FRANCHISING - CANADA

Franchisee defaults: when is it 'material' enough?

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Introduction

Few areas of contract law have created as much confusion as the nebulous distinction between material breaches, substantial breaches and breaches going to the root of the contract. While it has long been held that a contract may be terminated in such cases, what qualifies as 'material', 'substantial' or 'going to the root of the contract' is often the subject of debate.

In *Crescent Hotels and Resorts Canada Company v 2465855 Ontario Inc*,(1) the Ontario Court of Appeal clarified that in circumstances where a material breach includes an event of default that has not been cured within the required timeframe, the breach does not necessarily have to go to the root of the contract in order to warrant termination. In other words, depending on the language of the contract, a lesser breach could warrant termination of the agreement for cause if such breach is not cured in time. This distinction is important in a franchise context, where franchise agreements often provide that the franchisor has a right to terminate the franchise agreement for material breach by the franchisee, leaving what constitutes a 'material' breach open for interpretation.

Facts

On 22 July 2015 2465855 Ontario Inc (the owner) entered into a hotel management agreement with Crescent Hotels and Resorts Canada Company for a term of 10 years. The agreement defined 'events of default' as including a party's failure to "perform, keep, or fulfill a covenant... in any material respect" for more than 30 days after receipt of a written notice of default. In April and May 2016 the owner sent several written complaints to Crescent about its performance, advising it that such complaints constituted events of default which, if not remedied within the prescribed cure periods set out in the agreement, would result in termination of the agreement. Crescent disputed that the complaints amounted to events of default justifying termination of the agreement and contended that, in any event, the owner had failed to give proper notice of such disputed events of default. The owner finally terminated the agreement for cause on the basis that Crescent had committed a material breach of contract. Crescent brought an action alleging that the owner lacked cause to terminate the agreement and that the owner was required to pay Crescent an early termination fee pursuant to the agreement, given that the owner had terminated the agreement without cause during the first two years of the term.

Decisions

The Ontario Superior Court granted summary judgment against the owner, in the absence of sufficient foundational evidence for the alleged material breaches. The court explained that the breach of an agreement will be considered 'material' only if it deprives the owner of the entirety of all benefits of the contract or the very thing for which the parties contracted. On that basis, the court found that none of the alleged breaches amounted to material breaches depriving the owner of the very thing bargained for – namely, Crescent's operation and management of the hotel. The court also found that the early termination fee was owed to Crescent pursuant to the agreement.(2)

While the Ontario Court of Appeal upheld the Ontario Superior Court decision, it concluded that the lower court had erred with respect to its contractual interpretation analysis, finding that since the agreement provided that the contracting parties could cure breaches upon receipt of a notice of default, material breaches could include breaches that were far less serious than a breach going to the root of the contract as there was a possibility that such breaches could be cured. Despite the Ontario Court of Appeal's contractual interpretation of matters constituting a material breach overruling the interpretation given by the lower court in this respect, the Ontario Court of Appeal

nevertheless determined that there was an absence of factual foundation for the material breaches alleged by the owner.

Comment

This case confirms that although a 'material' breach will undoubtedly include a breach that goes to the root of the contract, lesser breaches that are capable of being cured may also qualify as being material enough to warrant termination in certain circumstances.

Although *Crescent* offers some guidance on the issue, there is still no clear test for assessing whether a breach is material. At a minimum, even where a curing provision exists, a material breach should likely be non-trivial.(3)

While there is no commonly accepted definition of a 'material' breach, it is clear from *Crescent* that the term 'material' must be carefully construed in light of the particular contractual context in which the term is being employed.(4) Accordingly, when evaluating whether a breach is material, a party must assess the breach in terms of the factual context of the actual relationship between the parties. Therefore, the circumstances in which parties are entitled to terminate a contract based upon a material breach provision are highly dependent on the wording of the relevant provisions of the contract. Notably, a cure period in a material breach provision may indicate that the parties intended material breaches by either party to include events that do not deprive the other party of substantially the whole benefit of the contract. Presumably, a more serious breach that undermines the entire foundation of the contract cannot generally be cured.

The general takeaway from this convoluted interpretation of materiality is that when considering whether a breach is material, the courts should look to the wording of the contract as a whole to determine the intention of the parties and the scope of their understanding and consider the surrounding circumstances when the contract was formed.(5)

This is particularly relevant in the context of franchise agreements, where a franchisee is often seen as the vulnerable party, compared with a terminating franchisor. As such, the courts often require that a material breach of a franchise agreement be proven before allowing its termination by a franchisor and will occasionally intervene to redress cases of abuse. As such, it may be prudent to include a cure period when drafting clauses entitling a franchisor to terminate on the basis of material breach so that it is clear that even lesser breaches that may not be interpreted as going to the root of the contract may nonetheless qualify as material breaches justifying termination.

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Endnotes

(1) *Crescent Hotels and Resorts Canada Company v 2465855 Ontario Inc*, 2019 ONCA 268.

(2) *Crescent Hotels and Resorts Canada Company v 2465855 Ontario Inc*, 2018 ONSC 5508.

(3) *Atos IT Solutions and Services GMBH v Sapient Canada Inc*, 2016 ONSC 6852.

(4) *John McCamus' Law of Contracts*, 2nd ed (Toronto: Irwin Law, 2012) p687.

(5) *Creston Moly Corp v Sattva Capital Corp*, 2014 SCC 53.
