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Franchising Law

A review of latest developments in franchising law & litigation

In this issue:

The Duty of Good Faith & Fair Dealing

Over the last four years, the courts have considered a number of claims against franchisors by franchisees alleging a breach of the duty of good faith and fair dealing. The allegations giving rise to these claims have varied, but the principles the courts have established regarding the nature and scope of the duty of good faith and fair dealing have been clear and consistent. In this article, Blair Rebane & Eric Little discuss three cases in which franchisees have brought class action claims against franchisors, purporting to rely on the duty of good faith and fair dealing to enforce alleged rights or obligations falling outside the four corners of their franchise agreements. In dismissing these claims, the courts have established or confirmed three key lessons regarding the duty of good faith and fair dealing.

Can Brand Protection Measures Lead to Joint-Employer Liability

An ongoing issue surrounding the franchisor/franchisee relationship has been the extent to which the franchisor should exert "control" over the franchisee, as too little may affect the quality of the products and services and erode the integrity of the brand, while too much may hinder the ability of the franchisee to run its business. That balancing act is now facing additional external challenges. This article examines this issue, and whether brand protection measures lead to joint-employer liability for franchisors.

Role of Franchisor's Conduct in Enforcing Non-Competition Covenants

Canadian courts have not hesitated to enforce non-competition covenants in circumstances where they seek to protect a franchisor's legitimate interests or those of its franchised system or network, provided that they do not unduly restrict a franchisee's potential to earn a livelihood after parting ways with the franchised business. However, recent case law suggests that a new trend is emerging whereby judges seem prepared to evaluate the conduct of the franchisor in deciding whether a non-competition covenant should be enforced. This article examine the increasing importance of a franchisor's conduct in enforcing non-competition covenants.

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WALKING THE TALK: THE INCREASING IMPORTANCE OF A FRANCHISOR'S CONDUCT IN ENFORCING NON-COMPETITION COVENANTS

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Most franchise agreements contain a non-competition clause that prevents the franchisee from competing with the franchised business for a certain period after the end of the franchise relationship. Non-competition provisions take many forms and are generally meant to ensure that the franchisee does not continue to use the resources and know-how obtained during the course of the franchise relationship in a manner that would lead to unfair competition with respect to the franchisor or other franchisees in the franchised network.

Traditionally, Canadian courts have not hesitated to enforce non-competition covenants in circumstances where they seek to protect a franchisor's legitimate interests or those of its franchised system or network, provided that they do not unduly restrict a franchisee's potential to earn a livelihood after parting ways with the franchised business. In other words, where a non-competition covenant does not provide for overreaching protections, it would typically be enforced.

However, recent case law suggests that a new trend is emerging whereby judges seem prepared to evaluate the conduct of the franchisor in deciding whether a non-competition covenant should be enforced. More specifically, judges appear to be increasingly reluctant to enforce non-competition clauses where a franchisor cannot demonstrate, through a commercially driven justification, that it has a legitimate interest for the clause to be enforced within a given geographical area.

TRADITIONAL ENFORCEMENT OF NON-COMPETITION COVENANTS

In determining the enforceability of covenants in restraint of trade such as non-competition clauses, courts have traditionally been faced with the dilemma of interpreting the breadth of such restraint while attempting to ensure a certain level of respect for the contracting parties' freedom to contract. In order to achieve a careful balance between these objectives, non-competition clauses have generally been found to be enforceable where they are *reasonable*. In assessing the reasonability of a non-competition covenant, three elements must be analyzed: the geographical area, the time period and the scope of activities covered by the restriction. The purpose of this test is to ensure that the non-competition covenant is not drafted more broadly than is necessary for the protection sought. In considering the enforceability of a non-competition covenant, judges enjoy broad discretion and their analysis is generally fact-driven and contextual, and tends to be informed by the rights and interests sought to be protected by each party.

There are many examples of non-competition clauses being struck down in the franchise context as a result of their being overly broad or insufficiently describing the restricted activities.

For example, in *Kynas* v. *Zippy Print Franchise ltd.*,[1] the Court was asked to issue an interlocutory injunction to prevent a terminated franchisee from carrying on a "printing business" in violation of its non-competition covenant. The request was denied because the language of the clause prevented the operation of a "printing business", which was considered to be too broad a restriction given that the franchised business involved a *quick* printing business. The Court found the restriction on the franchisee's activities to be imprecise and overly broad, and refused to enforce the non-competition covenant.

In addition, in *Yesac Creative Foods inc.* v. *Hohnjec*,[2] the Court held that the non-competition clause was unenforceable given that it prevented the franchisee from having an interest in any other business "which in any way is competing with the franchisor or its franchisees or which are related to the food, beverage or restaurant business." The judge believed that the wording of the clause was too broad and provided for wider protection than necessary and the non-competition covenant was not enforced.

RECENT DEVELOPMENTS

The landscape appears to be shifting, however, and the existence of the three essential elements of a non-competition covenant, namely a clearly defined activity and a circumscribed geographical area and timeframe, may no longer be sufficient in order to ensure the enforcement of a non-competition covenant in the franchise context.

More particularly, recent case law suggests that, despite the reasonability of a non-competition covenant, the conduct of a franchisor's business must be consistent with the restrictions on competition that it seeks to enforce against franchisees. In other words, non-competition clauses that may otherwise be enforceable on the basis of their including the three crucial elements and considered in the context in which they are sought to be applied, may nonetheless be found to be unenforceable if the party seeking protection lacks a legitimate interest to protect in the course of its business operations or if the clause is found to lack purpose when evaluated in the context of the franchisor's actual development plans.

Canadian courts have recently begun to engage in this type of analysis, both at the preliminary stage and on the merits, under both civil law and common law.

[1] (1985) B.C.J. No. 1291.
[2] (1985) O.J. No. 519.

For example, in *Groupe Sportscene Inc.* v. *2639-6564 Quebec inc.*,[3] the franchisor of sports bar-type restaurants operating under the banner "Cage aux Sports" was denied its application for preliminary injunctive relief before the Superior Court of Quebec, as the franchisor was unable to demonstrate its intent to open a franchised location in the same town where the former franchisee had continued operating a similar business in the same premises after the franchise relationship ended, in alleged violation of its non-competition and de-identification obligations. While the case was not heard on the merits, the franchisor's failure to demonstrate its specific 'interests' in the particular geographic area that was covered by the franchisee's non-competition covenant led to the Court's finding that the franchisor's application, at the very least, presented no urgency and could await a final determination on the merits. Great emphasis was placed on the conduct and the intended business plans of the franchisor as the Court denied the franchisor's motion for a provisional injunction.

Similarly, in *MEDIchair LP* v. *DME Medequip Inc.*,[4] the Ontario Court of Appeal refused to enforce a franchisee's non-competition covenant on the merits, even though the scope of the restrictive covenant was not found to be unreasonable in the abstract, but simply because the evidence demonstrated that the franchisor did not intend to open a franchised outlet within the restricted geographical territory. The Court concluded that the franchisor did not have the requisite legitimate interest to restrict competition by the franchisee within that territory.

This trend may not seem to be of particular interest or concern in circumstances where a franchisor intends to continue operating within the areas protected by the restrictive covenants undertaken by its franchisees. However, all franchisors should consider whether they may face resistance in enforcing non-competition covenants against franchisees in circumstances where they are experiencing uncertainty as to their continued presence in a given market or are contemplating downsizing their franchised network, as these factors may weigh significantly on a court's evaluation of the franchisor's legitimate interests as they relate to enforcing the non-competition covenants of its franchisees.

Guidance for Franchisors

It is well understood that franchisors should be very careful in drafting non-competition clauses with a view to ensuring their enforceability. Given the judiciary's reticence with respect to the enforcement of restraints on trade through restrictive covenants, non-competition clauses are typically interpreted restrictively and courts are not amenable to rewriting or amending non-competition provisions with a view to enforcing them.

Accordingly, practitioners should ensure that restrictive covenants present the three essential elements in order to increase the probability of such provisions being enforced; in other words, the covenant must be sufficiently specific with regards to time, scope of activities and geographical area. Above all, franchisors should refrain from insisting on overly broad non-competition covenants from their franchisees, in respect of any of the foregoing three elements, as such provisions run the risk of being more readily struck down when they are sought to be enforced.

In addition to ensuring that restrictive covenants are reasonable in principle on the basis of the scope and reach of their application, franchisors must also consider that the enforcement of such covenants may be increasingly evaluated in the context of the franchisor's business plans and other factors that may serve as indicators of the franchisor's legitimate interests at the time enforcement is sought. Courts seem more readily prepared to limit the enforceability of restrictive covenants based on their assessment of surrounding factors that may serve to indicate the franchisor's interests, and may be inclined to resist efforts by a franchisor to enforce a restrictive covenant in circumstances where it has no reasonable business interest to protect within the restricted area itself or in the restricted scope of activities.

As a result, it is becoming increasingly important for franchisors to ensure that their conduct is aligned with the content of any restrictive covenants that they may seek to enforce against franchisees.

Franchisors should bear these principles in mind as they elaborate concrete business and development plans and implement franchisee recruitment initiatives in respect of territories and markets previously serviced by a franchised business whose franchise agreement is terminated or not renewed, as these elements may ultimately be determinative with respect to their intentions and the legitimate interests of their networks in certain geographic areas.

[3] 2013 QCCS 17.
[4] 2016 ONCA 168.