Ruling in Canada Places Heavy Obligations on Franchisors

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Franchisors: thinking about expanding into Canada? Better think twice.

Since 2000, the Dunkin' Donuts franchisees and their franchisor have been doing battle in Quebec. In *Bertico, Inc. v. Dunkin' Brands Canada*, originally filed on May 20, 2003,[1] the essence of the franchisees' claim was whether the franchisor had fulfilled its obligations to its franchisees—a simple issue, it would appear. However, that turned out not to be the case.

At one point in time, the Dunkin' Donuts brand had been highly successful in penetrating the Quebec market. At its height, there were 212 stores operating in Quebec. However, as time oozed by, the system began to deteriorate. By the time this action was filed, the number of units had been reduced to 25, and at the time the decision was rendered by the Superior Court, the trial court, it was down to 12. Today, there are fewer than half a baker's dozen units in Quebec.

The plaintiff franchisees claimed that the franchisor had not adequately performed its express and implied obligations under their Franchise Agreements. In essence, the franchisees examined the terms of their Franchise Agreements and claimed that the franchisor had failed to protect and enhance the brand and the Dunkin Donuts system—which it had promised to do.[2] The franchisor blamed the deterioration substantially on poor performance by the franchisees and by the incredible growth by competitor Tim Hortons.

Franchise Agreement

The specific language of portions of the Franchise Agreement were critical to the outcome of the case. The preambles provided in part that the franchisor "has acquired experience and skill in the development, opening and operating of shops and distribution outlets involving the production, merchandising and sale of donuts…."[3] The preambles went on to say that the franchisor "has developed and used and continues to use and control…certain proprietary interests, trademarks and trade names…to represent to the public high and uniform standards of quality, cleanliness, appearance and service."[4]

The court also examined the obligations of the franchisor contained in the body of the Franchise Agreement. Typically, franchise agreements might provide with specificity the obligations of the franchisor before, at, and immediately after the opening of the franchise. Franchisors generally don't mind specificity at that point in time because these obligations will be performed relatively quickly after the franchise agreement is signed, and the franchisor can easily discern what it needs to do contractually. In contrast, franchisors' future obligations are normally expressed in vague terms that give the franchisor broad discretion. The agreement may, for example, provide that the franchisor "may" [not "shall"] provide the specified services or obligations. Such a provision giving the franchisor discretion lowers the future risk arising from the franchisor's obligations. The Dunkin' Donuts Franchise Agreement was along these lines.[5]

Most of the franchisor's obligations related to the initial activities of the franchise before and immediately after opening. These included: providing specifications for equipment; establishing a pre-opening training program; providing operating procedures; making available to the franchisee assistance based on the experience and judgment of the franchisor in the pre-opening, opening and initial operation of the franchise; and providing operating manuals.

As for post-operating obligations, the Franchise Agreements provided for a nebulous "continuing advisory relationship with the FRANCHISEE,"[6] and an obligation to "administer the…Advertising and Sales Promotion Fund…and to direct the development of all advertising and promotion programs….[and that] the content of all advertising, as well as the media in which the advertising is to be placed and the advertising area shall be at the discretion of the [the franchisor]."[7] These provisions are fairly typical of franchise agreements in general.

However, there was one other obligation in the Dunkin' Donuts agreement that was not so typical, and the court focused its attention on the language of this obligation. This provision stated that the franchisor had "to continue its efforts to maintain high and uniform standards of quality, cleanliness, appearance and service at all DUNKIN DONUTS SHOPS, thus protecting and enhancing the reputation of [the franchisor and its parent company] and the demand for the products of the DUNKIN DONUTS SYSTEM…."[8]

Relying heavily on the words "protecting" and "enhancing," the court held that the franchisor had breached its expressed and implied obligation of good faith and fair dealing in managing the DUNKIN' DONUTS system. Among other failures, the court found that the franchisor had failed to terminate franchisees who were not maintaining the Dunkin' quality standards,[9] and failed to take steps to protect and enhance the system,[10] notwithstanding warnings of franchisees given to the franchisor in 1996 about the system's decline and the threat resulting from Tim Hortons' entrance into the Quebec market and taking away Dunkin Donuts' position as the leading company in the Quebec donut market.[11]

On the issue of damages, the court concluded that the plaintiffs be awarded the sum of $16.4 million—the exact number asked for by the franchisor.[12]

The court gave little credibility to the franchisor's position that the franchisees were largely responsible for their demise because they (1) failed to maintain system standards and (2) refused to implement a remodeling program that was designed to bring the system up to date, thereby increasing sales.[13]

On appeal,[14] the Court of Appeals agreed with the lower court's ruling on every issue except that of damages. The appellate court reduced the damages awarded by the trial court to just under $11 million, reflecting the plaintiff franchisees' unpaid royalties and advertising fund contributions, and also reflecting the franchisor's contributions to its proposed renovation program as well as the court's reduction of lost profits from 100 percent to 75 percent of Tim Hortons' growth during the damages period.[15]

Higher Level of Attention

For those U.S. franchisors with systems in Canada, *Bertico* should send chills up their spines. Unless their franchise agreements provide for U.S. law to apply, and unless those provisions would be enforceable in the Canadian courts, *Bertico* places on a franchisor a higher level of attention and commitment to serving franchisees than a franchisor must provide in order not to be in default. The puzzling question is: how much higher?

The evidence as reported by the Superior Court showed that the franchisor had made some efforts to improve the system and ward off Tim Hortons, the formidable competitor. Among other tactical moves, the franchisor agreed to contribute up to $46,000 to the cost of each unit's renovation, if at least 75 of the Quebec units that were in good standing would agree to the remodeling program.[16] The record showed that because the requisite number of franchisees failed to approve the remodeling program, this contribution was never made.[17] But even if the program had been adopted, it might have been too little too late. Dunkin' only had Canadian units in Quebec and none in any other province, while Tim Hortons was spreading throughout all of Canada, and had also entered the U.S. market.

How much money should the franchisor have contributed to a dying system? What level of support should the franchisor have provided? And should the franchisor have been required to terminate franchisees who were performing inadequately? These are all business decisions, so in essence the court was substituting its own judgment for the judgment of franchisor's management.

In the United States, courts have adopted a business judgment rule that states that a court should not substitute its business judgment for the judgment of management. Although similar provisions are now found in some U.S. franchise agreements, apparently this is not the custom in Canada. Moreover, the Bertico appellate court noted that the business judgment rule was meant to protect company directors from liability and was not applicable in a franchise environment.[18]

One might contend that the case is distinguishable from most typical franchise situations because of the extremeness of the system's failure. However, there have been many franchise system failures in the United States. Perhaps one of the largest involved the demise of the Howard Johnson ice cream chain. At one time, there were more than 1000 units, all selling the company's premium ice cream. Today, there are only three or four stores flying the HoJo flag. Its market lead has given way to the rise of Baskin Robbins, and later up-and-comers like Maggie Moo's, Bruster's and Coldstone Creamery.

Other U.S.-based food chains that have failed include Arthur Treacher's, D'Lites, Po Folks and Stuckey's, not to mention the numerous start-ups that have gone out of business shortly after their brands' creation. The franchisor argued that the court's decision essentially made the franchisor a guarantor of the franchisee's success. Perhaps this might be considered hyperbole, but the fear of such a result is not unrealistic.

And one interesting scenario is: Suppose unit sales increase, but not to the same level or at the same rate as those of its competitors' units? Could a claim be made against the franchisor in this situation for failing to satisfactorily "enhance" the brand?[19]

What Franchisors Can Do

Even if *Bertico* is not precedent for U.S. courts, it sets an example that U.S. courts may decide at some point to follow. So, what can a franchisor do to minimize its exposure?

First, U.S. franchisors should carefully review their franchise agreements and be sure they understand the risk of using words like "enhance," "protect" and "develop." These words and other similar terms might support a conclusion that the franchisor has implied obligations and may create a risk that the franchisor did not intend to impose upon itself.

Second, U.S. franchisors might bolster language in its contracts that disclaim any implied obligations—much like one sees in sales contracts addressing the issue of implied warranties and certain of the disclaimers found in franchise agreements. For example, the provision might read: "Any implied warranties, including without limitation, any covenant of good faith and fair dealing, are hereby expressly disclaimed."[20]

Third, to reduce risk, the franchisor might modify its behavior—listen more to its franchisees; create evidence to support changes franchisors may wish to make to the system; examine what its competitors are doing; and do appropriate testing of changes it wishes to introduce into the system.

The first two points are of a legal nature. The third point speaks of some changes in the way some franchisors conduct their businesses. If this third point is the effect of *Bertico* on the U.S. market, then perhaps the decision is not all bad from the franchisor community's standpoint.

We have not necessarily heard the last word about *Bertico*. The case is being appealed to the Supreme Court of Canada, which has the discretion to hear, or not hear, the case. Sources say that the decision to grant or deny the appeal should be rendered by the end of the year, and if it is granted, it may be another year or two before the case is finally decided.

So, the Canadian franchise community is left in purgatory until the Supreme Court of Canada speaks its piece, and the U.S. franchise community is left to watch and wonder…

ENDNOTES:

1. 2012 QCCS 2809.

2. There were actually two forms of Franchise Agreement in effect, but for purposes of this article, we will assume that the later version is applicable. Generally speaking, the results and analysis would be essentially the same under both forms of agreements.

3. 2012 QCCS 2809 ¶13.

4. Id.

5. See id. ¶15.

6. Id.

7. Id.

8. Id.

9. Id. at ¶¶55-56.

10. Id. at ¶57.

11. Id. at ¶32.

12. Id. at ¶128. An extensive portion of the Superior Court's and the Court of Appeals' opinions were devoted to discussions of the calculations of damages. See ¶¶70-122 of the Superior Court's opinion and ¶¶148-227 of the Court of Appeals' decision. The scope of these discussions are beyond the subject of this column.

13. 2012 QCCS 2809 at ¶¶67-69. The franchisees had retained an expert when the remodeling proposal was first introduced and he advised them that the remodeling investment, as structured, would be a bad deal for them.

14. See 2015 QCCA 624.

15. Id. ¶¶214-215.

16. 2012 QCCS 2809 at ¶¶63-65.

17. Id. at ¶65.

18. 2015 QCCA 624 at ¶¶99-102.

19. A comparable problem has been faced by franchisors that have adopted encroachment policies intended to compensate impacted franchisees resulting from the placement of new units so close to an existing unit that the existing unit's sales end up being transferred to the new unit. In some cases, sales might still go up for the impacted unit even though their existing sales have been cannibalized, because the economy has improved generally or because of inflation or increased development in the neighborhood.

20. One problem facing the defendant in *Bertico* is that Quebec has a code provision almost mandating affected contracting parties to use good faith and deal fairly. See 2012 QCCS 2809 at ¶50 n. 9. It is questionable whether parties could contract away liability under this code provision if the provision reflects a public policy with respect to how businesses should act in contracting and performing contractual obligations.

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