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Should US Franchisors Be Worried about Implied Liability after The Dunkin' Donuts *Decision in Québec?*

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America may "run on Dunkin'" but it seems that in Québec, folks prefer Tim Hortons. Franchisees perceived failure of Dunkin' Donuts (Dunkin') as franchisor to protect the brand from growing Tim Hortons competition led to a recent decision in the Québec Court of Appeals. The Québec Court of Appeals found that Dunkin' as franchisor had an implied obligation to take reasonable measures to protect and enhance the value and reputation of its brand.[1] While the United States has received many valuable things from Canada, US franchisors may not want the Québec decision to take root here. Fortunately, as this article discusses, US franchisors likely have nothing to worry about because US courts are more reluctant to imply obligations under similar circumstances to those that occurred in *Dunkin' Donuts*.

What Happened to Dunkin' Donuts in Québec?

The facts in the *Dunkin' Donuts* case are clear. When Dunkin' experienced a decline in its position as a leader in the Québec marketplace for fast food, Dunkin' franchisees in the province complained to the franchisor. The franchisees said the franchisor was inattentive to their needs and failed to provide sufficient support in the face of increasing competition from the Tim Hortons fast food chain. The Dunkin' franchisees claimed that the franchisor failed to:

- Contend with newfound competition from Tim Hortons,
- Enforce properly the Dunkin' franchise standards across the network of restaurants, and
- Prohibit underperforming franchisees from freeriding on the goodwill associated with the Dunkin' brand.

The franchisor responded with some long-term solutions to renovate the restaurants in Québec. But this did not satisfy the Dunkin' franchisees who hoped for more immediate action, and consequently filed suit against the franchisor seeking damages for breach of contract.

The Québec Court's Reasoning

Finding in favor of the Dunkin' franchisees, the Québec court held that the franchise contract included an implied obligation on the franchisor "to protect and enhance both its reputation and the 'demand for the products of the Dunkin' Donuts System'; in sum, the brand." The court relied on the doctrine of implied obligations under Québec statutory law, which provides that a contract "binds the parties who have entered into it not only as to what they have expressed in it but *also as to what is incident to it according to its nature* and in conformity with usage, equity or law."[2]

The Québec court was convinced that the express terms of the contract gave rise to an additional implied obligation apart from the express terms of the contract that the franchisor was obligated to take reasonable efforts to protect and enhance the value of the Dunkin' brand. The court relied on the following express terms in finding this implied obligation:

- Paragraph 2.C—"continue its efforts to maintain high and uniform standards of quality, cleanliness, appearance and service… thus protecting and enhancing the reputation of DUNKIN DONUTS CANADA"
- Paragraph 2.D—make a training program available
- Paragraph 2.E—provide operating procedures
- Paragraph 2.F—assist in pre-opening, opening, and initial operation of the shop
- Paragraph 3.A—maintain a "continuing advisory relationship, including consultation in the areas of marketing, merchandizing and general business operations"
- Paragraph 3.B—provide operating manuals (including on-going revisions), set out standards, specifications, procedures and techniques for the franchisee to follow
- Paragraph 3.D—review and approve franchisee proposed advertising
- Paragraph 3.E—provide for programs to "increase sales and enhance and further develop the public reputation and image of DUNKIN DONUTS CANADA."

The court characterized the nature of the franchise agreement as one that established a relationship of cooperation, and determined that the Dunkin' franchisor agreed to be active in franchisee operations throughout the life of the agreement. By agreeing to make continuous efforts to maintain quality standards, the court found that the franchisor had impliedly ensured that its standards would be met by all franchisees. The Quebec court held that the franchisees were justified in their reliance on the franchisor to supervise and correct the weaker franchisees.

As a result of this contractually created cooperative relationship, the court explained it was "fair to characterize the obligation of means to protect and enhance the brand as a 'complement necessaire' [necessary complement] of the contracts due to their nature." So, the Quebec court inferred that the franchisor had implicitly agreed to take reasonable measures to "help the franchisees… to support the brand" including "assist[ing] them in staving off competition." The court found that its interpretation of the express terms and implied obligations accurately reflected the parties' intentions.

Do US Franchisors Need to Worry about *Dunkin' Donuts*?

The short answer is no with respect to their US franchise operations. In contrast to the Québec court's liberal application of the statutory doctrine of implied obligations, US courts are generally reluctant to imply obligations, and absent some kind of ambiguity in the contract terms, mistake or fraud, a written contract generally is seen as the whole agreement and no additional obligations are implied.[3] Though US franchisors who are licensing their trademark to franchisees may risk abandonment of their rights by failing to control quality and maintain certain standards that consumers expect, US courts do not typically imply a franchisor obligation to protect franchisees from legal competition as this would create something akin to a fiduciary relationship between the parties, which runs contrary to the majority view in the United States.

Notwithstanding the hesitancy to create a fiduciary duty, one obligation US courts are consistently willing to imply to a franchise relationship is that of good faith and fair dealing.[4] But, the implied duty of good faith and fair dealing generally is not likely to be construed broadly enough to encompass a requirement of brand enhancement and protection not explicitly specified in a contract, as found in the *Dunkin' Donuts* case. Accordingly, franchisors in the United States likely do not have to worry about the Québec decision because (1) unlike the United States, Québec statutorily allows for an expanded view of implied obligations, and (2) the implied duty of good faith and fair dealing is not a fiduciary duty that is likely to be extended to brand protection and enhancement in a franchise agreement to overcome legal competition.

Unlike US Law, Québec's Statutory Laws Expand Implied Obligations

The Québec civil code explicitly says that a contract binds parties not only to what they have expressed, but also what is incident to a contract's nature and in conformity with "usage, equity or law."[5] In the United States, however, there is no general federal or state law that implies obligations in contracts, franchise or otherwise.[6] Although there have been laws passed to cover certain segments of US business, there is no general law of implied obligations.[7]

The implied duty of good faith and fair dealing, however, is widely applied in US franchise contracts. Although not a federal statutory duty, the obligation is captured in both the Second Restatement and the Uniform Commercial Code (UCC).[8] It requires only that parties to a contract refrain from conduct that will injure the right of the other party to receive the benefits of the contract. The implied duty of good faith and fair dealing receives general recognition in cases involving franchise agreements when circumstances arise that make it appropriate to do so.[9]

Despite its general recognition and application in franchise cases, the implied duty of good faith and fair dealing does not create a cause of action separate from that created in the provisions of the contract.[10] In the majority of jurisdictions, a breach of the implied covenant of good faith and fair dealing is only actionable when an express term exists on which the implied covenant may be assumed. The breach of contract claim in the *Dunkin' Donuts* case, however, rested entirely on the notion that the Dunkin' franchisor failed to meet an implied obligation, not that it failed to satisfy any explicit term of the contract. In the United States, the implied duty of good faith and fair dealing does not create additional obligations. Therefore an obligation not explicitly included in a contract, such as to protect brand strength, would not likely be implied in a US franchising contract.

The Implied Duty of Good Faith and Fair Dealing Is Not a Fiduciary Duty

US courts tend to view the franchisor-franchisee relationship as one that is at arm's length and without implied obligations beyond the duty of good faith and fair dealing.[11] The obligations and requirements implied into the contract in *Dunkin' Donuts*, however, reflect a situation that more closely resembles a fiduciary relationship than an arm's length transaction protected by the implied duty of good faith and fair dealing. In *Dunkin' Donuts*, the court held that franchisors are bound by an implied obligation of loyalty toward franchisees such that they are "duty bound to work in concert with them and provide necessary tools if not to prevent economic hardship," to at least minimize the impact. Although the court used the term "good faith," the obligation described appears to reflect a fiduciary relationship more than an arm's length business relationship. The words "duty bound to work in concert" indicate that a franchisor must act for the benefit of the franchisee regardless of the effect it may have on the franchisor. The duty of good faith and fair dealing implied in US contracts does not extend so widely.

The implied duty of good faith and fair dealing is not precisely defined in the Restatement, but the UCC defines the duty as an obligation to act honestly in the transaction concerned.[12] A fiduciary duty under US law, in contrast, is a higher standard and involves parties who are placed in positions of trust and loyalty. A fiduciary must act in the best interests of the person or entity in its care, even if those actions are contrary to the fiduciary's own interests.[13] Although the franchisor and franchisee have a business relationship, they each also have their own business interests. Accordingly, a fiduciary relationship does not make sense.

In *Picture Lake Campground, Inc. v. Holiday Inns, Inc.*, the court described the relationship of a franchisor and franchisee as "inherently a business relationship, not a fiduciary relationship. Although Holiday Inns had a duty to deal fairly with Picture Lake, it did not have the duty of a fiduciary."[14] Therefore, it is unlikely that an implied duty of brand protection and enhancement, which seems to reflect a fiduciary duty, would be implied in a typical US franchising agreement absent express terms obligating the franchisor to do so.

The US Approach to Implied Obligations in the Franchise Context

The implied obligation of good faith and fair dealing generally is construed by courts in the United States as a way to qualify or limit rights arising under the specific language of a contract and fill in the gaps where a contract is ambiguous. Courts in the United States typically do not use the implied duty of good faith and fair dealing to put additional obligations on one party for the benefit of the other party. [15]

Two cases nicely summarize the general approach explained above of US courts to cases like *Dunkin' Donuts*. In *RHC, LLC v. Quizno's Franchising, LLC*, a couple in the United States, who had no prior franchise experience, opened a Quizno's franchise.[16] The franchise agreement gave the franchisor the right to approve the choice of location. Once the couple picked out a location, the franchisor approved the site, the restaurant opened, but shortly thereafter the restaurant failed. The franchisee sued the franchisor for a breach of the implied duty of good faith and fair dealing based on the notion that Quiznos, by approving the site, had become the guarantor of the restaurant's success. The franchisor prevailed.[17]

The Colorado court in *Quizno's* held that the franchisor's right to approve the site location in no way created an obligation, implied or otherwise, to be the guarantor of the success of that franchise. The court explained that the approval was merely a way for the franchisor to protect its own interests. Thus in the

United States, courts would not likely view the right of the Dunkin' franchisor to oversee quality standards as creating an implied obligation to protect the brand and fend off competition, as the court held in Québec.

In another case, a California franchisee's Sizzler restaurant failed and the franchisee sued the franchisor for, among other things, failing to provide advertising support to promote the restaurant.[18] There were no express terms obligating the franchisor to provide advertising. When the franchisee attempted to rely on the implied covenant of good faith and fair dealing, the court explained that, without an express duty on which to hinge the implied duty of good faith and fair dealing, the implied covenant will not apply.[19] In contrast, the Québec court found that Dunkin' was obligated to provide support, including additional advertising, against the competition posed by Tim Hortons without an express obligation.

Quizno's and *Sizzler* reflect the hesitation of US courts to imply obligations into otherwise express contracts. Accordingly, it seems unlikely that US franchisors need to worry about expanded liability based on the Québec decision. Notwithstanding the improbability of a US court finding an implied franchisor obligation of brand enhancement or protection, franchisors in the United States should still cautiously draft their franchise agreements.

It is widely agreed that the implied duty of good faith and fair dealing cannot be waived,[20] and, therefore, it is still a good practice to carefully define franchisor obligations, and expressly provide that the franchise contract will not allow for any implied obligations. Because it is unlikely a US court will imply any obligation contrary to the express terms of a franchise contract, the more a franchisor should takes steps to expressly disclaim any obligations other than those expressly defined.

1. Dunkin' Donuts Brands Canada Ltd. v. Bertico Inc., [2015] QCCA 624, para. 48 (Que.).
2. Civil Code of Québec, S.Q. 1991, c. 64, art. 1434 (Can.).
3. Birmingport Lumber Co. v. Chickasaw Wood Prods. Co., 13 So. 2d 770, 771 (Ala. 1943).
4. Joel Iglesias, "Applying the Implied Covenant of Good Faith and Fair Dealing to Franchises," 40 *Hous. L. Rev.* 1423, 1432 (2003).
5. Art. 1434.
6. Jane Cohen & Larry Weinberg, "Good Faith and Fair Dealing: A Primer on the Differences Between the United States and Canada," 22 *Franchise L.J.* 37, 37 (2002).
7. *See id*.
8. Joel Iglesias, *supra* n.4 at 1425.
9. *See id*. at 1432.
10. *Id*. at 1439.
11. *See generally*, Broussard v. Meineke Discount Muffler Shops Inc., 155 F.3d 331, 347-348 (4th Cir. 1998) (*citing* North Carolina law along with Original Great Am. Chocolate Chip Cookie Co., Inc. v. River Valley Cookies, Ltd., 970 F.2d 273, 280 (7th Cir. 1992); O'Neal v. Burger Chef Sys., Inc., 860 F.2d 1341, 1349 (6th Cir. 1988); Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285, 1292 (9th Cir. 1987); Jack Walters & Sons Corp. v. Morton Bldg., Inc., 737 F.2d 698, 711 (7th Cir. 1984) to support its refusal to find a fiduciary relationship or duty between a franchisor and franchisee). Nonetheless, it is worth noting, that the law can vary from state to state and there are a minority of courts that have found a fiduciary duty between a franchisor and franchisee under some circumstances. For example, although not an analogous case, in Arnott v. Am. Oil Co., 609 F.2d 873 (8th Cir. 1979), the franchisor was found to have breached a fiduciary duty to the franchisee. In *Arnott*, an oil company terminated its lease with a service station dealer franchisee without good cause. The court said that a "[a] franchisee, unlike a tenant pursuing his own interests, builds the good will… of the franchisor" and that aspect of the relationship imposes a duty upon the franchisor to abstain from terminating the franchise arbitrarily. The *Arnott* court made the bold statement that "[i]nherent in a franchise relationship is a fiduciary duty."
12. Joel Iglesias, *supra* n.4 at 1438.
13. Carmen D. Caruso, "Franchising's Enlightened Compromise: The Implied Covenant of Good Faith and Fair Dealing," 26 *Franchise L.J.* 207, 210 (2007).
14. Picture Lake Campground, Inc. v. Holiday Inns, Inc., 497 F. Supp. 858, 869 (E.D. Va. 1980).
15. Joel Iglesias, *supra* n.4 at 1427.
16. RHC, LLC v. Quizno's Franchising, LLC, No. 04CV985, 2005 WL 1799536 (Colo. Dist. Ct. 2005).
17. *Id*.
18. In re Sizzler Restaurants Int'l, Inc., 225 B.R. 466, 473 (Bankr. C.D. Cal. 1998).
19. *Id*. at 476.
20. Carmen Caruso, *supra* n.13 at 211 (*citing* cases).