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# Newsletter

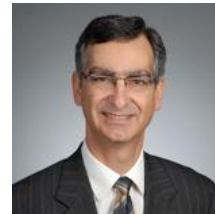
## Franchising

May 2016

### Dunkin' Brands: Lessons for Franchising in Quebec and Further Afield



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Following the Supreme Court of Canada's decision on March 17, 2016,<sup>1</sup> denying leave to appeal of the Quebec Court of Appeal's decision in the *Dunkin' Brands* case, former Quebec franchisees can finally confirm their victory in the historic 13-year saga against their former franchisor. The Quebec Court of Appeal decision in *Dunkin' Brands* was rendered on April 15, 2015, and upheld the Quebec Superior Court's decision.<sup>2</sup> Throughout the legal battle, Quebec courts made significant determinations with respect to the scope and extent of a franchisor's contractual obligations based on explicit contractual terms and implicit principles established by law. The *Dunkin' Brands* decisions could have a significant impact on franchising in both Quebec and common law jurisdictions.

#### Facts

The case involved a suit filed in 2003 by 21 franchisees, collectively operating 32 Dunkin' Donuts fast food coffee and donuts businesses, after the brand's demise in Quebec. The claim centred on the franchisor's insufficient actions with respect to competitive forces in the market, even after franchisees had brought their concerns to the franchisor's attention and made specific efforts to suggest corrections.

A major competitor with a similar business model, Tim Hortons, succeeded in rapidly gaining market share at the expense of Dunkin' Donuts franchisees in Quebec between 1995 and 2005. In late 2000, the franchisor proposed a remodelling plan to Dunkin' Donuts franchisees, who would be required to make a significant investment in their restaurants, with a certain level of investment by the franchisor but without any certainty as to the outcome for their businesses. The franchisor also sought broad general releases from the franchisees as part of this proposal.

Once the Dunkin' Donuts brand had been all but conquered by Tim Hortons in Quebec, the remaining franchisees sought the termination of their franchise agreements and leases as well as damages from the franchisor.

#### Trial Decision

The franchisees' action succeeded before the trial court, which concluded that the franchisor had breached its explicit contractual obligations as well as obligations that are implicit in franchise agreements under Quebec law. The court interpreted a provision in the preamble of the franchise agreement as imposing on the franchisor the obligation to "protect and enhance the reputation of Dunkin' Donuts and the demand for the products of the Dunkin' Donuts system",<sup>3</sup> which the franchisor failed to do. The court also found that the franchisor had failed to protect and enhance its brand in Quebec, in particular with respect to the fierce competition that it was facing

from Tim Hortons. The court rejected any argument advanced by the franchisor that the franchisees were poor operators and annulled the releases signed by certain franchisees on the basis of their being abusive and proper consent having been vitiated or non-existent. The trial court awarded the franchisees C\$16.4 million for loss of profits, loss of investment and other damages.

### Court of Appeal Decision

The Quebec Court of Appeal upheld the trial court's decision and confirmed the franchisor's liability for failing to protect its brand. However, the damages awarded to the franchisees were reduced to approximately C\$11 million based on additional factors that may have resulted in decreased financial performance by franchisees in any event, as well as certain portions of the claims being precluded on the basis of the applicable statutes of limitations.

A key finding of the appeal court was that the express terms of the franchise agreement required the franchisor "to protect and enhance" its brand. This was considered to be a binding contractual obligation.

In addition, the parties' respective obligations were analysed by the appeal court in light of the fundamental nature of the franchise relationship: the court considered that the franchisor had undertaken to support its franchisees and oversee the operation of franchised outlets over an extended period of time, and therefore its obligations to generally protect the brand and to take steps to protect the network were implied, including with respect to threats from competing businesses.

These essential themes were explored and reiterated throughout the decision. In particular, the appeal court found that the franchisor had emphasised the importance and the value of the Dunkin' Donuts brand to its franchisees in order to entice them to join its network.<sup>4</sup> The franchise agreement itself also contained provisions suggesting that the value of the brand was enhanced by virtue of the elevated operational standards of the system and the uniformity of operations imposed throughout the system.<sup>5</sup> As a result, the franchisees – individually and collectively – were entitled to rely on the franchisor's corollary duty to ensure that the value of the brand would remain intact and that the network would not be jeopardized as a result of the franchisor's failing to take measures to that end. The franchisor's obligations were found to apply both with respect to factors outside the franchised network, such as competitive forces, as well as internal matters, such as taking steps to ensure compliance by all franchisees with their obligations under their respective franchise agreements.

Further, noting how few express obligations were incumbent on the franchisor in the Dunkin' Donuts franchise agreement, the court implied certain obligations of the franchisor that flowed from the principles of cooperation, collaboration, ongoing interaction and

assistance that are essential in a long-term contractual arrangement, all of which the court determined to be fundamental tenets of the franchise relationship.<sup>6</sup> The court's understanding of these cornerstones of franchising further supported its conclusions with respect to the franchisor's duty to protect its network and to generally enhance its brand and related operations. Not only does a franchise relationship presuppose that the franchisor has invested in developing a brand and a business operating system and is prepared to oversee and direct the network's progress; there is also an expectation by franchisees that the franchisor will support them and provide ongoing assistance and cooperation over an extended period.

### Lessons for Franchisors

Through the explicit provisions of the franchise agreement and implied terms applicable to franchise relationships, the Quebec Court of Appeal has effectively and conclusively confirmed a franchisor's duty to support its brand and to take active measures that are consistent with this duty throughout the term of its franchise agreements.

It is not a novel concept for the nature of the franchise relationship itself to be seen as part of the foundation for the franchisor's obligation to conduct itself in good faith and to exhibit loyalty in favour of its franchisees.<sup>7</sup> However, the principle of good faith is not typically viewed under Quebec civil law as yielding a particular result or outcome, but rather simply informs the manner in which parties to a contract must conduct themselves and provides the basis for considering the reasonableness and sufficiency of their actions in a given set of circumstances. The duty has now been applied in order to establish that a franchisor must make a sincere effort to support its brand and its franchisees. In *Dunkin' Brands*, the practical effect was that the franchisor was required to take reasonable measures to protect its network from competitive forces in the market as part of its general obligation to provide ongoing assistance and cooperation.

### Impact Outside Quebec

Given the fundamental nature of the appeal court's findings and their connection to the nature of franchise relationships generally, the findings will likely be analyzed and some aspects may well be applied outside Quebec. This important decision forms part of an interesting convergence which is emerging between the duty for parties to conduct themselves in good faith under Quebec civil law and the duty of good faith in contractual performance in Canadian common law provinces.

Good faith and the role of implied contractual terms under common law were given a new slant when the Supreme Court of Canada stated that contractual parties have a duty to act honestly in contractual performance, which is

a manifestation of the "organizing principle of good faith performance in contracts".<sup>8</sup> This good-faith principle had already been recognized in common law provinces. For example, the Superior Court of Nova Scotia provided a detailed discussion of good faith in contracts in *Arton Holdings v. Gateway Realty Ltd.*,<sup>9</sup> which stated not only that "[t]he law requires that parties to a contract exercise their rights under that agreement honestly, fairly and in good faith", but also that bad faith is "conduct that is contrary to community standards of honesty, reasonableness or fairness".

The Supreme Court's decision in *Bhasin* essentially confirmed that the fundamental principles of good faith and honesty govern all contracts, and further elucidated that the specific effects of these principles must be analyzed in light of the nature of a given contract and the obligations that flow from it for the parties. Given that franchisees are often viewed as vulnerable parties and that franchise arrangements are generally considered long-term partnerships which require mutual cooperation and consideration, these characteristics will undoubtedly continue to have an impact on the manner in which franchisors and franchisees exercise their contractual rights and obligations in many jurisdictions. Vulnerable contractual parties have often been given special consideration under the common law, and common law courts may consider this central factor in interpreting the scope of the duties to act honestly and in good faith as they apply to franchisors and franchisees.

The duty of good faith in the context of franchise relationships has been discussed and applied in several common law cases, including *Shelanu v. Print Three Franchising Corporation*, where the Ontario Court of Appeal found that a duty of good faith stems from the power imbalance between a franchisor and a franchisee.<sup>10</sup> The court further recognized that "a duty of good faith exists at common law in the context of a franchisor-franchisee relationship",<sup>11</sup> and emphasized that the circumstances of a particular case will inform whether the duty has been respected.

As the legal landscape shifts, franchisors are required to navigate their contractual relationships with more uncertainty, and should proceed with caution at all stages of the franchise relationship, regardless of where franchisees are operating.

### What Can You Do?

Various practical tips may be gleaned from this landmark case. Please contact us to discuss how you might approach protecting your business going forward.

1. *Dunkin' Brands Canada Ltd. (formerly Allied Domecq Retailing International (Canada) Ltd.) v. Bertico Inc., et al.*, 2016 CanLII 13728 (SCC).
2. *Dunkin' Brands Canada Ltd. v. Bertico Inc.*, 2015 QCCA 624.
3. *Ibid.*, at paragraph 32.
4. *Ibid.*, at paragraph 81.
5. *Ibid.*
6. *Ibid.*, at paragraphs 59, 62 and 63.
7. The implied obligation for parties to a franchise contract to conduct themselves in good faith had been previously applied in the context of a franchisor competing directly against its franchisee in *Provigo Distribution Inc. v. Supermarché ARG Inc.* (1997), [1998] RJQ 47 (CA).
8. *Bhasin v. Hrynew*, 2014 SCC 71, at paragraphs 63 and 72.
9. [1991] 106 NSR (2d) 180.
10. [2003] 64 OR (3d) 533 (ONCA).
11. *Ibid.*

**The content of this newsletter is intended to provide general commentary only and should not be relied upon as legal advice.**

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