

Can good faith require parties to help each other properly exercise their rights?



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Introduction

Good faith in contractual performance has attracted significant global attention in recent years. It remains that the confines of good faith and its impact on how parties must exercise their contractual rights often lead to uncertainties in practice. In Canada, given the judiciary's growing acceptance of arguments and defences centred on good faith in contracts, parties and their counsel often find themselves erring on the side of caution in contractual dealings to avoid being perceived as having failed to respect the standards required by good-faith performance.

It is well known that franchisors have been facing increasing pressure to conduct themselves in accordance with the principles of good faith. A recent Ontario Superior Court case has led to questions with respect to a franchisor's duty to protect its franchisee's right to operate in circumstances where the franchisor is the gatekeeper of rights with respect to a third party. More particularly, in *Subway Franchise Restaurants v BMO Life Assurance Co*,⁽¹⁾ the court navigated the duty of good faith owed in respect of the renewal of a head lease between the franchisor and the landlord.

The court concluded that the duty of good faith in contractual performance did not require the landlord to provide the franchisor with advance notice of the expiration date of the lease or a reminder of the timeframe for giving notice of its option to renew. Conversely, the court held that the franchisor was itself responsible for keeping track of the deadlines for exercising its rights under the head lease.

This case serves as a useful reminder that franchisors must remain vigilant with respect to their contract management practices, especially when their failure to do so could prevent a franchisee from remaining in operation.

Decision

In *Subway*, the franchisor entered into a head lease with BMO (the landlord) to rent commercial premises in downtown Toronto. The franchisor in turn subleased the premises to a franchisee for the operation of a Subway restaurant.

The franchisor stored information about the lease in its central electronic database; however, the expiry date was incorrectly recorded and, as a result, the renewal right was not exercised on time.

Over the years, the franchisor had attempted to confirm the lease expiry date through multiple communications with the landlord, which remained unanswered. Once the window for the exercise of the renewal right had expired, the landlord advised the franchisor that it had missed the deadline to extend the lease.

The franchisor brought action against the landlord for relief from forfeiture, arguing that the landlord had acted intentionally in failing to confirm the lease expiry date and the timeframe for providing notice of renewal, in breach of the duty of good faith in the performance of contracts. On the other hand, the landlord contended that it was not required to provide information about dates that were within the franchisor's (ie, tenant's) own knowledge and responsibility. The court ultimately upheld the latter contention and concluded that the franchisor was at fault for failing to provide its renewal notice within the requisite timeframe; as such, there were no grounds to grant relief from forfeiture.

A key takeaway from this decision is that the duty of good faith in the performance of contracts requires a party to honour its contractual counterpart's rights once the circumstances giving rise to their exercise have occurred. However, it does not require a party to ensure that the other party properly exercises its rights. Practically, in *Subway*, the landlord would have been required to honour the renewal had the notice been provided in time, but had no such obligation since the renewal right was not properly exercised.

Comment

While not specifically mentioned in the judgment relating to this dispute, this case serves as a useful reminder of the importance of franchisors making a diligent effort to comply with the terms of their contracts, particularly where their failure to do so could have a direct and real impact on one or more franchisees' operations.

The tenets of good faith in contractual performance by franchisors and franchisees impose a heightened level of performance, especially for franchisors, and particularly in jurisdictions with specific franchise legislation or in civil law jurisdictions where implied duties can result from the fundamental principles underlying good faith in contractual performance. These rules are gaining traction and being given increasingly favourable consideration by the Canadian courts.

In *Subway*, the franchisor's practice was to confirm the records maintained in its central contract database by sending periodic communications to all of its landlords. These communications were generated automatically by the franchisor's IT system and contained standard language. Following this judgment, it may be advisable for franchisors to re-evaluate the merits of such a practice, particularly where the communications go unanswered or fail to result in adequate responses allowing the database to be properly completed and maintained.

More specifically, in this case, the court took a negative view of the franchisor's efforts to track and comply with the relevant notice requirements to renew the lease, noting that:

- it was unclear why the franchisor would have needed to make periodic enquiries of the landlord as to the expiry of the lease term since it had already signed and delivered to the landlord an estoppel certificate specifying the expiry date;
- the periodic enquiries sent to the landlord failed to provide any immediate context for the information requests; and
- the franchisor apparently understood the landlord's lack of response to its enquiries as confirmation of the expiry date contained in its erroneous records, without taking any further steps to verify that date.

The applicable standard for a tenant applying for relief from forfeiture is to demonstrate that it made a diligent effort to comply with the terms of the lease.**(2)** It follows that, in *Subway*, the franchisor should have performed internal due diligence and periodically reviewed the documents relevant to its lease in order to meet the standard of making a diligent effort, rather than relying solely upon the landlord to confirm the accuracy of its records.

Also of importance was the court's finding that the duty of good faith in contractual performance does not impose on a landlord any obligation to validate a tenant's records, even when specifically requested.

These considerations are even more significant in the franchise context where a franchisor (or an affiliate) holds the head lease and its failure to make diligent efforts in the performance of the head lease has negative consequences for a franchisee.

While franchisees are generally understood to be vulnerable parties, having to depend on the franchisor to properly exercise its rights under the head lease exacerbates how precarious a franchisee's situation can be, especially where the term of the franchise agreement is dependent on the head lease term and no specific relocation measures are contemplated for the franchise if the initial premises are no longer available.

Unless a franchise agreement specifically provides that the sublease and franchise agreement will terminate upon expiry of the head lease (including where it results from the franchisor's failure to renew as tenant thereunder), a franchisor's failure to properly renew a head lease may allow an Ontario franchisee to bring an action for damages against the franchisor for breach of the duty of good faith under Section 3(2) of the Arthur Wishart Act,**(3)** in addition to compensatory damages.**(4)**

To be sure, where a franchisor holds a position that can be determinative as to the franchisee's continued right to operate its business – notably, as tenant under the head lease for the franchise premises – the franchisor would arguably have a duty to take any measures necessary to avoid an adverse impact on the franchisee resulting from the franchisor's performance in that capacity. In other words, where the franchisee is at the franchisor's mercy for the exercise or enforcement of rights against third parties, the franchisor could be regarded as having an obligation to properly exercise its rights in order to protect or, at a minimum, avoid causing damages to the franchisee.

Practical tips

Franchisors must not lose sight of their obligations to avoid material harm to the interests of franchisees which could result from the franchisor's failure to exercise, or its negligent or improper exercise of, rights available to it in respect of third parties that can affect franchisees. While *Subway* highlights the importance of the franchisor's role with respect to landlords, where applicable, the same may be said of other third parties where the franchisor is essentially an intermediary – for example, with respect to suppliers of products and supplies, IT service providers, equipment vendors and marketing service providers.

In circumstances where the franchisor fails to exercise its rights or insist on proper performance by such parties, or negligently or improperly exercises its rights, there is a risk that the franchisor may ultimately be held liable where one or more franchisees suffer damages as a direct result of same. Given the long-term nature of franchise agreements, the perceived vulnerability of franchisees and the increasingly recognised duty of franchisors in some jurisdictions to act in the best interests of their systems and franchisees generally, franchisors must ensure that their actions and contractual positioning align with the expectations and obligations that flow from the foregoing considerations.

As such, franchisors should always conduct themselves with due regard for the impacts of their actions (and inaction) in respect of their franchisees, particularly where the latter could be denied access to their premises or availability of other goods or services essential to the operation of their franchised business by reason of the franchisor's failure to exercise, or its negligent or improper exercise of, rights available to it. The importance of this intermediary role must not be taken lightly by franchisors and advice should be sought from specialised counsel where any uncertainty exists.

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Endnotes

- (1) 2020 ONSC 371.
- (2) *Ross v T Eaton Co*, 1992 CanLII 7470 (ON CA).
- (3) 2000, SO 2000, c 3.
- (4) *Salah v Timothy's Coffees of the World Inc*, 2010 ONCA 673.

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