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Franchising - Canada

A franchisor's obligation to protect its brand

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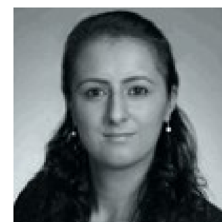
Authors

Bruno Floriani

Kiran Singh



Introduction

In the recent case of *Bertico Inc v Dunkin' Brands Canada Ltd* the Quebec Superior Court ordered Dunkin' Brands Canada Ltd, the franchisor, to pay more than C$16 million in damages (the full amount of the claim) to 21 former franchisees for repeatedly failing to protect and enhance the Dunkin' Donuts brand in Quebec over the course of a decade. This landmark decision may be seen to impose a burdensome obligation on franchisors and an analysis of the court's reasoning is warranted in light of the exceptional circumstances of this case.

Facts

The Dunkin' Donuts fast-food coffee and doughnuts business was a successful franchise network in the province of Quebec, with over 250 establishments in the province until the mid-1990s. At that time, Tim Hortons – a successful chain of fast-food coffee and doughnut shops in other Canadian markets – began an aggressive foray into the Quebec market and gained market share rapidly. In 1996 Dunkin' Donuts franchisees notified the franchisor that the competition from Tim Hortons was fierce and affecting their business. However, the franchisees claimed that the company did not react. In fact, 200 Dunkin' Donuts locations closed between 1995 and 2005.

In 2000 the franchisor introduced a voluntary remodelling incentive programme to combat Tim Hortons's takeover of the market, the goal of which was to encourage franchisees operating no less than 75 Dunkin' Donuts shops to renovate before being contractually required to do so pursuant to their franchise agreements. The franchisor stated that it would make incentive payments to franchisees which spent at least C$200,000 renovating their shops, provided that they signed a full and final release in its favour.

The franchisor attributed Tim Hortons's takeover of the market to the fact that the Dunkin' Donuts franchisees were operating "tireworn stores" and were not working as hard as they should have been. The franchisor further argued that:

- it was not an insurer for its franchisees and in no way guaranteed their success; and
- the franchisees had signed releases and were therefore barred from claiming damages.

The franchisees denied any fault and argued that the franchisor did not react in the face of structured competition. The franchisees sought the termination of their franchise agreements and leases, as well as damages.

Decision

The court held that the franchisor had breached its contractual obligations and the obligations that are implicit in franchise agreements. The court interpreted a provision in 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". The court held that the franchisor did not meet this principal obligation which it assigned to itself in the franchise agreements and should thus accept the consequences of its failure. The court further observed that the franchisor made a "huge and costly mistake" by allowing Tim Hortons to capture the lion's share of the Quebec fast-food doughnuts and coffee market between 1995 and 2003. The

court found that the franchisor's greatest failing was not protecting its brand in Quebec, stating that "when a brand falls out of bed, collapses, so too do those who rely upon it".

The court completely rejected the franchisor's argument that the franchisees were bad franchisees and the architects of their own demise, and held that this defence was "utterly devoid of substance". In addition, the court firmly rejected the cross-claims of the franchisor to the effect that certain of the franchisees had failed to pay arrears of royalties, ad-fund contributions and other similar sums, finding that when a contract is fundamentally breached by one of the parties, the other cannot be held accountable for a subsequent breach by it.

As for the full and final releases executed by certain of the franchisees, the court annulled them on the basis of their being abusive and consent having been vitiated or non-existent. The court found that the franchisor did not meet its obligations under the remodelling incentive programme and that the full and final releases were:

> "*overkill, ill advised, and in a time when the franchisees were struggling to survive, it was abusive to impose it upon those who chose to adopt the franchisor's recommendations, albeit under false pretences and on the faith of representations that turned out to be false.*"

Comment

This potentially landmark decision is based on the franchisor's breach of contract and breaches of obligations flowing from general principles of Quebec civil law, among which are the requirements that:

- a party to a contract must perform its contractual obligations in good faith; and
- each party to a contract is bound by obligations "that are incident to it according to its nature and in conformity with usage, equity or law".

While some commentators have noted that the court may have incorrectly interpreted various provisions of the franchise agreement in finding an express covenant of the franchisor to protect and enhance its brand, arguably the court's more fundamental finding is that it is "an underlying assumption of all franchise agreements" that the "brand will support a viable commerce" and that "franchisors are bound by an obligation of good faith and of loyalty towards their franchisees such that they are duty bound to work in concert with them". The court cited with approval the following passage in the Quebec Court of Appeal's decision in *Provigo Distribution Inc v Supermarché ARG Inc*: (1)

> "*[The franchisor], bound by an obligation of good faith and loyalty toward the [franchisee], had the duty to work with its franchisee and provide it with the necessary tools to at least minimize the impact of any economic prejudice that could be caused, if not to prevent it altogether. Between doing absolutely nothing and maintaining the status quo, which might have cost it its place in the market, and exercising its right to compete freely with third parties, there is a middle ground… It should have worked with the franchisees to establish an adequate marketing response that would have enabled them to minimize their losses and reposition themselves in an evolving market.*"

In the courts' view, a franchisor has an obligation to help its franchisees to compete effectively in the market – a franchisor which sits idly by while its brand is suffering may be liable to compensate its franchisees for their loss. The court's conclusion was expressed in strong language that could be viewed as sending a warning to all franchisors in Quebec:

> "*But the greatest failing of all was [the franchisor's] failure to protect its brand in the Quebec market. No doubt the host of failings chronicled by the Franchisees contributed to the collapse of the Dunkin' Donuts brand in Quebec. A successful brand is crucial to the maintenance of healthy franchisees. However, when the brand falls out of bed, collapses, so too do those who rely upon it. And this is precisely what has happened in this case.*"

However, the facts underlying this decision are very specific. The decline of Dunkin' Donuts in Quebec was extraordinary and perhaps an extreme example of how an established giant in a market cannot remain oblivious to competing forces. It appears from the tone of this decision that the court, in rendering its judgment, was heavily influenced by the severe fall from grace and decimation of the Dunkin' Donuts system: "It is a sad saga of how a once successful franchise operation, a leader in its field, fell precipitously from grace in less than a decade." In fact, the court interpreted the franchisor's requirement for a release from its franchisees in connection with its remodelling incentive programme as "a requirement to forgive the sins of the past – some five years of benign neglect in the face of a determined new player in the Quebec fast food market".

The franchisor has appealed this ruling and the court of appeal proceedings will

hopefully provide guidance regarding the scope and extent of a franchisor's implicit obligation to protect its brand in Quebec.

Nevertheless, the confirmation of basic principles of Quebec civil law as applied to franchising relationships – including by the Quebec Court of Appeal in *Provigo* – should give pause to franchisors entering the Quebec market.

At the very least, caution is urged against including statements in the franchise agreement that could be interpreted as representations as to the reputation and standing of a franchisor's brand or covenants to protect or enhance the brand or increase the demand for its products.

Despite the unique circumstances leading to this decision and *Provigo*, the obligation of good faith and the duty of loyalty that franchisors owe to their franchisees under Quebec law would seem to require, as an implicit obligation in Quebec law, that franchisors:

- proactively communicate and work with their franchisees in addressing significant market forces that they are facing; and
- avoid conduct that could be interpreted as complacent with respect to competitive forces in the marketplace.

This of course constitutes good business practice in any event and franchisors should be encouraged to act in good faith in all circumstances but, beyond that, franchisors should attempt to take some form of remedial action – particularly when their franchise network is facing a calamitous situation such as the one faced by the Dunkin' Donuts franchise in Quebec.

Interested parties should continue to monitor developments in this fascinating case and, more generally, the interpretation that Quebec courts give to the franchisor's duty of loyalty to its franchisees. In the meantime, caution is urged in the Quebec market until further clarifications emerge.

For further information on this topic please contact Bruno Floriani or Kiran Singh at Lapointe Rosenstein Marchand Melançon LLP by telephone (+1 514 925 6300), fax (+1 514 925 9001) or email (bruno.floriani@lrmm.com or kiran.singh@lrmm.com).

Endnotes

(1) [1998] RJQ 47 (CA).

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