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When it's not 'better late than never' with franchisee claims

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AUTHORS

Bruno Floriani

Marissa Carnevale

Tanya Nakhoul

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Introduction

In the recent decision *9145-5055 Québec inc (Restaurant Au Vieux Duluth LaSalle) v Restaurants Au Vieux Duluth inc*,(1) the Quebec Superior Court revisited certain franchising principles and reaffirmed the leading principles of *Dunkin' Brands Canada Ltd v Bertico inc*(2) concerning the duties of franchisors, while holding both franchisor and franchisee responsible for their respective actions and negligence that led to the downfall of their relationship.

While it is well established that even in Quebec, where no formal franchise legislation has been enacted, franchisees are viewed as vulnerable parties and are often afforded additional protections to their franchisor counterparts, this decision highlights the importance of exercising franchisee claims in a timely manner and the dangers of tacit acceptance of franchisors' misrepresentations. It also confirms that the court will not ignore the requirement that franchisees establish a causal link between the franchisor's defaults and misrepresentations and the franchisee's damages simply because franchisees are viewed as vulnerable parties.

With claims from both the franchisor and franchisee, this decision also explores franchisors' obligation to provide assistance and support throughout the franchise relationship and the damages that may be awarded in light of such continuous default.

Facts

From 2005 to 2015 the franchisee operated a Vieux Duluth franchise in Quebec, offering 'bring your own wine' casual Greek dining. The franchisee, having family or friendly ties with the franchisor and its principals who had previously worked as waiters and managers in other Vieux Duluth restaurants, began negotiations with the franchisor six months prior to signing the franchise agreement. In 2013, dissatisfied with their business relationship, the franchisee instituted proceedings against the franchisor claiming loss of profits and investment. The franchisor counterclaimed for unpaid royalties.

The franchisee alleged that the misfortune of its franchised business was attributable to the franchisor having made false representations in respect of projected sales of the franchise restaurant and failing to disclose the bankruptcy of the prior franchisee which had operated at the same location, as well as the common ownership of the franchisor, contractor and supplier of the franchise system at the time of entering into the franchise agreement – failures which the court noted had been known to the franchisee for several years prior to bringing its claim. The franchisee further argued that the franchisor had breached its obligation to provide technical and commercial assistance and cooperate and collaborate with the franchisee during the term of the franchise agreement.

In response to such allegations, the franchisor denied any wrongdoing and claimed that the franchisee had failed to establish an immediate and direct causal link between any alleged misrepresentation and the damages suffered by the franchisee. In addition, the franchisor claimed that the franchisee had failed to mitigate its damages and that, in any event, the franchisee's claims were prescribed.

Conversely, the franchisee asserted that it had been justified in withholding payment of royalties given the franchisor's failure to perform its obligations under the franchise agreement, based on the exception for non-performance.

Decision

Finding that the franchisor had failed to satisfy its disclosure obligations – namely, with respect to the projected sales of the franchise location – the court reaffirmed that the duty of good faith, recognised in Quebec as applying during both the pre-contractual and contractual phase, requires franchisors to disclose, prior to entering into a franchise agreement, any relevant information which may materially influence the franchisee's decision to enter into such agreement. In addition, the court recognised that a pre-existing relationship of trust existed between the parties given their history, imposing a more onerous disclosure obligation on the franchisor.

However, the court found that while the franchisor had breached its pre-contractual disclosure obligations, such breach was evident to the franchisee as of its first year of operation given that sales were far from those projected by the franchisor. The court determined that by choosing to continue to operate the franchise business and paying royalties for several years after having knowledge of such misrepresentations, the franchisee had confirmed the franchise agreement. The court therefore found that the franchisee's claim, initiated more than three years after learning of the franchisor's breach, was statute barred; as such, there was no immediate and direct causal link between the franchisee's loss of profits and the franchisor's default.**(3)**

The court's finding that the franchisee's claim was prescribed was also based on the fact that the franchisee had tried to sell its franchise restaurant in 2009, receiving offers well below the value of its investment, and yet had still elected not to bring a claim against the franchisor for the loss of its investment until 2013.

The court further found that while the franchisor had failed to disclose the prior franchisee's bankruptcy, as well as the common ownership of the franchisor, the contractor hired to build the franchise restaurant and the exclusive food supplier, such information was likely known to the franchisee in light of its prior relationship with the franchisor and the factual circumstances. Further, even if the franchisee was unaware of such information, the franchisee failed to demonstrate that knowledge of such information would have materially influenced its decision to enter into the franchise agreement.

However, with respect to the franchisor's contractual obligation to provide commercial assistance and guidance in order to protect the franchise and its brand and adapt them to the evolving circumstances of the market, the court agreed that the franchisor had failed to perform such obligations throughout the term of the franchise agreement. Considering that the nature of these obligations was continuous, the franchisor's failure to perform them resulted in inflicting continuous damages to the franchisee. Therefore, the claim for damages suffered within the immediate three years preceding the claim was not statute barred.

In light of the franchisor's failure to fulfil its duty to continuously support its franchisee, the court found that the franchisee had been justified in withholding payment of royalties, without interest, until such time as the franchisor paid damages to the franchisee to compensate for its failure. Based on the decision in *Dunkin'*, the court evaluated the damages suffered by the franchisee at 50% of the royalties owed to the franchisor during the period that was not statute barred during which such default persisted. The court then offset amounts owed by the franchisee in respect of unpaid royalties against the amount of damages owed by the franchisor.

Comment

This case is an interesting example of the application of contractual liability principles in the franchise context. While relief is available to franchisees which enter into franchise agreements based on misrepresentations, franchisees will not be excused from proving the causal link between such misrepresentations and the damages incurred. In addition, franchisees should be weary of being deemed to have tacitly accepted such misrepresentations and confirming the franchise agreement by continuing their operations, despite clear indications of misrepresentation, beyond the applicable statute of limitations.

Further, while franchisees will be compensated for damages suffered as a result of the franchisor's defaults, franchisees should remember that such compensation will be limited to direct damages actually incurred during the applicable statute of limitation period immediately preceding their claim. As such, while franchisees may hold off on bringing a claim in hopes that the franchisor complies with its obligations, waiting too long may result in a lesser recovery of damages for the franchisee.

This decision is also notable for its detailed discussion in respect of the manner in which damages may be awarded in light of the franchisor's continuous failure throughout the franchise relationship to support its franchisees and adapt its franchised concept. In its evaluation of damages incurred by the franchisee, the court determined that pursuant to the franchise agreement, royalties had been paid in consideration of the use of the franchisor's trademark and the franchisor's marketing of the franchised concept, as well as other considerations. However, the franchisee had been partially deprived of such benefits as a result of the

franchisor's failure to support and adapt the franchised concept, amounting to damages equivalent to 50% of the royalties payable in consideration thereof during the period which was not statute barred. Further, the court determined that as a result of the franchisee withholding payment of its royalties, the franchisor had clearly been made aware that it was causing damages by depriving the franchisee of a portion of its revenues without fair compensation. As such, the franchisee's damages were a direct and foreseeable consequence of the franchisor's breaches.

This decision is also interesting for its discussion regarding the application of the exception for non-performance – a Quebec civil law concept which allows a party to withhold performance of its obligation under a contract by reason of its co-contracting party's failure to perform its corresponding obligation under the contract. As outlined by the court, the exception may be invoked when:

- the parties are bound by a 'synallagmatic' contract (roughly equivalent to a bilateral contract in common law);
- one party fails to perform an obligation in favour of the invoking party;
- the obligations at issue are equivalent in nature; and
- the invoking party is acting in good faith.

In the case at hand, the court found that the franchisee was entitled to withhold payment of royalties on the basis of the exception for non-performance as the franchisor had defaulted on its obligations to:

- provide technical and commercial assistance;
- adapt its franchise system to the evolving market in order to maintain the value of the brand; and
- collaborate in good faith with its franchisees for such purpose.

The court came to such conclusion on the basis that the franchise agreement constituted a synallagmatic contract in respect of which the franchisor had failed to perform a fundamental and corresponding obligation in favour of the franchisee which went to the essence of the franchise agreement, thereby fulfilling the first two conditions of the exception for non-performance. The court also found that there were equivalent obligations at issue – namely, the franchisor's obligation to support the franchisee and adapt the franchised concept and the franchisee's obligation to pay royalties – thereby satisfying the second condition of the exception for non-performance. The court also determined that the franchisor's failure to respect such an important obligation under the franchise agreement justified the franchisee's withholding of payment of royalties. The fact that such withholding of payment was warranted was further confirmed by the franchisor choosing not to terminate the franchise agreement on such basis, despite its right of termination for non-payment of royalties. Finally, the court found that:

- the franchisee had acted in good faith given that the franchisee had not provoked the franchisor's breaches;
- these breaches pertained to a primary obligation by the franchisor owed under the franchise agreement; and
- the franchisee had deposited the withheld royalties in trust with a lawyer.

Finally, as was the case in *Dunkin'*, the court confirmed that the exception for non-performance had allowed the franchisee to withhold payment of royalties only on a temporary basis until the franchisor performed its obligations under the franchise agreement. As such, the payment of damages by the franchisor, which constituted 'performance by equivalence' of its obligations under the franchise agreement, required the franchisee to perform its corresponding obligation of payment of royalties as if the franchise agreement had been properly performed. Further, since the franchisee's obligation to pay royalties was essentially suspended, no interest was due on the withheld amounts.

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 marissa.carnevale@lrmm.com). The Lapointe Rosenstein Marchand Melançon LLP website can be accessed at www.lrmm.com.

Endnotes

(1) *9145-5055 Québec inc (Restaurant Au Vieux Duluth LaSalle) v Restaurants Au Vieux Duluth inc*, 2020 QCCS 4365.

(2) *Dunkin' Brands Canada Ltd v Bertico inc*, 2015 QCCA 624.

(3) The statute of limitation for personal actions in Quebec is three years from discovery of the basis for a claim.

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