steps to protect its brand and franchise network.(11)

Although a statutory duty of good faith in contracts has not been enacted under Canadian common law, the Canadian courts are increasingly inclined to apply the duty of good faith as a general organising principle of contracts, particularly in the context of commercial agreements involving vulnerable parties, such as franchise arrangements.(12)

In the case at hand, despite facing difficult circumstances and admittedly limited chances of success, Second Cup appears to have endeavoured to act in good faith by pursuing this claim under the head lease to protect its franchisee, whose sales were allegedly being harmed by the existence of a competitor. When Second Cup found itself between a rock and a hard place, it conducted itself in accordance with elevated standards arguably imposed upon franchisors to engage in the protection of their franchisees and their business interests – at least in Quebec. Franchisors which generally take leasehold positions and sublease space to their franchisees as a risk mitigation strategy should therefore be mindful of the heightened risks associated with this approach, especially as concerns

being potentially required to spearhead the enforcement of rights arising under the lease against the landlord and other parties when the need arises.

For further information on this topic please contact Bruno Floriani, Marissa Carnevale or Tanya Nakhoul at Lapointe Rosenstein Marchand Melançon LLP by telephone (+1 514 925 6300) or email (bruno.floriani@lrmm.com, marissa.carnevale@lrmm.com or tanya.nakhoul@lrmm.com). The Lapointe Rosenstein Marchand Melançon LLP website can be accessed at www.lrmm.com.

Endnotes

(1) *Second Cup Ltd v 8702934 Canada Inc (Café Vasanti),* 2018 QCCS 2064 (CanLII).

(2) *Ibid,* Paragraph 11.

(3) *Ibid,* Paragraph 30.

(4) *Ibid,* Paragraphs 37 to 38 and 43 to 56.

(5) *Ibid,* Paragraphs 57 to 63.

(6) *Second Cup Ltd v 8702934 Canada Inc (Café Vasanti),* 2016 QCCS 274, Paragraphs 30 to 36.

(7) *Supra* note 1, Paragraphs 76 to 86.

(8) *Ibid,* Paragraphs 35 and 87 to 109.

(9) *Ibid,* Paragraphs 122 to 128.

(10) *Ibid,* Paragraphs 110 to 114, 129 to 139 and 161 to 167.

(11) *Dunkin' Brands Canada Ltd c Bertico Inc*, 2015 QCCA 624 (CanLII); *Provigo Distribution Inc v Supermarché ARG Inc*, 1997 CanLII 10209 (QC CA).

(12) *Bhasin v Hrynew* [2014] 3 SCR 494, 2014 SCC 71 (CanLII); *Shelanu Inc v Print Three Franchising Corp*, 2003 CanLII 52151 (ON CA).