

Newsletter - TerraLex Connections

Good Faith and Brand Promotion in Franchising

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Introduction

Throughout a major legal battle in the franchise context, Quebec courts have made significant determinations with respect to the scope and extent of a franchisor's contractual obligations relating to promotion of the franchised brand and policing of the franchised network, based on explicit contractual terms and implicit principles established by law. The Dunkin' Brands decisions rendered by Quebec courts will likely have a significant impact on franchising in both Quebec and common law provinces of Canada, particularly given that the concept of good faith in contracts is evolving under Canadian common law. In addition, the regulatory framework for franchising is shifting, resulting in increased protections for franchisees as well as scrutiny and a certain re-evaluation of the role of franchisors in respect of franchise operations.

Following the Supreme Court of Canada's decision on March 17, 2016,¹ 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 legal saga against their former franchisor. The Quebec Court of Appeal decision was rendered on April 15, 2015,² and upheld the trial court's decision.

Facts

The Dunkin' Brands 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 complete demise in the Quebec market, where it had once been the dominant brand in its market segment. The claim centred on the franchisor's alleged insufficient response to competitive forces in the market, even after franchisees had expressed their concerns to the franchisor and suggested various initiatives to attempt to counter threats in the market.

A new 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, largely in response to concerns raised by *Dunkin' Donuts* franchisees in Quebec, the franchisor proposed a remodelling plan to the franchisees, pursuant to which they would be required to make a significant investment in their restaurants, with a certain level of investment by the franchisor. The franchisor also sought broad general releases from the franchisees as part of this proposal.

Once the dominance of the *Dunkin' Donuts* brand had been all but vanquished by *Tim Hortons* in the Quebec market, 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,"³ 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 proper consent having been vitiated or non-existent and, in any event, considered the releases abusive. The trial court awarded the franchisees CAN\$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 CAN\$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 of the franchisor.

In addition, the parties' respective obligations were analysed by the appeal court in light of the special, long term and collaborative nature of the franchise relationship: the court considered that the franchisor had undertaken to support its franchisees and oversee the operation of franchised locations over an extended period of time. Therefore, the franchisor's obligations to generally protect the brand and to take steps to protect the franchised 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 franchised network.⁴ 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.⁵ 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 franchised network would not be jeopardized as a result of the franchisor 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 so as to avoid having poor, substandard performers tarnish the image of the brand to the detriment of the other franchisees in the franchised network.

Further, noting the few express obligations 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.⁶ The court's understanding of these cornerstones of franchising further supported its conclusions with respect to the franchisor's duty to protect its franchised 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 franchised network's progress; there is also an expectation by franchisees that the franchisor will provide reasonable commercial support and ongoing assistance and cooperation over an extended period.

Lessons for Franchisors

Through a broad interpretation of some fairly typical provisions contained in 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 franchised network, as well as 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 a certain degree of loyalty in favour of its franchisees.⁷ 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 franchised network from competitive forces in the market as part of its general obligation to provide ongoing assistance and cooperation.

Impact Outside Quebec

This important decision forms part of an interesting convergence that is developing 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. 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.

Good faith and the role of implied contractual terms under common law were given a new slant when the Supreme Court of Canada stated, in its decision in *Bhasin v. Hrynew*,⁸ 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."⁹ 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.*,¹⁰ 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 decision of the Supreme Court of Canada 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 relationships that require mutual cooperation and consideration, these characteristics will undoubtedly continue to have a significant 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 in Canada, including *Shelanu v. Print Three Franchising Corporation*,¹¹ where the Ontario Court of Appeal found that a duty of good faith stems from the power imbalance between a franchisor and a franchisee. The court further recognized that "a duty of good faith exists at common law in the context of a franchisor-franchisee relationship"¹² and emphasized that the circumstances of a particular case will inform whether the duty has been breached.

Practical Suggestions for Franchisors

As the legal landscape in Canada continues to shift, franchisors must navigate their contractual relationships with greater uncertainty, and should proceed with caution at all stages of the franchise relationship, regardless of where franchisees are operating. However, various practical tips may be gleaned from the *Dunkin' Brands* case:

- In order to avoid interpretative ambiguity and to mitigate the risk that courts will read in more onerous obligations for a brand than were intended, franchisors should critically review their franchise agreements with a view to removing statements pertaining to the significant value and goodwill of their trademarks and business model, as well as any provisions that may be construed as commitments to enhance or engage in continued development of their brand.
- Considering the significant operational requirements often imposed on franchisees that are central to their contractual compliance, franchisors should be mindful of possible corollary obligations for them to enforce these obligations across the franchised network. As a result, franchisors may consider including in their franchise agreements specific defaults and termination rights where franchisees fail to comply with imperative

operating requirements or otherwise engage in behaviour that may tarnish the reputation of the franchised network, and franchisors should not shy away from exercising their rights under such provisions.

- Franchisors may wish to include provisions in their franchise agreements pursuant to which franchisees expressly acknowledge and agree that the franchisor is entitled to make decisions and take actions in the exercise of its discretion or rights with respect to an individual franchisee with a view to protecting or otherwise benefitting the franchised system or network generally.
- Franchisors are also encouraged to act responsibly and to take steps to protect their franchised networks, including by responding to competitive threats in the market in a timely manner and by offering practical solutions to franchisees who raise legitimate concerns about the viability of the franchised system or the future of the franchised business.

There is no specific guidance on the types of actions that would be considered adequate and there is no obligation for a franchisor to achieve success with the measures that it implements; however, if a franchisor is in a position to demonstrate that it genuinely took reasonable actions to assist its franchised network in dealing with competitive forces, it is unlikely that its conduct will be met with severe scrutiny.

Other steps to mitigate risks for franchisors may also be explored and will vary based on a franchisor's operations and market segment. Specific solutions may need to be adapted based on the nature of any given business and its approach to franchising.

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 *Supra*, note 2, at paragraph 32.

⁴ *Ibid.*, at paragraph 81.

⁵ *Ibid.*

⁶ *Supra*, note 2, 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 by the Quebec Court of Appeal 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 2014 SCC 71.

⁹ *Supra*, note 8, at paragraphs 63 and 72.

¹⁰ [1991] 106 NSR (2d) 180.

¹¹ [2003] 64 OR (3d) 533 (ONCA).

¹² *Ibid.*

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