Who is Responsible When the Brand Falters?

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WHAT MAKES A BRAND FALTER?

• Brand Standards Issues
• Bad Acts (F’r, F’ee, 3rd Pty)
• Bad Business Decisions
• Unanticipated Regulatory Changes

OUTCOME: LAWSUITS, LOSSES, BANKRUPTCY ... FAILURE

WHO IS TO BLAME?
Twin Peaks

Twin Peaks – restaurant concept that serves food and beverages in a lodge-themed environment. Its servers are called “Twin Peaks Girls.” They wear revealing uniforms that match the lodge them (e.g. low-cut plaid shirts tied at the waste and low-cut short shorts).

Franchisor sanctions biker nights throughout the system.
Twin Peaks

May 2015, rival banker gangs meet at the franchised Twin Peaks restaurant in Waco, Texas.

Fights and a shoot-out ensued; 9 people were killed, 18 were injured, and 177 were arrested.
Resulting litigation: Franchisor sued franchisee seeking declaratory judgment that:

• The Waco restaurant was closed by authorities for health and public safety reasons;
• The Waco incident materially impaired the goodwill associated with brand and the Marks;
• Franchisor was entitled to terminate the franchise agreement, effective immediately with no opportunity to cure;
• Franchisee must immediately comply with all post-term obligations; and
• Franchisor be awarded reasonable attorneys fees.
Twin Peaks

Outcome

• Franchisee sued franchisor for breach of contract.
• Neighboring restaurant (Don Carlo’s) sued franchisee for negligence.
• Resulting litigation: Wife of slain biker sued franchisor and franchisee for negligence.
Twin Peaks

Who was to Blame?

• Which party is liable? Franchisor or franchisee?
• Is there a contributory negligence component given franchisor’s sanctioning of biker events in general?
• Who can bring such claim: customers, family members, franchisee?
• Was the franchisor’s action to terminate the franchise agreement the prudent action to take to help protect the brand from further damage?
Dunkin’ Donuts

Brief History
Trial Court Decision
Appeal
Dunkin’ Donuts

Outcome

- The obligational content of the franchise agreements
- The intensity of the franchisor’s contractual obligations
- The business judgment role
- The evidence of the fault
- Causation
- Releases
Dunkin’ Donuts

Who was to Blame?

- Damages
  - Lost profits
  - Loss of investment

Key Lingering Questions and Application Outside Quebec and Canada
At height circa 2001, public company, 750 Restaurants, robust turnkey and area developer (AD) programs

Problems arise due to:

• Development of larger, costlier locations
• Expansion into new, far-flung markets
• Growth in competition
• Economic slowdown
Schlotzsky’s

Problems exacerbated due to:
- Costly buybacks of ADs/Growth expectations
- Free spending of public money
- Rapid expansion by “best franchisees”
- Franchisor guarantees on turkey locations

AD/Franchisee claims:
- Restaurant design changes (bait and switch)
- Supply chain gouging
- Advertising fee misuse
Schlotzsky’s

Outcome

- Bad result in one AD lawsuit lead to copycats
- Franchisor buyouts for the “lucky” early adopters
- Bad relations with franchisees led to attempts to reverse engineer bread/take over supply chain
- Franchisor ousting of CEO and COO
- Franchisor Chapter 11 bankruptcy and sale of assets at auction
- Slow turnaround by new owners and subsequent owners
Schlotzsky’s

Who was to blame?

• Slippery Slopes
  – franchisor innovation
  – free spending of public money
    • free computers
  – focus on intensive growth
    • AD buyout required store count growth
• AD claims can be more deadly than franchisee claims
• AD programs can both increase and slow growth
Quiznos

At height circa 2004, one of the fastest growing franchises

Model of AD sales

Problems arise due to:
• SNOWs
• Unsophisticated and undercapitalized franchisees
• Sales focus over service
• Supply Chain as revenue generator
Quiznos

Problems exacerbated due to:
• Public squabbles with franchisees
• Founders cashing out to private equity
• State examiner and plaintiff’s attorney focus

AD/Franchisee claims:
• Supply chain gouging/antitrust claims
• Real estate and service failures
Quiznos

Outcome
• Deceleration of growth
• Store closures
• Lax quality
• Multiple attempts to reinvent the company and focus on service
Quiznos

Who was to blame?

• Laser sales focus and lax requirements can create tremendous growth
• Integrated supply chain can create tremendous profits ... and franchisee unprofitability
• Lax service and attention to detail can crater growth and profits, lead to lawsuits
Burger King

Financial problems arose due to:

• Extensive monetary outlay required by image makeover requirements
• Tightening credit markets
• Franchisees do not receive return on investment commiserate with investment
• Frequent leadership turnover; 5 Presidents in 6 years
In 1999, after years of stagnate same store sales and industry-lagging average unit volumes, franchisor undergoes image makeover.

Makeover requirements included:
- New logo and signage replacement
- New roofs and rooflines
- Major interior and exterior remodels
- New interior and drive-thru menu boards
- New kitchen equipment holding equipment
Burger King

Outcome

• Largest franchisee filed bankruptcy
• Hundreds of locations closed
• Franchisor/franchisee relations deteriorated even further
Burger King

Who was to blame?

• Franchisees for neglecting restaurants for years? (Restaurants in 2000 with 1980 décor packages)
• Franchisor for requiring such capital-intensive makeovers at one time?
• If litigation had ensued, what would the claims have been?
Blockbuster

At height circa 2000, one of the most respected and profitable franchises

Model of innovation/reinvention in 1990’s and early 2000’s

Problems arise due to:
• Constant evolution of electronic media options
• Historical reliance and investment in bricks and mortar stores
• Internet or quasi-internet start-up competition
• Reliance on old technology jurisdictions
Blockbuster

Problems exacerbated due to:
• Costly competitor acquisitions
• Failed co-branding attempts
• Muddled strategies

AD/Franchisee claims:
• Failure to keep up with times
• Loss of competitive advantages due to opening of market
Blockbuster

Outcome

- Franchisee consolidation – real estate play
- Franchisor bankruptcy
- Purchase by DirectTV for online assets
- Negotiated disassociation with existing franchisees
Who was to blame?

- Writing was on the wall due to evolution in technology
- Franchisor can only change so much when real estate is involved.
- Opportunistic franchisees and competitors sold to get out or bought for real estate play
THANK YOU!
WHO IS RESPONSIBLE WHEN THE BRAND FALTERS?

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WHO IS RESPONSIBLE WHEN THE BRAND FALTERS?

I. INTRODUCTION

The actions of a franchisor or a franchisee, or even external factors, may tarnish the brand image or create a public relations nightmare – sometimes catastrophically for the entire system. When the brand falters, who can be held liable?

A franchisor might be too slow or unresponsive to changing consumer tastes, new technology, a change in the regulatory environment, or competition, causing the system to lose competitive footing. Or the converse, a franchisor may be overly aggressive with new ideas or may want to implement new programs or methods of doing business, so much so that the franchise system becomes financially weak. Individuals with a position of power or influence with the franchisor or franchise may act in a certain manner – on one end of the spectrum expressing a polarizing opinion and on the other, committing an illegal offense - casting a negative light on the system as a whole. A foodborne illness outbreak, even if the fault of a third party supplier, can envelope the system in negative publicity and years of litigation, negatively impacting the entire system by taking focus and resources away from the business.

This paper seeks to addresses the potential liability, if any, of franchisors and franchisees for loss of brand value or other economic loss and the impact to the brand’s reputation in these difficult situations.

First, we consider a laundry list of contract obligations and related controllable and uncontrollable defaults and mistakes at both the macro and micro level in a franchise system, with an eye to considering liability and theories of recovery from both a legal and practical standpoint. Next, we provide a brief overview of the duty of good faith and fair dealing, which historically has been a primary theory on which parties have attempted to find liability outside of the letter of the franchise agreement. We also provide a brief overview of the duty of competence, which is an additional, controversial theory for finding liability in unique situations where harm is unquestioned, but liability and culpability may be a more difficult determination. Finally, we present an in-depth discussion of a recently decided and much talked about case that at its heart is about the diligence and competence of a franchisor and the potential harm and related liability that franchisor can have to its franchisees; the landmark Dunkin’ Donuts Canada case that was filed in 2003 and decided April 2015.

II. SYSTEM-WIDE/BRAND RISKS

Franchise agreements typically contain a series of express obligations committing each party to undertake certain pre-opening, operating, and post-termination actions. From pre-opening training, initial personnel, and site selection and construction decisions, to opening and operating requirements regarding products and services, vendor relationships, and brand trademark and trade dress usage standards, to post-termination requirements related to de-identification, confidentiality, and non-competition, both parties to a franchise agreement have a lot to live up to in their franchise agreements. Most would concede, however, that franchisors generally attempt to avoid placing too many specific, quantifiable obligations on themselves in the franchise agreement. Instead, franchisors use broad language, substantive descriptions of obligations, and business judgment rule provisions to avoid hemming the franchisor in on its own actions and obligations.

Of course, contracts sometimes seem like they were meant to be broken. It is inevitable in franchising that franchisors and franchisees will make mistakes, and one or both parties may be in “default” and give rise to claims for breach, rights of termination (or non-performance), and potential attendant damages. Some breaches may be intentional. Some may be inadvertent. Some may occur
despite the best of intentions of the offender. Some may arise from malicious intentions of the offender. Just as franchise agreements outline the parties’ respective pre-opening, operating, and post-termination obligations, franchise agreements generally outline the consequences for franchisee mistakes in the form of default and termination provisions, and some franchise agreements address franchisor defaults and provide termination options for franchisees. Regardless of whether a franchise agreement addresses consequences for a franchisor or franchisee mistake or default, there can be material damage done to a brand, a subset of franchisees, or even a specific, targeted franchisor or franchisee. The inevitable questions are: Who had the obligation? What was the obligation? Who is at fault? Who is going to pay for this? What is the theory of recovery?

In this section, we outline a number of express obligations and the corresponding controllable and uncontrollable defaults and mistakes, and seek to determine who should be liable under applicable law, who really is liable (and if so, under what theory(ies) of law?), and whether practically speaking anyone ever can or will be made whole. The focus is on damage to the brand as a whole (which may of course be linked to damage to the franchisor), and not necessarily damage to a single franchisee when the rest of the system is otherwise not materially affected.

Bear in mind that when it comes to franchisors bringing claims, it seems that most claims are brought under breach of contract-related theories, including non-payment of monies, breach of covenant against competition, breach of confidentiality, misuse of intellectual property and the like—often with tag lines claiming acts, errors, or omissions are “materially injurious to the goodwill associated with the System” (in other words, your actions have harmed the brand). On the other hand, franchisee claims are in many cases based not on a direct breach of contract (although these claims are invariably included in an action). Instead, because the franchisor has not ordinarily boxed itself in via the franchise agreement, franchisees tend to rely on finding breaches of more subjective duties and obligations under theories such as fraud, misrepresentation, deceptive trade practices, the duty of good faith and fair dealing, and even the duty of competence or fiduciary standard—often claiming that the franchisor “intentionally or negligently treated the franchisee unfairly and robbed the franchisee of its ability to receive the fruits of its contract.”

A. **Brand Standards and Controllable Defaults**

One of the key features of a franchise system is the use of the franchisor’s trademarks, and by extension, its concept and system, which are sometimes referred to collectively and rather amorphously as the “brand.” The brand is the franchisor’s most valuable asset and thus commands its protection and policing. Most, if not all, franchise agreements contain a plethora of rights and obligations relating to the protection and policing of the brand.

The franchisor is usually the owner of the trademarks or an authorized licensee and will include its rights to control the use of such trademarks in the franchise agreement. These rights may include the right to visit the franchised premises; the right to reject any unauthorized use of the trademarks by the franchisee; the right to sanction any unauthorized use of the trademarks by the franchisee; the right to modify or add to the existing trademarks; and the right to resort to legal proceedings to protect its trademarks.

Conversely, the franchisee will face many obligations regarding the trademarks, including the obligation to sign and deliver to the franchisor any document or do anything required to confirm the franchisor’s ownership of the trademarks; the obligation to affix in a conspicuous location in the premises a sign containing a notice indicating that the franchised business is owned and operated by the franchisee and that the franchisee is a licensee of the trademark; the obligation to refrain from registering the trademark; the obligation to advise the franchisor of any infringement or threatened infringement of the trademark to the franchisor; and the obligation to comply with any changes and use any new additional or modified trademarks.
To instill knowledge and understanding regarding brand standards, franchise agreements typically contain obligations dealing with pre-opening training and personnel. The franchisor’s obligations include the obligation to provide to the franchisee and to its key personnel an initial training program, which is usually for a duration deemed necessary and at a location to be designated by the franchisor, at the franchisee’s expense (which may include expenses related to the training material, travel, and accommodations during the period of such training). The extent of training is subjective (by design as noted above) and varies from one franchisor to another but a pre-opening training program provided by the franchisor is essential to setting the franchisee up for success and for the franchisor to maintain brand standards.

Conversely, the franchisee will be obliged not only to attend the franchisor’s training, but to successfully complete such training and pass whatever tests or evaluation methods that are used to measure the franchisee’s ability to run a successful franchised operation, such as complying with the operation standards mentioned in the operations and other manuals. The franchisee’s failure to successfully complete pre-opening training should be cause for concern, delay in opening and, potentially, default.

Training and instilling an understanding of brand standards can certainly aid in dealing with the day-to-day vagaries of operating a franchised business, and almost every franchise agreement has a force majeure clause to deal with things that can happen that are outside the control of the parties. In those types of situations, there is usually less animosity or consternation between the parties, even if one side believes the other could have planned better or had contingencies in place. However, regardless of the amount of training or the understanding of brand standards, there are bad actors who commit bad acts. These types of “controllable defaults” normally create the most tension and strife in a franchise system and breed the most disputes and litigation.

In some instances, bad acts occur after the relationship with a particular franchisees has ended, but causes problems for the franchisor and remaining franchisees. Enforcing post-termination obligations, such as de-identification, confidentiality, and non-competition, can often prove challenging for franchisors. While the policing of such obligations begins with carefully drafted covenants that specifically set out the franchisees’ obligations in this regard, follow through by franchisors (and specifically the ability and fortitude to spend money for follow through) are actions (or, unfortunately, inactions) can make or break a system.

With respect to de-identification, franchise agreements will invariably require franchisees to de-identify their franchised businesses and undertake certain actions, which may include: (a) returning to the franchisor all manuals, proprietary software, and all other forms, documents, or other information provided to the franchisee; (b) ceasing to use in any manner whatsoever all materials, methods, procedures, names, and techniques associated with the franchise concept; (c) ceasing to use all signs, packaging, advertising, stationary, forms, or any other materials bearing any of the franchisor’s trademarks; (d) refraining from using any reproduction, counterfeit, copy, or colorable imitation of the trademarks which is likely to cause confusion or mistake or to deceive and refrain from utilizing any commercial symbol or designation of origin or description or representation which falsely suggests or represents any association with the trademarks or the concept of the franchise business; (e) ceasing to use all telephone numbers and listing services or any other listing, which includes the Internet; (f) and making changes to the physical appearance and structure of the premises, including the removal of signs or other distinctive replica of the trademarks or concept.

Confidentiality provisions are certainly the most challenging to enforce. First, confidential information is effectively passed to franchisees who will acquire the actual know-how that they can
reproduce to a certain extent without having actual hard copy or electronic materials. Second, franchisees can easily make copies of materials and make use of such materials covertly. Consequently, policing confidentiality will prove difficult. Copycat concepts are unfortunately a reality that can damage the brand, but also instill in franchisees a belief that they can do it too.

Non-competition covenants are generally a bit easier to enforce; but again, only if non-competition covenants are carefully crafted so as to specifically set out what franchisees cannot do upon the termination or expiration of the franchise agreements and make sure that the time and geographic scope are reasonable and enforceable. Once again, franchisors need to keep a sharp lookout for contraveners of non-competition covenants that may damage the brand.

With these contractual obligations and limitations in mind, the next section of this paper provides a detailed description of some real and some contrived fact patterns to illustrate what can happen when franchisors and/or franchisees create their own problems for themselves and the brand is affected by their actions (or inactions); and theories of recovery relating to these situations.

B. Franchisor/Franchisee Bad Acts

Sadly, there is definitely an undercurrent in some franchisee systems that the franchisor and its personnel are evil, or only looking out for themselves with no regard for the franchisees or their businesses. And conversely, there are some franchisors and their personnel who are convinced that a particular franchisee or group of franchisees are evil and are more than willing to damage the brand if it means more money in their own pockets. While situations are rarely cut and dry, there have been and will continue to be instances of extreme misbehavior, and franchisors and franchisees can be materially and adversely affected.

Liability and theories of recovery are more cut and dry in situations where a criminal or bad act are directed to a specific party or small group of parties. Breach of contract, fraud, misrepresentation, deceptive trade practices, and the duty of good faith and fair dealing can all be viable claims in such situations. It becomes more difficult when a criminal or other bad act is not directed at a particular party that is harmed. It becomes a bit more like a law school tort case where the acts and errors on a train wreck in one city create a chain-reaction of unintended consequences in multiple other cities. The parties seeking recovery end up claiming a special or fiduciary duty or a duty of competence to overcome causality and foreseeability defenses.

Most franchise agreements have some form of "compliance with all laws" requirement targeting the franchisee. It is rare that a franchise agreement has a corresponding compliance with all laws provision for the franchisor, but franchisors and franchisees are not above the law, and crimes or alleged crimes occur in franchise systems just as they do in society.

While a franchise agreement may provide for default and termination rights, and indemnification rights, in favor of a franchisor when a franchisee or key person commits a crime (or even if they are charged with a crime), the potential for devastating and long-term harm to a brand and the franchise system can transcend the types of remedies available in a franchise agreement.

Reports of franchisors committing crimes or other misbehaviour come in all shapes and sizes, and franchisees have had varying success in seeking redress. Like any business, franchise systems that endure criminal and other misbehaviour frequently experience negative publicity, where both franchisors and franchisees suffer financially. For example, criminal trials, government agency inquiries, public class action lawsuits, labor disputes, and even contaminated product incidents can damage the brand, which can lead to franchisor bankruptcy or even can bring down a brand in its entirety. Notable examples of criminal
or other misbehaviour by a franchisor or system that were likely to affect the brand as a whole include the following:

In 1994, Denny’s paid $54 million to settle a class action lawsuit filed by black customers alleging racism. As part of the settlement, Denny’s signed a Fair Share diversity pledge with the National Association for the Advancement of Colored People (NAACP). Following this settlement, in 1997, the Denny's franchise filed for Chapter 11 bankruptcy protection, which was at least in part due to the negative publicity caused by the racism allegations. While the bankruptcy likely eliminated the option for franchisees to claim that Denny’s actions eroded what was likely a large customer base for some of its franchisees (especially for franchisees in minority markets), and while the NAACP pledge may have been a viable effort as remediation, it is interesting to consider whether or not a class action by franchisees, claiming that the franchisor's failure to comply with laws gave rise to claims for effected franchisees, could have survived. Of note, since the early 2000’s, Denny’s has topped several employment lists and has been able to recover from the negative publicity of the 90’s, but at the time, franchisees were essentially along for the ride, were at the mercy of the decisions being made by the franchisor, and had to endure the negative publicity and lingering effects.

Similarly, Krystal Burger has largely put negative publicity of the 90’s behind it. However, in 1995, the burger chain filed for bankruptcy in an attempt to settle lawsuits from 6,000 former employees who alleged they were not paid for overtime. After paying $13 million to settle the claims, Krystal Burger emerged from bankruptcy, and in 1997, was purchased for $108 million. It is not hard to imagine that the publicity related to the overtime cases found its way to plaintiffs' attorneys wondering if the franchisees were following a similar model. Although difficult to track, assuming one or more franchisees were targeted for similar claims, could there be a cause of action that the franchisor's failure to comply with overtime laws gave rise to claims by the effected franchisees; so much so that a target was put on their business because of the franchisor’s actions? If so, and if the franchisor were found to be liable, would the franchisor have a defense that franchisee’s own noncompliance with the overtime laws precluded recovery?

Franchisees who believe that mark-ups charged for required goods are excessive sometimes assert civil theft and racketeering claims against their franchisors. For example, in Avengers v. Quiznos, filed in the United States District Court for the District of Colorado, franchisees alleged that Quiznos formed pass-through companies to hide excessive mark-ups on food, paper, and supplies that franchisees were obligated to buy. The franchisees claimed that Quiznos implemented a fraudulent scheme to steal millions of dollars from Quiznos’ franchisees and asserted 28 claims for relief, including violations of the Colorado Organized Crime Act, civil theft, fraud, and conspiracy. Specifically, the franchisees described Quiznos as “a rogue franchisor” who, through a fraudulent scheme based on deceptive and illegal business practices, stole hundreds-of-millions-of dollars from its franchisees and left them in “financial ruin.” Quiznos eventually settled the lawsuit in this latest battle with its franchisees, but the case is an


example where one side might argue that its actions are just good business practices (i.e., leveraging the supply chain to maximize profits beyond traditional royalties), and the other side argues theft, conversion, and unclean hands. Given where the Quiznos system is today, as opposed to several years ago, but for the settlement that likely covered tangential claims, would the franchisees have had a second bite at the apple via a claim that Quiznos’ potentially illegal actions not only caused the direct harm for which they originally sought damages, but also eventually was an overarching reason for the brand becoming a fraction of what it once was?  

In 2014, a co-founder of the frozen yogurt chain, Pinkberry, was sentenced to seven years in jail after being found guilty of beating a homeless man with a tire iron. Since Pinkberry had ended it ties with the jailed co-founder prior to the incident, Pinkberry did not have to contemplate whether to fire its co-founder, and the franchisees would be hard-pressed to state a viable claim either against the franchisor or the former owner given the attenuated relationships. However, the fact scenario creates an interesting issue. What if an individual founder of a franchisor commits a serious crime outside of the business? Depending on the ownership and/or management structure of the business, the person at issue may or may not be removable, and such person’s remaining presence could have multiple negative effects on the brand and the franchisees. Do the franchisees have a claim against the franchisor, or against the owner? How would the claim be couched?

Unfortunately for franchisees, many of these more macro types of events (ex. Denny’s and Krystal’s) do not have corresponding published court opinions outlining claims made, liability assigned, or damages awarded. It is likely that this is due to a number of different legal and practical factors, including potentially: (a) lack of specific standing or causality; (b) inability to state a specific claim or quantifiable damages; (c) the franchisor facing severe financial difficulties rendering them an unattractive target (i.e., a subsequent bankruptcy as was the case in the two examples); and/or (d) the franchisor taking remedial actions to placate franchisees. This last action – taking remedial actions to placate franchisees – seems the most likely in these types of macro actions as it is “Public Relations 101” to attempt to appease the base, and for franchisors, the base includes the franchise system. And, in many cases, the attempts to appease the franchise system are done behind closed doors and outside of the public eye.

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5 In another overcharging case against a franchisor, three former franchisees sued franchisor Dazbog Coffee, claiming that the franchisor fraudulently overcharged its franchisees through unreasonably high mark-ups on goods. The lawsuit accused the franchisor of civil theft and even racketeering. One of the franchisees presented its claim to an arbitrator, who found that although the theft, racketeering and fraud claims were unsubstantiated, the implied covenant of good faith and fair dealing had been breached by the franchisor. While no damages were awarded to either party, the franchisee was required to buy back its branded property.Ed Sealover, Franchisee lawsuit against Dazbog Coffee is settled, but a new one is filed, Denver Business Journal (Feb 23, 2015), http://www.bizjournals.com/denver/news/2015/02/23/franchisee-lawsuit-against-dazbog-coffee-is-settled.html; George Demopoulos, Bitter coffee feud continues with new suit, BusinessDen (June 2, 2015), http://www.businessden.com/2015/06/02/bitter-coffee-feud-continues-with-new-suit/. Another example involves the Brightstar brand, which found itself embroiled in a series of lawsuits based on the criminal history of a franchisee named Brian Duncan, who allegedly had a long arrest record and several criminal convictions and who allegedly was authorized to perform services for other franchisees. Franchisees began to complain, and seized on this apparent criminal history to bring claims against the franchisor. Brightstar ultimately filed suit in the United States District Court for the Northern District of Illinois, requesting a declaration that Brightstar could terminate Duncan’s franchise agreement without further notice or opportunity to cure. See Complaint, Brightstar Franchising, LLC v. Brian Duncan Enterprises, LLC, et al., No. 1:13-CV-02988 (N.D. Ill. April 22, 2013) (No. 1). After the case was settled, Duncan’s franchise was sold to buyers, who entered into litigation with Duncan.

6 Kate Mather, Pinkberry co-founder ‘merciless’ in beating homeless man, judge says, LOS ANGELES TIMES (March 14, 2014), http://touch.latimes.com/#section/-1/article/p2p-79624363/.
Franchisees are of course equally capable of criminal and other misbehaviour, and their crimes and other acts can result in both criminal and civil actions, termination of the actor’s franchise, and in a limited number of situations can adversely affect the value of the entire system or brand. One example that actually does appear to have resulted in brand damage involved the acts of a large Jiffy Lube Franchisee.

In 2006, a large Jiffy Lube franchisee with over 400 locations was embarrassed by a May 2006 investigation by KNBC-TV in Los Angeles in which test cars with hidden cameras were shown to have been charged for services that were not actually performed.7 The damage and bad press to the brand as a whole was enormous, and the authors are aware of a tremendous amount of back and forth between the franchisor and franchisees regarding defaults, damages, and related claims as well as customer claims related to the underlying actions uncovered by the exposé. Ultimately, in January 2008, the franchisee filed for bankruptcy protection to try to save its business and stave off franchisor and customer actions, which of course again affected the brand via negative press and the franchisor in the pocket book, but also helped the franchisee survive — something that the franchisor of course needed with respect to its cash flow. Incidentally, in 2013, the same Jiffy Lube franchisee settled California-based class action claims relating to spam texts that were sent to customers by agreeing to pay between $35 million and $47 million in cash and services.8 This particular franchisee’s situation brings to mind the classic “can’t live with them; can’t live with out them” and “too big to fail” analogies for Jiffy Lube.

Overarching brand harm is more of a stretch in a typical franchisee criminal matter scenario. For example, tax evasion by a franchisee is a typical example of a crime that can cause damage to the franchisor, but not necessarily a crime that one would immediately think would cause damage to the brand. In the Dunkin' Donuts system, a Dunkin' Donuts franchisee pled guilty to tax evasion and was sentenced to jail. After the guilty plea, the franchisor entered into a fifth franchise agreement with the franchisee on the basis that a new operator be installed.9 The number of franchised stores increased during the period the franchisee was in jail. After being released from jail, the franchisee attempted to take back control of the business, and the franchisor terminated the franchise agreement. Even given the fact that Dunkin’ Donuts knew of the convictions and allowed an alternative operator to run the donut shops while the franchisee was in jail, the court determined that the convictions were “acts injurious or prejudicial to the goodwill” of Dunkin’ Donuts and therefore termination was justified under the franchise agreements.10

In this Dunkin’s case, while likely a throw-away statement in the case, the court found the illegal acts of a similar franchisee were "acts injurious or prejudicial to the goodwill" of Dunkin’ Donuts. Were customers less likely to go to Dunkin' Donuts generally because of a tax evasion arrest? Doubtful, but again, while not a brand harm case at the outset, the court found harm to the brand, which of course means that harm to the brand can come in different shapes and sizes. For purposes of the “harm to the

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7 Jiffy Lube’s Largest Franchisee Bankrupt, George Gill, LUBE REPORT, Vol. 8, Issue 3; Wednesday, January 16, 2008 (http://www.imakenews.com/lng/e_article000993988.cfm?x=bc0qgn0,b186n0qP).
8 In re: Jiffy Lube International Inc. Text Spam Litigation, case number 3:11-md-02261, in the U.S. District Court for the Southern District of California.
10 The court looked to the language of the franchise agreement defining events of default. The court considered the facts that Panagakos pleaded guilty and that the tax evasion scheme was “intimately connected with the operation of his Dunkin’ Donuts’ franchises in determining that Panagakos’s activity constituted a material breach of the agreement.”
brand” focus of this paper, would the reverse be true? Would a similar situation involving a franchisor’s executive or the company itself give rise to rights of a franchisee to claim breach of the franchise agreement and harm to the brand, and thereby the franchisee? Importantly, this is where corresponding franchisor default provisions for “acts injurious or prejudicial to the goodwill,” which are conspicuously absent in most franchise agreements, creates a potential double standard in the franchise system. However, franchisors combat this theory by arguing that the franchisee is buying the franchise for the brand and not any particular parent or individual associated with the brand; whereas the franchisor likens the franchise agreement to a personal services agreement such that the actions (and sometimes reputation) of the individual(s) owning the franchise is material to the contract.

While the Dunkin’ case was a win for a franchisor, not every bad act by a franchisee gives rise to a right of termination or damages to a franchisor based on a harm to the brand basis. In Wisconsin, a state with a franchise relationship statute requiring good cause for termination, a court determined that a misdemeanor theft conviction was not good cause for termination despite negative press that one could legitimately argue harmed the brand in the market (even if not globally).11 In the case, a Wisconsin franchisee convicted of three counts of misdemeanor theft for collecting government benefits, despite earning well over the maximum income threshold. After a local newspaper ran an article with the headline entitled, “Once Upon a Child owner sentenced to jail for BadgerCare fraud,” and noted the location of the two Once Upon a Child stores, franchisor Winmark notified the franchisee of its intent to terminate the franchise agreements. The franchisee filed an action to enjoin Winmark from terminating the franchise because there was not good cause for termination under the Wisconsin Fair Dealership law. After finding that franchisee would suffer irreparable harm if the franchise agreements were terminated, the court determined that plaintiff had “some” likelihood of success on its claim that good cause did not exist for termination, and the Wisconsin court granted the franchisee an injunction prohibiting the termination.12 One wonders if this case turned on the nature of criminal acts and less on the bad press that resulted, or if the case would have been different if not in a relationship law state such as Wisconsin. Also, since franchise agreements typically have termination upon notice provisions for franchisee criminal acts, but may have cure rights associated with “acts that are injurious to the brand” defaults, the outcome could have been different based on the contract drafting itself.

Other than the Jiffy Lube situation, when could a single franchisee’s acts actually harm the brand on a macro level? The authors are aware of a situation where the main owner and operator of a franchised unit of a children’s-focused franchise system was arrested and charged with indecency with a minor, made all the worse because the location was in the franchisor’s most densely packed market, and the acts

11 Romper Room Inc. v. Winmark Corp., 60 F.Supp.3d 993 (W.D. Wis. 2014).
12 The court focused on the fact that the franchisees were long time owners and operators of the franchise. In assessing the likelihood of success and whether or not there was good cause for termination, the court looked to how good cause was defined in the franchise agreement. The agreement stated: a franchisee is in default if an owner is convicted of “violating any law which adversely impacts the reputation of the franchised business” or if the franchisee “is involved in any act or conduct which materially impairs the good will associated with the name ‘Once Upon a Child’ or any of the Marks or the Business System.” The court noted that there was “no evidence...that the name “Once Upon a Child” or any of its marks [were] materially impaired,” and that the franchisor only pointed to several “isolated comments” that were made after a newspaper article reported on the owner’s conviction. The court also mentioned the significance of sales – i.e. the fact that sales had actually increased at the franchise since the article. The court seemed primarily concerned with the actual effects of the publicity rather than the conviction or conduct itself. Id. At 998.
occurred at the location – something made very clear in the press. The harm to over half the system was palpable, but in the end, the franchised location closed, and the perpetrator went to jail (and was essentially judgment proof anyway). While there was a lot of consternation, the aggrieved franchisor and franchisees united and focused on rehabilitation marketing.

C. Questionable Franchise Business Choices

1. Unsuccessful System Standards

Developing and opening a business from scratch is difficult. Incredibly difficult. Maintaining and growing a mature business is also difficult. Incredibly difficult – perhaps even more difficult than merely opening a business. A key concept underlying franchising is that the franchisor was able not only to build a business from scratch, but has been able to maintain and grow that business and get to an enviable point where the franchisor is able to replicate that success with its franchisees. Of course, franchise agreements are long-term relationships, and franchisors have to make decisions every day that not only affect their own business, but also the businesses of their franchisees. While the duty of good faith and duty of competence are discussed in greater depth below, this section considers several areas where franchisor concept decisions can go awry, negatively affecting brand or system value. Again, as noted in this paper, the more attenuated the direct link between a franchisor's actions or inactions and intended consequences on a franchisee or group of franchisees, the more the franchisees need to be creative to find liability.

As noted above, franchise agreements generally contain an acknowledgment by the franchisee that brand standards are important and that maintaining high and uniform standards of quality, appearance, and service are paramount to the franchise relationship. Franchisors will therefore set out their rights to maintain brand standard, while franchisees will undertake to comply with such standards, often as more specifically defined or outlined in operations manuals. This compliance obligation can be strict, full, or even material compliance.

The parties’ respective obligations regarding brand standards starts at the beginning of the relationship. Franchisors typically reserve unto themselves the right to consent to the site of a franchisee’s location. Such site approval may take various forms depending on whether the franchisor’s business model involves legal control of the site (as owner or head tenant). Likewise, construction may also be controlled by the franchisor in cases where the franchisee is acquiring a “turnkey” franchise. Save for those situations, the franchisee will have the obligation to identify a site (more often than not with the assistance of the franchisor) and will be required to have such site approved by the franchisor. Furthermore, once the site has been selected and approved, the franchisor and franchisee will each have certain obligations regarding the construction of the premises or build-out of the space occupied by the franchisee. The franchisor's obligations may include: (a) providing the franchisee with a copy of its standards for the construction, design, and layout of the franchise concept, including plans, drawings, specifications, materials, supplies, etc; (b) providing the franchisee with consultation and advice regarding the construction of the premises; and/or (c) approving the various construction stages.

As for the franchisee, typical obligations may include such obligations as: (a) carrying out the construction and layout of the premises in accordance with the norms and specifications set out and provided by the franchisor; (b) choosing and instructing the architects, engineers, designers, or other professionals in accordance with the franchisor’s norms and specifications; (c) submitting plans and drawings relating to architecture, engineering work, decoration, interior and exterior layout to the franchisor for approval; (d) obtaining the required permits and complying with municipal or other authoritative bodies in connection with the construction of the premises; (e) ensuring that the premises are built in accordance with drawings and specifications approved by the franchisor; and (f) submitting periodic construction reports to the franchisor.
These site and construction based obligations are typically governed by more subjective agreement provisions that provide the franchisor subjective approval rights. Claims that arise due to site and construction based obligations are more contractual in nature in terms of timing constraints and satisfaction of brand standards, but at times more subjective rights, duties, and obligations are questioned, especially where ulterior motives are alleged for rejecting or delaying approval for a site, requiring a specific architect or contractor, or rejecting or delaying consent for opening. In these situations, franchisees again rely on theories such as fraud, misrepresentation, deceptive trade practices, and the duty of good faith and fair dealing.

While the look and feel of a unit is important to brand standards, the products and services are generally the core to the brand. The franchisor may (and usually does) identify and designate certain suppliers with whom the franchisee will be required to carry on business and purchase supplies or materials used in connection with the franchised business. The franchisee will be required to deal with those designated suppliers or other suppliers approved by the franchisor. The franchisee will also generally be required to maintain good relations with such suppliers and promptly pay all outstanding bills, accounts, taxes, and other payables to suppliers in connection with the franchised business. As will be discussed below, these vendor relationships can be sore spots in the franchise relationship as the tensions and fine line between franchisor profit and setting and adherence to brand standards (especially with respect to vendor rebates, etc…) collide with franchisee autonomy and profit maximization.

The franchisee profit and return angle can never be overlooked when considering brand standards issues. Franchisees will spend a large amount of money at the outset to satisfy the brand standards as they exist at the time they open their location, and the franchise agreements will generally require them to remodel, modernize, and otherwise maintain brand standards throughout the franchise relationship. Sometimes there are cost limitations or governors on the timing or costs of the changes to be made to maintain brand standards, and sometimes there are not. Franchisors, as the stewards of the brand, bear the brunt of making the hard decisions regarding brand standards and system upgrades, but of course in many instances, it is the franchisees that bear the capital outlay. To that end, franchisors and franchisees always need to take a proactive approach and consider the following.

Whether the franchise agreement(s) expressly permit a franchisor to implement a system-wide change or strategy. First, agreements that provide a franchisor with discretion or reserve a franchisor’s right to change its system give franchisor’s protection from franchisee claims that system changes breach the agreement or duty to act in good faith. Second, the inclusion of arbitration provisions can limit the ability of franchisees to place the entire system at risk through class actions.

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13 Edward Wood Dunham & Kimberly S. Toomey, The Evolution of the Species: Successfully Managing Franchise System Change, 24 FRANCHISE L.J., no. 4, Spring 2005, at 231 (“When franchisees have claimed that system changes breached their franchise agreements, franchisors have generally prevailed by relying on the express franchise agreement reservation of rights, allowing a franchisor to change the system in its sole discretion and as may be required from time to time”); see, e.g., Carlock v. Pillsbury Co., 719 F. Supp. 791 (D. Minn. 1898) (franchisor used the agreement’s provisions to defeat a challenge to its decision to distribute its products through competing outlets); Economou v. Physicians Weight Loss Centers of America, 756 F. Supp. 1024 (N.D. Ohio 1991) (express contract term allowing franchisor discretion); TLH International v. Au Bon Pain Franchising Corp., 1986 WL 13405, No. 86-2061-MA (D. Mass. Nov. 13, 1986) (challenge based on increasing franchisee costs).

14 William L. Killion, Balance the Interests of the Franchisor, Franchisee, and System, 25 FRANCHISE L.J., no. 3, Winter 2006, at 106 (“The franchise agreement must protect the right of the franchisor to morph the system to respond to competition and changes in consumer demands.”).
Whether there is discord between the franchisees with regard to the proposed action. Does the system have a culture of voluntary compliance? If a substantial portion of the franchisees’ support the altered business strategy, it becomes difficult for franchisees to challenge the actions on the grounds that the franchisor acted solely for its own benefit. 

Whether the law limits system-wide actions which may ultimately cause the brand to falter. For example, Wisconsin and New Jersey statutes impose limitations on a franchisor’s right to implement system-wide changes. Notably, the New Jersey Franchise Practices Act: (a) places restrictions on a franchisor’s ability to change its system in a way which requires an unreasonable standard of performance from its franchisees; and (b) potentially blocks a franchisor’s rights to modify its system if such changes cause substantial financial losses to its franchisees. In other states, however, the general common law theories discussed above apply.

Interestingly, franchise agreements seldom contain provisions where the franchisor covenants to carry out research and development or innovate with new or improved products or services. The absence of obligations in this regard therefore begs the question: is this an implied obligation of the franchisor? As addressed in the case study at the end of this paper, at least one Canadian court has ruled that franchisors have an implicit obligation to protect and enhance the brand, which could cover a franchisor’s possible obligation to carry out research and development and innovate. It remains to be seen, however, whether this specific obligation actually exists and in what manner. The authors see this type of claim the most in small franchise systems where the franchise never took off, and there are perhaps two or three franchisees who feel like they are an island unto themselves, and must fill the void left by the franchisor's lack innovation by enacting their own innovations. While many times the franchisor is happy to continue to receive a check for royalties, the franchisee may either want more service for its money or want to pay less for the reduced or lack of service it receives. In other words, the franchisee does not feel part of a brand and wants out. These claims are generally couched in terms of breach of contract, but in the authors’ experience, settlements are normally forthcoming due to the practical realities of the costs of litigation and the size and financial wherewithal of the parties.

2. Failure to Change with Times

Everyone involved with franchising can identify systems that have failed to change with the times. Some systems seem to have been stuck in the mud and may not have even tried to change. Some, try as they might, just cannot keep up with technology, competition, or customer trends. Although such issues may not result in published case law and therefore make it difficult to analyze from the perspective of causes of action, a few examples are well known and interesting to note as meaningful context to ask questions relating to who is liable and under what theory.

Blockbuster is a quintessential example of a once, top-tier brand and franchise opportunity that repeatedly changed with the times. Blockbuster went from renting VHS and Betamax videos to selling candy to selling videos to renting and selling DVDs to renting and selling video games to developing and selling online content. Blockbuster tried to innovate and keep up with the times, but the times eventually caught up with Blockbuster. The juggernaut of the late 80’s and 90’s filed Chapter 11 bankruptcy in 2011 and was bought by a company (DirectTV) that essentially valued the bricks and mortar stores at almost

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15 See Killion, supra note 52, at 106.
16 See Dunham & Toomey, supra note 51, at 238-239.
18 See Dunham & Toomey, supra note 51, at 239.
nothing. Was the franchisor at fault for Blockbuster’s fate even though it had continued to innovate and reinvent itself? Regardless of the bankruptcy, was the franchisor truly liable for the ultimate outcome?

In the end, Blockbuster’s once venerable retail establishments were considered almost worthless – except perhaps as a real estate play for other brands. Consider, was anyone really liable for this? The bankruptcy and ensuing direction taken from the new brand owner meant that those franchisees who still remained lost whatever potential claims they might have had in the bankruptcy and were considered dead weight to some extent by the new owners. In reality, many (but not all) Blockbuster franchisees saw the writing on the wall long before Blockbuster’s ultimate demise, and many sold out, re-branded, or closed and leveraged their real estate holdings to recoup a portion of their investment. The authors are aware that those remaining franchisees ultimately brokered deals with the defunct brand to either obtain trademark licenses or obtain approval to convert to other brands. Ultimately, a business solution was the best course for the affected franchisees given the lack of bargaining power placed upon them via the bankruptcy process.

Those of us in our forties and fifties will remember Howard Johnson’s more than those in their twenties and thirties. It was once one of the largest restaurant chains in the U.S. with more than 1,000 combined company-owned and franchised outlets in the 1960’s and 1970’s. It was unique in offering both hotel and/or restaurant franchises and operations. While the hotel side of the business still exists, it is a fraction of its former self, and there are only a few remaining Howard Johnson’s restaurants. Whether it was the roadside inn aspect of the business, the mom and pop look and feel, or failure to adapt to the times, Howard Johnson’s is another example of a brand that bears little resemblance to its prime in terms of market share, impact, and future prognosis.

In February of 2015, RadioShack, a struggling electronics franchisor, filed for Chapter 11 bankruptcy. The decline of RadioShack occurred over decades and has been blamed by some observers as the result of the company’s failure to adapt to changing times, having largely missed out on the technology revolution. RadioShack had its origins as a hobbyist’s chain, selling CB radios and electronics parts. Many kids today have not even heard of RadioShack and yet are into electronic gadgets of all types and sizes. RadioShack introduced one of the first mass-produced computers, but its computer business became obsolete. RadioShack then tried many new concepts with new stores selling batteries, refurbished electronics, and audio and video equipment – none of which were successful. Having lost its focus, the big box stores captured most of the electronic business. Failing to capture the bulk of the electronics business, including computers and cellphones, RadioShack became a local shop to find cables and other ancillary equipment like headphones, but its business model was not sustainable. Ultimately, a hedge fund bought more than 1,740 RadioShack stores and then bought the RadioShack brand name for $26.2 million. In addition, Sprint reportedly plans to build Sprint shops within 1,435 RadioShack stores, which will be called The Sprint Store at RadioShack. Thus, the RadioShack brand may live on after bankruptcy, although it is unclear whether the brand will be able to find its niche identity again. And of course, its franchisees had to endure this entire process with more questions than answers.

3. **No Advertising/Botched Advertising**

Most franchise agreements provide for the franchisor to receive and spend some amount of money on advertising the brand. It is of course good business to advertise, and we have all grown up with advertisements for McDonald’s, Subway, and others. Some of those advertisements are iconic and hugely

19 See Michael Einbinder & Terrence M. Dunn, *A Franchisee’s Guide to Franchisor Bankruptcy*, 34 Franchise L.J., no. 2, Fall 2011, at 61 (“A franchisee’s claim against the franchisor arising pre-petition will generally be treated as an unsecured claim, with the lowest priority for payment”).
successful (e.g., Subway’s Jared (with a big caveat noted below) or McDonald’s Ronald McDonald). Some have perhaps had less success.

Two iconic burger brands have faced claims related to insufficient and/or ineffective advertising. In *Burger King Corp. v. Austin*, the franchisor’s failure to expend money to market and promote a franchise was found to potentially constitute a breach of the implied covenant of good faith and fair dealing where the franchisor does not exercise discretion reasonably or act consistent with the parties' reasonable expectations. Also, in *In re Burger Chef Franchise Litigation* it was found that the franchisor might have breached an implied covenant of good faith and fair dealing by failing to provide national advertising, among other things, and thus preventing the franchisees from receiving the fruits of their franchise agreements after purchasing the system from a predecessor franchisor.

One interesting advertising case study is Quiznos. In 2006, Quiznos had over 5,000 locations and was one of the fastest growing franchise systems. In 2004, Quiznos came out with an advertising program that involved a number of singing rodents (ok, we will call them rats). The ads were novel, cutting edge – even *avant garde*. They also drove a number of people known by the authors to declare they would never eat at a Quiznos again. Rats and a restaurant chain that has its primary food items sitting out in the open and is perhaps not best known for its sanitation and restaurant appearance – not a winning combination. The advertising programs were perhaps the least of many factors that lead to the Quiznos system’s hard times, but is there a claim against the franchisor for bad decision making? The authors did not find specific instances of the advertising being addressed in the cases, but how would the claim be couched? Breach of a duty of competence? Breach of a fiduciary duty related to the use of the market fund?

To show how subjective it could be to assess success or failure in advertising for a brand, at the start of this paper drafting process, the authors noted (and still note, now with a caveat) that the Subway Jared campaign was a huge success for the Subway brand and had been for years. Then, as the end of the paper drafting process, Jared Fogle’s home was raided in what initially a child endangerment investigation and later turned out to be a child pornography case for which he will purportedly plead guilty. Subway purportedly cut ties with Fogle almost immediately after the story first became known to the public. The story made front page news upon its release, then again when Fogle pled guilty and other details came out, and serves as a reminder that not all press is good press. The unfortunate Subway/Fogle events illustrate that what is deemed today to be a stroke of genius on the part of the franchisor may not always have a happy ending. Posing whether a claim for failure to vet Fogle could be lodged if facts come out that make the situation and history much worse than might currently be anticipated? For instance, if Subway knew about Fogle’s actions and chose to ignore its knowledge, or worse, cover it up; could franchisees who benefited financially from the Fogle campaign now bring claim for damages?

Couponing is another area that can be a plus or minus for a business; the age old question of maximizing sales vs. profits. So long as a franchisee stays open, the franchisor makes money regardless of whether the franchisee is in the black or in the red. Couponing, Grouponing, sweepstakes, contests, and

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21 *BUS. FRANCHISE GUIDE* (CCH) ¶ 9072 (N.D. Ohio 1987).


other advertising programs are designed to drive customers to a business and increase top line sales. But such programs also cut into the operator’s profits. Franchisors routinely decide on global couponing or discounting plans (think 99-cent Big Mac®), but not all of them work. And sometimes if couponing is too aggressive or used too often, the customer base expects a deal, and the franchisee has to reduce or eliminate a margin to retain a customer base that perhaps was okay paying a bit more a month or year before. An example of an industry that has embraced (and perhaps overly embraced) couponing is the pizza delivery market. Customers expect coupons and daily specials, and many times will search out the coupons and specials that are available as a factor weighing on the purchase decision as much as the product itself. If a franchisor embraces couponing and goes overboard, and a franchisee is adversely affected either because they go along with the program or holdout and lose customers to company-owned or rival franchisee locations that do embrace the couponing, is there a claim against the franchisor? How would the claim be couched?

To protect the brand, it is important that promotions be honored as advertised. The case of In re Kentucky Grilled Chicken Coupon Marketing & Sales Practice Litigation²⁴ is a good example of the importance of honoring promotions. After developing a new menu item called “Kentucky Grilled Chicken,” KFC announced on the Oprah Winfrey show that it would give away a grilled chicken meal during a two-week period to anyone who downloaded a coupon. Over ten million coupons were downloaded. Thereafter, KFC altered the promotion to make it harder to redeem. Plaintiffs, a class action group of over five million customers who alleged that their coupons were refused, filed suit against KFC for breach of contract, fraud, and statutory consumer protection claims. KFC subsequently settled the lawsuit, but upsetting five million customers most likely had a lasting effect.

After a short-lived honeymoon period for Kentucky Grilled Chicken, sales of grilled chicken began to decline, and the KFC National Council & Advertising Cooperative (NCAC), representing all U.S. franchisees, sued KFC for control of the marketing strategy.²⁵ The NCAC believed that the grilled chicken buzz would hurt the brand’s primary focus on fried chicken. On January 31, 2011, the Delaware Chancery Court found the franchisee advertising cooperative had the power to propose and approve advertising for the KFC brand, while the franchisor FKC had control over the brand’s national advertising and public relations firm.²⁶

Organized in 1964, the NCAC’s purpose was to maintain and use advertising fees paid by each KFC franchise. After an eight-year class action lawsuit between the NCAC and KFC regarding each party’s control over advertising, the parties settled the lawsuit in part by renegotiating the terms of the NCAC’s Certificate, which set forth the powers of the NCAC and KFC, including each party’s role in approving advertising plans and strategies. Since the Certificate was not a model of clarity, the Court used contract interpretation rules and examined extrinsic evidence to construe the certificate to mean that “KFC[C] has primary responsibility to make recommendations to the NCAC for the Committee’s approval but the NCAC retains the authority to make recommendations of its own or modify KFC[C]’s recommendations and then vote on those recommendations by majority rule.”²⁷


²⁵ Of note, this matter was an action for declaratory relief so some of the more creative actions and theories of recovery addressed in this paper were not raised.


²⁷ Id. at *28.
Franchisees and the franchisor may have different visions on how to help the brand succeed. Thus, the power allocated between any marketing co-op and the franchisor should be clearly set forth (unlike the KFC/NCAC Certificate, the ambiguity of which led to litigation).

D. Franchisor and Franchisee Bankruptcy

Many in franchising consider a bankruptcy filing the ultimate sign of failure, and while bankruptcies come in a variety of forms and can lead to a number of different results for a brand or for individual franchisees, there are always those who will lose money, time, and goodwill, and in many cases that money, time, and goodwill is not capable of being recouped. Still, for a brand, and sometimes even for its franchisees, a bankruptcy can be a chance to turn things around and create some sunlight at the end of the tunnel – even if passage through the tunnel is extremely difficult and wrought with obstacles. This section highlights some of the pros and cons for both franchisors and franchisees arising from the bankruptcy process.

1. Chapter 7

A Chapter 7 bankruptcy in a franchisor context is the equivalent of global thermo nuclear war; the franchisor is going out of business and a court-appointed receiver liquidates the assets (including corporate stores) and distributes the proceeds to creditors. Typically, the franchise agreements are voided, and the franchisees are permitted to continue operating using some other name and system, but in some instances may be permitted to use the existing brand name and system if the brand itself is bought by a party that sees some value in the brand. In such a situation, there is typically some trade-off between service obligations for the new owner and royalties and other payments owed by the franchisees.

Original Roadhouse Grill is an example of a chain of casual dining steakhouses that originally filed for Chapter 11 bankruptcy in October of 2007, but was then was forced into Chapter 7 liquidation in May 2008 when all the company stores were sold. A few franchises remained open, but obviously faced a new world order.

2. Chapter 11

In the franchise industry, a Chapter 11 bankruptcy is more common that Chapter 7, especially for a franchisor with an otherwise strong brand and “fixable” problems. In Chapter 11, a franchisor continues to do business and seeks to develop a reorganization plan to return the franchisor to a financially viable position. Since the franchise payments are usually a primary source of revenue for the franchisor, the franchisor will generally want to reaffirm the franchise agreements as part of its plan of reorganization.

One of most factually interesting Chapter 11 bankruptcies occurred with the Ground Round System. Formed in the late 1960’s, the system grew to almost 60 company-owned locations and 60 franchised locations. Then, in February 2004, the franchisor abruptly closed all 59 corporate-owned restaurants and staff stopped answering the phones, leaving the franchise system without any answers to their myriad of questions. The franchisor eventually filed for Chapter 11 bankruptcy, and bidders appeared for the brand, but an enterprising group of franchisees orchestrated a purchase of the system and created their own “independent owners cooperative” to run the system. This was a situation where it appears there were no specific court cases brought by affected franchisees because of the bankruptcy and a focus on a resolution through the fairly quick buyout. While Ground Round has not been a huge


success story, there are still upwards of 30 locations operating, and the brand's sordid past is an example of a path franchisees can take, via the bankruptcy process, to control their own destiny if properly motivated and funded.

Schlotzsky’s is another interesting Chapter 11 story. By 2001, Schlotzsky’s was publically traded with almost 760 stores and over $400 million in sales. However, certain programs and decisions that helped with the rather explosive growth of the system (including an area representative sales/service program and a turnkey franchise sales program with limited franchisor guarantees) coupled with a downturn in the economy, growing competition in the sandwich sector, and a number of other factors, ultimately resulted in a mass of restaurant closures, lawsuits, and cash flow issues that resulted in a forced change of management and ultimately a Chapter 11 filing in August 2004. Before and after the bankruptcy filing, and continuing to and through the eventual bankruptcy auction sale of the brand to a third party in January 2005, management and the franchisees struggled with the vision for the brand (larger, higher end buildings with sit-down service vs. smaller, leaner buildings with core menu items), and control over the supply chain and key proprietary products and advertising programs, among other things.

Although most of the Schlotzsky’s cases that preceded the bankruptcy were not published, the key argument by many of the area developers and franchisees was that the management changed the brand from what it was originally, and the changes did not work. The franchisees who built and maintained a unit that was built on the then-current prototype found difficulty characterizing their claims, but the area representatives who purchased rights to offer and sell franchises when the prototype was smaller, cheaper, and (allegedly) easier to sell found a stronger perch in arguing that the move to the larger, more expensive prototype was harder to sell and therefore harder to make quota and make money. These changes were the topic of their claims, couched as breaches with respect to disclosure and contract rights at the time of sale of the area representative right, but at the heart of the claims lies concept of a franchisor’s competence and decision-making authority, some discussed in greater depth later in this paper.

In the end, the Chapter 11 bankruptcy enabled the brand to jettison its area representative program and certain disgruntled franchisees and flush away a number of costly pending lawsuits and legacy lease and equipment guarantees, which helped enable the new owners and later subsequent owners to focus on the brand, the products, and the franchisees that remained. While it has never come close to the almost 760 stores it had, the brand has definitely been reinvigorated, and those franchisees that weathered the bankruptcy and related storm have definitely seen the benefits of the Chapter 11 process in terms of how it can revitalize a brand for the benefit; not only for the brand’s creditors, but also for its franchisees who were negatively affected by the failures of its franchisor but were able to weather the storm.

The bankruptcy of a major franchisee can of course have material effects on a brand, and induce assistance from a franchisor for the betterment of the system. The majority of Burger King locations are franchised stores, and in the early 2000’s, many Burger King franchisees were facing financial distress. Burger King’s largest franchisee, the almost 400-location AmeriKing, filed for Chapter 11 bankruptcy. AmeriKing’s bankruptcy most likely played a role in the decision by Burger King’s British parent at the time (Diageo) to sell the company at a sharply discounted price to a group of American investors. After the sale, Burger King initiated a program to help about twenty percent of its franchisees who were in financial distress by partnering with an investment banking firm and establishing the Franchisee Financial

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30 Schlotzsky’s, Ltd., v. Sterling Purchasing and Nat’l Distribution Co., Inc., No. 06-50720, United States Court of Appeals, Fifth Circuit, March 5, 2008.
Restructuring Initiative. In addition to taking advantage of the Initiative, franchisees also took advantage of AmeriKing’s failure by purchasing locations at a deeply discounted price. After investment and retraining, many of the former AmeriKing locations have shown increased profitability.

3. **Affiliate Failure**

Similar in part to Ground Round, in 2008, a private equity parent of the Bennigan’s chain closed all 150 corporate restaurants and filed for Chapter 11 bankruptcy. At the time, there were 137 franchised restaurants. The franchisees were technically not directly affected in terms of their franchisor entity and franchise agreements, which were not part of the bankruptcy. However, the onslaught of negative press, the existence of multiple “Closed” signs on neighboring restaurants with the distinctive Bennigan’s coloring, and the effect on vendors definitely resulted in the franchisees' suffering. The franchisees underwent a series of attempts to organize for purposes of action against the franchisor and its affiliates. Ultimately, the efforts proved unsuccessful in terms of a litigation solution or remedy.

While there were certainly a number of franchisees that could not sustain the massive closure of corporate restaurants, Bennigan’s became an interesting success story with a new CEO and private equity owner that essentially took the position that there was nowhere to go but up, and while Bennigan’s can never change the past, it can focus on the future. Bennigan’s experiment ultimately lead to a 2014 purchase of the chain by the very CEO who took over after the affiliate bankruptcy.

E. **Third Party Bad Acts or Events**

1. **Supplier Actions**

While franchisor and franchisee profit and return are obvious reasons to enter into a franchised business and focus on supply chain matters, risk analysis dictates that supply chain diversification and redundancy is just as important if not more important. If a concept has an irreplaceable secret sauce or widget that is crucial to its system, is it prudent to have only one manufacturer with one factory for such sauce or widget, or is it necessary in order to maintain the proprietary nature of the item? Does that factory sit on an edge of a large river that has a tendency to flood, or on a wide open plain in Oklahoma that gets a little wind from time to time? Regardless, if the franchisor has not diversified with other manufacturers or demanded that its one manufacturer produce the item at multiple factories, is the franchisor liable for negative outcomes? If the franchisor in default of the franchise agreement; acting in bad faith? What standard does a franchisor have to follow when selecting/vetting suppliers?

If a supplier fails to deliver or delivers damaged goods, the franchisor could be subject to liability. Customers could get sick if the product is bad, or a franchisee without product to sell might have to close. Because of these risks, suppliers, franchisees, and franchisors generally attempt to allocate these risks in their franchise agreement. Indemnification and insurance are important provisions and typically provide that the franchisor will be indemnified by the supplier for the supplier’s breach of the supply contract. And when a third-party, like the ill customer for example, brings suit against the franchisor and franchisee, a properly drafted indemnity provision requires the supplier to be ultimately responsible for any damages and attorneys' fees. In addition, requiring insurance of suppliers brings in a deep pocket source for major claims (i.e. customer food-borne illness claims) against the franchisor and franchisee.

Whenever health and safety are of immediate concern, the thoughts of franchisors and franchisees alike should both run to immediate action, but the aftermath is always more nuanced. Does the franchisor have a legal, moral, or relationship obligation to prop up the brand and/or directly help the franchisees? Do the franchisees have legal claims against the franchisor or other franchisees who may have been directly involved with the underlying event?
A worst case scenario example of catastrophic supplier issues bringing down a franchise system is the 2003 Chi-Chi’s Mexican restaurant chain outbreak of Hepatitis A, which was the largest such outbreak in U.S. restaurant history. While the cause of the outbreak was later found to be the fault of certain suppliers, Chi-Chi’s could not fulfill the claims that came out of the outbreak and the overarching brand damage was too much to overcome. Many franchised and other locations closed or were converted, and the system was never the same. The suppliers were also overwhelmed with claims. While Outback eventually purchased Chi-Chi’s, the remaining restaurants were all closed or converted.

In 1993, the Jack in the Box franchise system was rocked by an E. coli outbreak in which 732 people were infected across 73 Jack in the Box restaurants in California, Idaho, Washington, and Nevada. Making matters worse, many of the victims were children. The ensuing litigation resulted in individual and class-action settlements totaling more than $50 million. While definitely not an issue isolated to Jack in the Box, the system has been forever linked to food borne illnesses, and the brand and its franchisees have and will likely continue to suffer harm and incalculable losses due to this now 20-year old event. Of course, new franchisees would likely have knowledge of the event and buy in with such knowledge, but what if a similar incident were to occur in the future? Customers are loyal and can have short memories, but for some, would it be two strikes and you are out?

What about the supplier who caused the foodborne illness? Can a franchisor recover against the supplier for damage to the brand? In July of 2000, over 150 people became ill after eating food contaminated with E. coli at two Wisconsin Sizzler restaurants. The meat was apparently cross-contaminated by the supplier, Excel. Excel supplied the meat to two Wisconsin franchisees under a sales agreement with the Sizzler franchisor. Plaintiffs sued Excel, the franchisee, and the franchisor. After the claims with the injured plaintiffs were settled, Excel, the franchisor, and the franchisee went to trial to apportion liability. The meat packer claimed that the franchisor and franchisee should share responsibility and blamed the franchisee for causing the cross-contamination by using unsafe practices. After a jury trial, the jury assigned 80 percent of the liability to Excel, 20 percent to the franchisee, and none to the franchisor. Sizzler then sought indemnification for its lost profits caused by the scandal from Excel. After 12 years of litigation, in 2012, the Wisconsin Supreme Court confirmed the jury’s verdict and awarded the franchisor $13.5 million in lost profits, costs, and interest.

2. **Terrorism or Criminal Event in Region or at Location**

In May 2015, a franchised Twin Peaks restaurant in Waco, Texas was the scene of a gun fight between police and rival biker gangs in which 9 bikers died, 18 were wounded, and more than 170 landed in jail. The franchisee allegedly cultivated the biker community and hosted events at the restaurant, and the police allegedly warned the franchisee about violence to no avail. After the gun fight, the franchisee

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31 See Vons Cos., Inc. v. Seabest Foods, Inc., Cal.4th 434, 441 (Cal. 1996)

32 Id. at 442.

33 Estate of Kriefall v. WSizzler USA Franchise, Inc., 816 N.W.2d 853 (Wis. 2012).

34 The authors did not find published actions franchisees against franchisor, only claims against supplier. Estate of Kriefall v. Sizzler USA Franchise, Inc., 816 N.W.2d 853, 867 (Wis. 2012).

35 It is important to note that much of the information about this specific event in the hours and days after it occurred came from the Waco police department, which made many of the statements regarding these alleged actions by the franchisee. Posing whether the franchisee has any claims against the Waco police department if the statements made in those first hours and days turn out to be incorrect?
quickly attempted to terminate the franchisee’s franchise agreement. Thereafter, the franchisor filed a petition seeking a declaration that it was entitled to immediately terminate pursuant to the franchise agreement, which allows for immediate termination with no opportunity to cure when a restaurant is closed by any state or local authority for health or safety reasons and when the franchisee defaults in a manner that materially impairs the goodwill of the franchisor. While the disputes between the franchisor and franchisee over the incident and the ensuing termination will likely continue for some time, it is also likely that there will be third-party lawsuits filed against the franchisor and franchisee by victims’ families and others.36

It is not just isolated events that can give rise to disputes over terrorism or criminal activity. The authors are aware of one scenario involving a large U.S. restaurant brand that attempted to enforce development schedule obligations for a franchisee whose territory included the western border of Mexico. The franchisee (who actually lived across the border in Arizona) claimed force majeure or some type of equivalent was precluding it from meeting its obligations under its development agreement. Specifically, the franchisee claimed the “ongoing and escalating drug war and violence in Mexico” was preventing it from developing new locations. Importantly, the franchisee had territory across seven different Mexican States (Sonora, Sinaloa, Chihuahua, Baja California, Baja California Sur, Nayarit, and Durango) covering approximately 300,000 square miles of land in what was admittedly the heart of Mexican drug war violence at the time (circa 2010 to 2012). The franchisor disputed the force majeure claims and pointed to the franchisee’s existing restaurants in the territory and the franchisee’s own admitted visits made to the existing restaurants. The franchisee ultimately dropped its argument. Still, the potential for a more viable force majeure claim made on a smaller swath of territory is definitely possible both domestically (consider recent troubles in Ferguson, Missouri) and internationally (there are still certainly smaller areas of Mexico and portions of the Middle East that one might be able to legitimately claim are off limits on a force majeure basis).

Franchised businesses can also be uniquely vulnerable to payment card data breaches.37 In 2014, Dairy Queen, Jimmy John’s, and the UPS Store were all victims of hackers. Franchisees, which often use the franchisor’s mandated point-of-sale payment systems, can be at high risk for targeting by hackers. If the standardized point-of-sale system at a franchised location is breached, hackers could have entrée to the other franchisees who use the same point-of-sale. The greatest cost of a data breach to a franchised system can be damage to the brand since customers often associate a breach at one franchised location with a data breach of the brand as a whole, but even at the micro level, a franchisor and franchisee involved in a breach are likely to have to deal with third-party claims, indemnification demands, insurance coverage issues, and related fall-out for years to come.

3. Protests

McDonalds, Burger King, Hooters, Chick-fil-A and other high profile brands have historically been targets for political, social, or religious agendas. From bombings at locations in the Middle East, to

36 The first of such suits was publically announced right before the deadlines for this paper. See DC Waco Restaurant Inc. v. Peaktastic Beverage LLC et al., No. DC-15-05787 (44th Dist. Court, Dallas County, Texas May 21, 2015). Others have since followed. See, e.g., Chalak TP Waco, LLC v. Twin Restaurant Franchise, LLC, No. DC-15-05954 (68th Dist. Ct., Dallas County, Tex. May 27, 2015) (breach of contract); Chalak Peak Restaurants, LLC v. Twin Restaurant Franchise, LLC, No. DC-15-05955 (116th Dist. Court, Dallas County, Tex. May 27, 2015) (breach of contract); Rodriguez case (victim – alleges negligence); DC Waco Restaurant Inc. v. Peaktastic Beverage LLC et al., No. DC-15-05787 (44th Dist. Ct., Dallas County, Texas May 21, 2015) (neighboring restaurant – alleges negligence).

protests for workers’ rights to sit-ins for religious tolerance (or intolerance), these types of disruptions cause harm and damage to the brands and the specific businesses.

Chick-fil-A was picketed and boycotted in 2012 after its CEO, Dan Cathy, publically expressed his view opposing same-sex marriage. Petitions were launched by social activism groups demanding that universities remove Chick-fil-A restaurants or prevent new ones from opening, and mayors in Boston and Chicago proposed bans of the restaurant chain. Marketing research companies reported a significant drop in perception of the Chick-fil-A brand, although sales increased despite the bad public relations, in part due to backlash from Cathy supporters. Also, anecdotally, it is fairly well known that many of the Chick-fil-A franchisees are of a like mind with Cathy and may have actually supported his positions despite potential effects on their businesses. Cathy later backed away from a socially conservative agenda, perhaps recognizing that mixing personal opinions on social issues and business may do long-term damage to a brand – especially a brand with a goal of major growth outside of its traditional Southern base.

F. Uncontrollable Defaults

As noted above, almost every franchise agreement has a force majeure clause, and almost every franchisor and franchisee understand that things can happen that are outside the control of the parties. Franchise agreements may provide for a tolling of operations or obligations, or even a right of termination if the uncontrollable event is catastrophic, but many uncontrollable defaults or mistakes do not rise to the level of force majeure or do not completely block operations or performance. In these types of situations, the secret of franchising rears its head again. The franchisor is likely better off if the location stays open and has sales and generates royalties, even if materially less than before the uncontrollable event. The franchisee on the other hand is likely better off closing, relocating, or retooling operations assuming the uncontrollable event has made making a profit impossible or improbable. This section reviews the interplay between franchisor and franchisee when the outside world has macro or micro effects on a brand.

1. Regulatory Changes/Economic Downturns

There are requirements in Item 1 of the FDD to describe both the general nature of the business and potential competition, as well as the laws, rules, and regulations pertaining to the franchisor’s industry. Sometimes, this portion of Item 1 is given short shrift with fairly vague language about competition from many sources, and potential regulation at the federal, state, and local levels, and then a final admonition is given that the franchisee should consult its own advisors to confirm which laws and potential restrictions or prohibitions may apply in their territory.

While no one can predict the future, and regulation is a fact of life in the United States and many international jurisdictions, there have been instances when entire franchise industries or systems, or even just regional or local groups of franchises, have been affected by laws that make their business either impossible to operate or unprofitable.

2. Legal Changes

Quasi-medical franchise systems in the optical, dental, laser hair removal, weight loss, and spa industries have been at the cutting edge of law and regulation vs. industry issues. When reading an FDD for these systems, one may see language regarding the need for a licensed doctor or technician along with language regarding the separation of medical and administrative services. The legal issues at play, which include the corporate practice of medicine, Health Insurance Portability and Accountability Act of 1996, and related state privacy laws, licensing requirements, and fee-splitting prohibitions are myriad and are
traps for those who do not conduct proper research and due diligence. Whose obligation is it to wade into and resolve these issues? The FTC does not really weigh in with its franchise rule; nor do the states — although certain states are becoming more vigilant in this area. Regardless, a franchisor remains vulnerable to deceptive trade practices and fraud claims if the legality of the franchise model described in the FDD is questioned.

Just because a franchisor was able to get its business up and running in Texas does not mean that it will work in California, and in fact California was one of the first to wade into this area. In California Ass’n of Dispensing Opticians v. Pearle Vision Center, the Court considered whether Pearl Vision was effectively practicing medicine. The franchisor essentially controlled the look and feel of the location, but also aspects related to frames, lenses, and the laboratory for machining the lenses to fit the frames selected. In considering whether franchisee laymen were practicing medicine, the Court found that the franchisee could not have any authority over an optometrist or split fees for the medical work, BUT could control and manage the business elements (vs. healing arts elements) of the system. This management services model is now the norm for healthcare businesses, but that is not to say it works everywhere. Interestingly, the California Department of Business Oversight has recently taken to demanding additional information and disclosures regarding California-specific laws, rules, and regulations in its Item 1 descriptions, even in restaurant franchise disclosures.

More recently, the U.S. Food and Drug Administration and regional and state and local governmental equivalents have been attempting to regulate the waistlines of Americans by continuing to find ways to make restaurant brands highlight unhealthy products to consumers. Whether via a ban on a certain ounce soda targeting convenience stores or the new FDA rules requiring calorie information be listed on menus and menu boards in chain restaurants and similar retail food establishments, this type of regulation can have materially adverse repercussions on businesses that promote taste or bang for the buck over light and lean menu items. Additionally, if the franchisor takes the lead in determining the calorie and other nutrition information presented to consumers, it is still up to the franchisee to prepare the product and deliver it in portions that correlate to the calorie information presented. If consumers are sold menu items that are tested and are determined not to contain the number of calories consistent with the information presented, who is liable; the franchisee for not preparing the item properly or the franchisor for not enforcing its standards (assuming the calorie information is accurate if the product is prepared and served to standard)?


39 All of us know that certain fast foods or amounts of food are unhealthy, but that does not mean we want to read about it right before eating it. For example, the new menu labeling rule is designed to help consumers understand the significance of the calorie information in the context of a total daily diet by requiring a succinct statement: “2,000 calories a day is used for general nutrition advice, but calorie needs vary” to be included on menus and menu boards. In addition, an adjusted calorie count statement for children must be present on kids’ menus. The final menu labeling rule also requires covered establishments to provide, upon consumer request, written nutritional information about total calories, total fat, calories from fat, saturated fat, trans fat, cholesterol, sodium, total carbohydrates, fiber, sugars, and protein. Interestingly, the FDA announced in July 2015 that it was postponing the compliance deadline until December 1, 2016.

There are lots of franchised restaurants that are likely to have embarrassingly high numbers that are required to be placed on menus and other materials. Franchisors will need to weigh the options of healthier ingredients and smaller portions against upsetting a core customer group that may know and not care about the healthiness of the franchisor’s products.
One of the most recent and pressing “global” shifts is the minimum wage requirements in Seattle and most recently in Los Angeles. While it is still too early to tell how high employee count/low margin businesses will be affected and how franchisors and franchisees will react, it is not hard to imagine scenarios where claims will be made that a franchisor has an obligation to change its standards as to employee counts in units, or help automate the business to reduce employee counts, and then conversely whether the franchisee has options to close the business without penalty if the cost paradigm makes the business unprofitable.

III. POTENTIAL PATHS TO RECOVERY FROM THOSE LIABLE

As previously mentioned, when franchisees seek to recover alleged damages stemming from actions or inactions of the franchisor, they typically rely on breach of covenant of good faith fair dealing claims, which are analyzed by interpreting case law, and in a few instances, by applying state statutes. To prevail on deceptive trade practices claims, franchisees typically rely on state relationship and other state laws. Some franchisees may seek recovery under the lesser alleged breach of duty of competence claims. (The authors referenced a RICO claim in one example discussed above, but the majority of cases relating to the topic of this paper do not illustrate that RICO claims are commonly alleged.)

A. Good Faith and Fair Dealing Claims and Jurisdictional Overview

Section II of this paper provides detail regarding the obligations that exist in the franchisor/franchisee relationship, and “ensure the brand does not fail or falter” was not listed or discussed. Most franchise agreements (if not all) do not create a specific obligation on the part of the franchisor or the franchisee to “ensure the brand does not fail or falter.” But does the implied covenant of good faith and fair dealing create such an obligation? As mentioned above, franchisees often make this claim when trying to recover alleged damages from franchisors.

The covenant of good faith and fair dealing is recognized in most states as an implied duty in all commercial contracts. The common law imposes a duty to seek diligently and in good faith to comply with all terms of a contract. But, as with the UCC, the common law requirement of good faith and fair dealing is not an independent source of duties for the parties to a contract. General allegations of breach of the implied duty of good faith and fair dealing not tied to a specific contract provision are not actionable. Further, “[t]he covenant to perform in good faith modifies the meaning of all explicit terms in a contract.”

Therefore, based upon current U.S. law, if a party wishes to rely on the covenant of good faith and fair dealing to determine the appropriate roles of the franchisee and the franchisor when the brand falters, the franchise agreement would most likely need to include specific obligations requiring the franchisor and the franchisee to "prevent the brand from faltering." Given the myriad of events and

40 Teri J. Dobbins, Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts, 84 OR L. Rev. 227, 227 & n.4 (2005). Texas, Indiana, and Virginia are exceptions. Texas has specifically rejected that the duty of good faith and fair dealing applies in all contracts. See Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp., 823 SW2d 591,595 n.5 (Tex. 1992). Indiana courts have held that the covenant can be inferred in a contract in order to effectuate the clear intent of the parties. See Prudential Ins. Co. v. Crouch, 606 F.Supp. 464, 469 (S.D. Ind. 1985), aff'd, 769 F.2d 477 (7th Cir. 1986). Virginia appears not to recognize the covenant unless the contract is governed by the UCC. See Green Assocs., Inc. v. Crestar Bank, 448 S.E.2d 399, 402 (1994).
41 Am. Casual Dining, L.P. v. Moe's Southwest Grill, L.L.C., 426 F. Supp.2d 1356, 1370 (citing Alan's of Atlanta, Inc. v. Minolta Corp., 903 F.2d 1414, 1429 (11th Cir. 1990)).
42 Id. See also C.K.H., LLC v. The Quizno's Master, LLC, Bus. Franchise Guide (CCH) ¶ 13,027 (D. Colo. 2005) (stating that the duty of good faith and fair dealing does not inject substantive terms into the parties' contract; rather, it requires only that the parties perform in good faith the obligations imposed by their agreement.)
variables that could contribute to the faltering of a brand or that could prevent a brand from faltering, drafting such provision presents a daunting challenge.

1. **Reasonable Performance of Obligations**

Some courts have interpreted the covenant to mean that the parties must “honestly and reasonably carry out their contractual obligations.” This interpretation dictates the manner in which (how) the parties must meet their obligations, but it still requires that such obligations exist.

Therefore, in order for a plaintiff to state a claim for breach of the implied duty of good faith and fair dealing, a plaintiff must present facts that show a breach of an explicit term of the franchise agreement, and rarely, if ever, is “ensuring the brand does not fail or falter” an explicit obligation of the franchisor or the franchisee.

2. **Fruits of the Contract**

Some courts equate a party's obligations under the covenant of good faith and fair dealing to mean that the party must deliver the “fruits of the contract” to the other party. In *Emerson Radio Corp., v. Orion Sales, Inc.*, Emerson alleged breach of the implied covenant of good faith and fair dealing against Orion. In an agreement between Emerson and Orion, Orion had the right to distribute Emerson-branded products to Walmart, and Emerson had a minimum annual royalty payment requirement of $4,000,000. However, Emerson alleged that Orion persuaded Walmart to purchase Orion's products instead of Emerson's, and even though Orion paid the minimum royalty to Emerson, Emerson claimed that it expected more than the minimum.

The Third Circuit held that Orion could be held liable for failure to perform its obligations in a manner that did not meet Emerson's expectations. The Court stated that in New Jersey, the implied covenant has been defined to mean that “neither party shall do anything which shall have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.” The Court entered into an inquiry of the parties' reasonable expectations, and even though Orion had fully complied with the terms of the agreement, it faced potential liability for failure to meet Emerson's expectations, which were deemed by the Court to be reasonable.

The broad definition of good faith provided by the *Restatement (Second) of Contracts* is not inconsistent with the “fruits of the contract” interpretation. The *Restatement* provides:

The phrase “good faith” is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving “bad faith” because they violate community standards of decency, fairness, or

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45 *Id.* at 166.
46 *Id.* at 171.
47 *Id.* at 170 (quoting *Sons of Thunder, Inc., v. Borden, Inc.*, 690 A.2d 575, 587 (N.J. 1997)).
48 *Id.* at 170-71. (According to the Court, Emerson put forth considerable evidence of damages it suffered as a result of Orion's intentional conduct.)
reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.49

In Emerson, the Court undertook an analysis that went beyond the explicit obligations set forth in the agreement. And the “bad faith” definition provided by the Restatement clearly takes into account variables that are not found in the explicit terms of franchise agreements.

3. State Relationship Laws

As further guidance when determining whether or not a franchisor can alter the franchisor/franchisee relationship (such as in the case of termination or nonrenewal) as a result of a franchisee’s actions that caused damage to the brand, one can look to state relationship laws. Seventeen states and the District of Columbia have included “good cause” as a condition to altering the relationship, and several states define “good faith” in their state franchise relationship laws.50

B. Duty of Competence Claims and Jurisdictional Overview

When a franchisee enters into a franchise agreement with a franchisor, the franchisee is exposed to the experience and inexperience of the franchisor. While most, if not all, franchise agreements state that the relationship between the franchisor and the franchisee is an independent one, and that the day-to-day operations and success of the location lie with the franchisee, the nature of the relationship is extremely intertwined because the strategic direction and system programs are typically determined by the franchisor. Given that franchisees rely heavily on the franchisor’s ability to make decisions, does the franchisor have a duty of competence that makes it liable to its franchisees for certain decisions or indecisions?

Past efforts to impose federal regulation that would require all franchise agreements to include a duty of care and competence have failed. In 1998, U.S. Representative Howard Coble introduced the Small Business Franchise Act, which passed the House but failed in the Senate. The act would have provided minimum standards of conduct (good faith, due care, and limited fiduciary duty) for each party to a franchise agreement.51 And courts analyze duty of care and competence claims in the same manner as they analyze breach of the covenant of good faith and fair dealing claims – courts look to whether or not the explicit terms of the contract impose such duty on the franchisor.52

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49 RESTATEMENT (SECOND) OF CONTRACTS § 205 & cmt. (a).
52 JRT, Inc v. TCBY Sys., Inc., 52 F.3d 794, 738 (9th Cir. 1995) (stating that the contract did not contain an express term that provided the franchisee an express or inherent right to succeed). See also TCBY Sys., Inc. v. RSP Co., Inc., BUS. FRANCHISE GUIDE (CCH) ¶ 10.206 (E.D. Ark. 1993) (stating that there is a duty of care only where the professions are sanctioned by state law); RHC, LLC et al v. Quizno’s Franchising, LLC et al, BUS. FRANCHISE GUIDE (CCH) ¶ 13,119 (2nd Dist. Colo. 2005) (stating that franchisees cannot create a duty of competence with respect to approval of sites for the establishment of locations); In re Sizzler Rests. Int’l, Inc., BUS. FRANCHISE GUIDE (CCH) ¶ 11,408 (U.S.
Therefore, based upon the prevailing case law, if the franchise system/brand is damaged due to decisions or indecision on the part of the franchisor, franchisees most likely will not be able to rely upon a duty of care and competence theory to impose liability onto the franchisor for such damages.

IV. CASE STUDY: DUNKIN’ DONUTS CASE OVERVIEW AND KEY QUESTIONS

A. History

Dunkin’ Donuts is a world-renowned quick service restaurant (QSR) brand that franchises thousands of restaurants around the globe. Founded in 1950 in Massachusetts, Dunkin’ Donuts first expanded outside of the United States in the Province of Quebec, Canada, in the 1960’s. For more than 40 years, Dunkin’ Donuts thrived in Quebec and built a leading and successful franchise system.

In the mid to late nineties, other competing franchise systems, including a growing Canadian coffee and bakery products concept, Tim Hortons, began to increase its presence in Quebec by opening many new stores in good locations, often with drive-thru facilities. At the same time as the coffee market was becoming more and more competitive, an increasing number of Dunkin’ Donuts stores were experiencing decreasing sales and profits.

In response to the challenges faced by the changing market conditions in Quebec, in late 2000, Dunkin’ Donuts devised a Strategic Growth Plan (SGP), which involved a store remodel program, a heightened focus on operations and standards compliance, a marketing plan, and a franchise development program. One of the key elements of the SGP was the “Remodel Program” which offered specific financial incentives to encourage franchisees to renovate their franchised establishment.

In order to achieve critical mass to quickly impact consumers in Quebec and maximize the positive effect of the remodeled stores on sales, Dunkin’ Donuts determined that a minimum number of stores needed to be remodeled over a two-year period. In the months that followed, the Remodel Program was gaining some traction, but Dunkin’ Donuts faced continued resistance from some franchisees to proceed with remodeling, among other reasons, because they could not afford to renovate.

By mid-2003, only 35 Dunkin’ Donuts stores had renovated, which fell far below the minimum number of stores that the franchisor felt was needed to impact the system. Also, by 2003, Alimentation Couche-Tard Inc. (Couche-Tard) had become one of the more significant Dunkin’ Donuts multi-unit franchisees in Quebec. Pleased with the success of its Dunkin’ Donuts franchises in Quebec, and convinced of Dunkin’ Donuts’ strong brand presence, Couche-Tard persuaded Dunkin’ Donuts to allow Couche-Tard to become the master franchisee for all existing and new stores in Quebec.

Unfortunately, in December 2008, the relationship with Couche-Tard was terminated because of its under-estimation of the Tim Hortons competition and its decision not to invest in the opening of new Dunkin’ Donuts stores in Quebec. Under Couche-Tard’s tenure as master franchisee, the number of Dunkin’ Donuts stores fell from 115 to less than 65.

On May 20, 2003, a group of franchisees sued Dunkin’ Donuts for damages (lost profits) in the amount of $7.4 million based essentially on Dunkin’ Donuts’ failure to comply with its contractual obligations under the franchise agreements and a host of civil faults such as intimidation, tolerance of underperforming franchisees, unfair economic pressure to sign the releases, poor management practices, failure to provide proper support to the franchisees, failure to protect and enhance the value of the brand Bankruptcy Ct., C.D. Cal. 1998) (franchisee’s claim that the franchisor must insure franchisees against failure if the franchisees follow the Sizzler methods and system was unacceptable).
in Quebec, an absence of a proper marketing plan, bad faith in the performance of the franchise agreements, and violation of the general obligation of loyalty owed to the franchisees. Their claim was further amended to add a new claim for loss of investments in an additional amount of $9 million. The total amount of damages claimed was $16,407,143.

B. Original Opinion
On June 21, 2012, the Superior Court of Quebec rendered Judgment in the case of *Bertino Inc. et al v. Dunkin’ Brands Canada, Ltd.* concluding as to Dunkin’ Donuts’ liability on the basis of the breaches of contract and civil faults noted above and awarding all of the franchisees’ claims for the full amount of $16,407,143; *i.e.* $7.4 million for lost profits based on the comparison with Tim Hortons’ sales growth from 1998 through 2005, and $9 million for lost investments, plus interest and costs. In addition, the trial judge denied all offsets in unpaid royalties and ad-fund contributions, thereby dismissing Dunkin' Donuts' counterclaims, and nullified releases signed by some franchisees in the context of their undertaking to accept financial incentives pursuant to the Remodel Program.

Applying the law to the facts, the trial judge decided that the most important explicit obligation agreed to by the franchisor was its promise “to protect and enhance both its reputation and the ‘demand for the products of the Dunkin’ Donuts System’; in sum, the brand” (para. [54]). In the trial judge’s view, the franchisor had done neither, and the judge referred to the interpretations given to paragraph 3.C. of the 1992 franchise agreement and the last recital of the 2002 franchise agreement which read as follows:

3. Dunkin’ Donuts Canada agrees [...]  

3.C. 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 DUNKIN’ DONUTS CANADA, DUNKIN’ DONUTS OF AMERICA, INC. and the demand for the products of the DUNKIN’ DONUTS SYSTEM and, to that end, to make reasonable efforts to disseminate its standards and specifications to potential suppliers of the Franchisee upon the written request of the Franchisee;  

2002 Recital:  

ET CONSIDÉRANT QUE le franchisé comprend et reconnaît l’importance, pour chaque système, des normes et spécifications élevées en matière de qualité, de propreté, d’apparence et de service, ainsi que la nécessité d’exploiter l’établissement conformément à celles-ci afin d’accroître d’achalandage créé par l’élaboration et l’amélioration de chaque système; [...]  

The trial judge also ascribed “a host of other explicit and implicit failings” to the franchisor during the period from 1995 to 2005: failure to consult, support and assist the franchisees; absence of a corporate store to train new staff and test new products; inordinately high turnover of its executives; too few consultants for the network of franchisees; failure to remove underperforming franchisees from the network.  


54 Trial Judgment, Paragraphs 15 and 18.
network; and the implementation and subsequent withdrawal of frozen products, “to name but a few – all chronicled in considerable detail at pages 278 to 341 inclusive of Plaintiffs’ ‘Plan d’argumentation’ (para. [55]). He concluded that these faults had “for the most part been substantiated convincingly from the evidence adduced by the franchisees and from the acknowledgments and admissions flowing from several of Defendant’s witnesses and exhibits” (para. [56]).

The judge rejected, in very strong terms, the franchisor’s defense that the franchisees’ poor business practices were responsible for their own losses, finding instead that it was the breach of the franchisor’s obligations that caused the losses sustained. Furthermore, the judge held that the releases signed by the franchisees as an inducement to renovate their premises after 2001 were signed under the false pretenses as to the amount the franchisor would itself invest in the renovations and on misrepresentations as to the increase in sales that the renovations were to produce. The judge decided that the releases were null, that they were abusive, and that the necessary consent from the franchisees was missing or vitiating (para. [69]).

Having found the franchisor liable, the judge devoted paragraphs [70] to [122] to a consideration of the franchisees’ claims in damages for lost profits and lost investments and to the counterclaim for unpaid royalties and other amounts by the franchisor. The judge awarded the franchisees $7,360,000 for lost profits and $9,047,143 for lost investments, dividing the total among the various franchisees according to his calculation of their individual losses (para. [112]).

The judge dismissed the franchisor’s counterclaim for unpaid royalties and the like as well as damages for defamation and abuse of process. The judge explained his refusal to award damages for unpaid amounts under the agreements on the basis of the doctrine of fundamental breach and the exception of non-performance. He dismissed the claims for defamation and abusive proceedings as unfounded on the evidence.

In sum, the Superior Court maintained the franchisees’ actions, dismissed the cross-claims, annulled the releases, terminated the leases and the franchise agreements, and awarded an aggregate sum of $16,407,143, with interest at the legal rate and the indemnity of article 1619 C.C.Q. from the later of the date of institution of the action and the last day of each fiscal period during which lost profits were sustained or lost investments were realized due to store closures.

At the heart of this decision is the notion that the most important explicit obligation agreed to by the franchisor was its promise “to protect and enhance both its reputation and the “demand for the products of the Dunkin’ Donuts system; in sum, the brand.”55 In the trial judge’s view, the franchisor: (a) had failed to consult, support, and assist the franchisees; (b) had failed to open a corporate store to train new staff and test new products; (c) had an inordinately high turn-over of its executives; (d) had too few consultants for the network of franchisees; (e) failed to remove under-performing franchisees from the network; (f) failed to implement and subsequently withdraw frozen products; (g) and ultimately concluded that all of these faults had “for the most part been substantiated convincingly from the evidence adduced by the franchisees and from the acknowledgments and admissions flowing from several Dunkin’ Donuts witnesses and exhibits.”56

C. Appeal/Opinion

55 Trial Judgment, Paragraph 54.

56 Trial Judgment, Paragraph 56.
On April 15, 2015, the Court of Appeal of the province of Quebec rendered its long-awaited decision on appeal. In short, the Court of Appeal confirmed the trial court’s finding on liability but reduced the damages and granted the Dunkin’ Donuts’ counterclaims.

On the issue of liability, the Court of Appeal stated that the case was not “unprecedented” and summarized its view in the following terms:

[8] In describing the case as one that is “unprecedented” in the annals of franchise law, the Franchisor has, in my respectful view, wrongly characterized aspects of franchise arrangements widely understood by courts and legal scholars in this province as uncontroversial, in particular in respect of duties that may be inferred from the nature of agreements such as the ones in the case at bar. The collapse of the Dunkin’ Donuts chain may well have no match as a financial misfortune in the annals of the quick-service restaurant business in Quebec – that is not an issue for this Court to decide – but nothing in the judge’s account of the Franchisor’s obligations was “unprecedented” or even demonstrably wrong-headed; in point of fact, he was expressly careful to follow precedent, namely the doctrine of implied obligations under article 1434 C.C.Q. and the duty of good faith set forth in Provigo Distribution Inc. v. Supermarché A.R.G. Inc., decided by this Court eighteen years ago and generally recognized as the leading authority in Quebec law since that time.

Of particular note is the Court of Appeal’s reliance on Article 1434 of the Civil Code of Quebec (CCQ), which reads as follows:

“Article 1434. A contract validly formed 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.”

The Court of Appeal also relied on its own decision in the case of Provigo, a landmark decision in the Quebec franchise law landscape rendered in 1997, which essentially extended and to a certain extent, defined some implicit obligations that flow from the explicit provisions of franchise agreements essentially based on the concept of good faith, enshrined in the CCQ as follows:

Art. 6. Every person is bound to exercise his civil rights in good faith.

Art. 7. No right may be exercised with the intent of injuring another or in an excessive and unreasonable manner, and therefore contrary to the requirements of good faith.

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57 Appeal Judgment, Dunkin’ Brands Canada Ltd. vs. Bertico Inc. et al., 2015 QCCA 624, April 15, 2015.
58 Appeal Judgment, Paragraph 8.
59 Civil Code of Quebec, S.Q. 1991, c.64.
61 Supra Note 18.
D. Liability

In its analysis of the trial court decision, the Court of Appeal found that the trial judge had failed to show a revisable error, and more specifically, regarding the following issues:

1. The Obligational Content of the Franchise Agreements

The interpretation of the terms of the franchise agreements was the focus of considerable debate particularly regarding the franchisor’s principal obligation to “protect and enhance the brand.” On this issue, the Court of Appeal found that the franchisor had failed to show an error committed by the trial judge in his interpretation of the contract. In arguing that the judge’s “entire reasoning” was based on paragraph 3.C of the 1992 contract and the recital of the standard form of 2002, the franchisor has misread the judgment to suit its argument. The obligation of means to protect and enhance the brand imposed on the franchisor was not incompatible with explicit terms of the contracts. But, just as importantly, the judge’s interpretation of the duties owed to the franchisees rested on the whole of the agreements, including the implicit obligations based on the nature of the franchise arrangement and, in particular, the implied obligation of good faith incumbent on both parties. The Court found no palpable and overriding error in the trial judge’s conclusion that the franchisor had promised to take reasonable measures to protect and enhance the brand. The Court added that even if one was to consider the inference of obligations based on the nature of the contract under article 1434 C.C.Q. or the obligation of good faith as raising a question of law, it was of the view that no error of law had been shown either.\(^{62}\)

Regarding implied obligations incidental to the nature of the franchise agreements, the Court of Appeal reaffirmed the trial judge’s well founded reliance on Article 1434 C.C.Q.\(^ {63}\) and held that the franchise agreements established a relationship of cooperation and collaboration between the franchisor and its franchisees, reflecting both common and divergent interests, over a long period of time. Unlike in other arrangements where a franchisor might merely provide a licence and some modest start-up advice, the Dunkin’ Donuts franchisees were by no means left to their own devices after their launch in this quick service restaurant business. Protecting the brands was no doubt too important to the franchisor not to take an active hand in the arrangement over the course of its term. Sustaining the “system” as a flourishing restaurant chain required, as the terms of the agreement made plain, an ongoing interaction between the franchisor and each of its franchisees. The franchisor took on a role in choosing appropriate franchisees and approving new acquirers of existing franchises, of advising franchisees at the start of the venture, and of offering assistance to them along the way to be sure that each franchisee respected the system upon which the reputation of the brand rested. The franchisee relied on the franchisor assuming this role to justify its investment. Not only would each franchisee receive assistance and benefit from the collaboration of the franchisor, but the franchisees were entitled to count on the franchisor to see that the system would be supervised and that the weaker links in the chain of franchisees be corrected or excised. This relationship was required to continue over the life of the agreement. In this sense, the agreement was a “relational” one which, as is often the case in such long-term arrangements, did not spell out all of its terms.\(^ {64}\)

In addition, the Court held that these implicit obligations formed part of a long-term collaborative relationship, between the franchisor and each individual franchisee, within an established network in which service and quality of experience were imagined as nearly identical from restaurant to restaurant.

\(^{62}\) Appeal Judgment, Paragraph 48.

\(^{63}\) Civil Code of Quebec, S.Q. 1991, c.64.

\(^{64}\) Appeal Judgment, Paragraph 62.
The Court found important that the trial judge held as important the recognition that the character of these specific franchise arrangements was an “on-going” one in respect of a “system” that the parties agreed to sustain as critical to the success of the brand. As a result, the trial judge found that the obligations the franchisor has in respect of the brand were necessarily “continuing” and “successive” (para. [59]). The collaborative nature of these quick-service restaurant franchising agreements that extended upwards of 20 years was central to explaining why article 1434 C.C.Q. served to import the obligations it did.65

Moreover, given the role the franchisor assigned to itself in overseeing the ongoing operation of the network and the uniform system of standards, the Court held that it was fair to characterize the obligation of means to protect and enhance the brand as a “complément nécessaire” [necessary complement] of the contracts due to their nature. It was thus appropriate, in the Court’s view, for the trial judge to infer that the franchisor had implicitly agreed to undertake reasonable measures to help the franchisees, over the life of the arrangement, to support the brand. This included a duty to assist them in staving off competition in order to promote the ongoing prosperity of the network as an inherent feature of the relational franchise contract.66 This necessary complement to the express terms rested on the presumed intention of the parties to these particular agreements. The trial judge inferred the franchisor’s obligations flowing from the nature of the agreements not from a body of suppletive or public order rules, but from his sense of the unstated intention of the parties, consonant with articles 1425 and 1426 C.C.Q. In light of the theory of implied obligations, this was a principal justification for obligations inferred from the nature of the agreement under article 1434 C.C.Q. In other words, in characterizing the essential obligation of the franchisor as a duty to protect and enhance the brand, the trial judge did not assign a new and unintended obligation on the franchisor, but he drew on the explicit terms, supplemented by implicit obligations flowing from the nature of the agreement that, in both cases, reflected the intention of the parties. The “élargissement du cercle contractuel” [increase of the contractual circle] in this case was based on the trial judge’s finding of fact as to parties’ intent. The Court also noted that the franchisor pointed to no express term that would have ousted the implied obligations that came with the nature of this long-term agreement.67

The Court of Appeal revisited the notion of implied obligation of good faith analysed at length in Proviso68 and found as follows:

[69]  The judge was correct to rely on Proviso as support for an implicit obligation of good faith which, in connection with the present franchising arrangement, buttressed the obligation to protect and enhance the brand based on the parties presumed intent. The judge rightly decided that the duty outlined in Proviso is not confined to the circumstances of franchisors who compete unfairly with their franchisees.69

[...]

65 Appeal Judgment, Paragraph 63.
66 Appeal Judgment, Paragraph 64.
67 Appeal Judgment, Paragraph 66.
68 Supra Note 19.
69 Appeal Judgment, Paragraph 69.
The Court of Appeal also found that where the parties must work together to achieve the object of the franchise arrangement over a long period of time, the *Provigo* case recognized that both the nature of the agreement and equity allowed a “duty to cooperate” to be inferred as a contractual obligation for the franchisor. Accordingly, in the present case, the nature of the agreement, on one hand, and equity, on the other, provided two distinct normative justifications for this implied obligation of good faith under article 1434 C.C.Q. Thus, where the nature of the agreement justified the inference, the implied obligation is best viewed as a reflection of the presumed intention of the parties. Parties to a long-term franchise agreement like the ones in the case at bar can typically be presumed to have intended reasonable standards of cooperation based on the relational nature of the arrangement. Equity does not depend on presumed intention, but is more closely connected to the law’s concerns for fairness in contract. In this particular case, the Court found that equity mandated the franchisor’s due regard for the franchisees’ interests, taking into account what the Court called in *Provigo* the franchisor’s superior know-how and expertise, without which long-term common objectives of both parties could not be met. Thus the implied duty of good faith under article 1434 C.C.Q. acts to reinforce and confirm the duties of assistance and cooperation for the franchisor associated with the nature of the contract. In sum, good faith brings with it, as an implied obligation based on both equity and the long-term nature of these franchise agreements, an intensification of the cooperation which remains the fundamental characteristic of any relational contract.70

The Court of Appeal found, in addition, that beyond the duty not to take actions that would wrongfully cause the franchisees harm, the franchisor assumed, on the basis of this implied duty of good faith in the 1992 and 2002 franchise agreements, a duty “to assist and cooperate with the franchisees by taking certain active measures in support of the brand.”71 This meant that the franchisees were entitled to rely on the franchisor, as a matter of contractual fairness and as a reflection of their own presumed intentions, to take reasonable measures to protect them from the market challenge presented by Tim Hortons. The Court found that the trial judge correctly identified these two sources of implied obligations such that where a violation of these implied obligations incident to the nature of the contract and in conforming to equity was established, the judge was entitled to conclude that there was a contractual fault as the Court held in *Provigo*.72

The Court also held that it was important not to exaggerate the content of the implied obligation of good faith and its attendant “duty to collaborate.” Thus, despite some shared objectives, franchisors and franchisees also have divergent interests but are no less in a relationship of collaboration. The pursuit of these divergent interests was possible, but only within the parameters of the terms of the contract and the implied obligation of good faith.73 The Court of Appeal found that in this light, it was fair to see the parties, despite the aspirational language of “partnership” sometimes used in connection with the arrangement, as having some different goals. The parties were thus entitled, within the bounds of the execution of the contract in good faith (article 1375 C.C.Q.)74 and the content of the obligation of good faith that is implicit in their agreement (article 1434 C.C.Q.) to pursue those divergent interests. As the

70 Appeal Judgment, Paragraph 71.

71 Appeal Judgment, Paragraph 72.

72 Appeal Judgment, Paragraph 72.

73 Appeal Judgment, Paragraph 73.

74 Supra Note 18.
Supreme Court held in a comparable context, the obligation of good faith does not displace the “legitimate pursuit of economic self-interest” that is at the core of freedom of contract.\textsuperscript{73}

The Court of Appeal found that the judge had not imposed on the franchisor, through the duty of good faith, an unfair standard of disinterested behaviour or required it to confer a liberality on the franchisees. It was in the franchisor’s interest, broadly speaking, to assist its franchisees, to supervise the network and to collaborate with them by proposing reasonable measures to combat a competitor who, in the longer term, threatens the value of the brand for both parties. When established, the failure to do so was a contractual fault that gave rise to damages not as an arbitrary measure of redistribution of wealth but as an ordinary contractual remedy based on corrective justice. In any event, the Court found that it was enough to observe that the trial judge had made no error in identifying an implicit obligation for the franchisor to take reasonable measures to promote and enhance the brand and that this conclusion found justification both in the nature of the agreement and in equity. Thus, whether the doctrine of the implied obligation of good faith might have a more robust or more expansive content, including the question as to whether “good faith” and “loyalty” are qualitatively different sources of contractual duty, was a matter best left to another day.\textsuperscript{76}

The Court of Appeal found that beyond the obligation to allow individual franchisees to use the Dunkin’ Donuts system, the contracts created, through express language and by necessary implication, a duty owed to the franchisees, collectively to take reasonable measures to support and enhance the brand. This included the duty to respond with reasonable measures to help the franchisees as a group to meet the market challenges of the moment and to assist the network of franchisees by enforcing the uniform standards of quality and cleanliness it holds out as critical to the success of the franchise.\textsuperscript{77}

Finally, the Court found that beyond the obligation to allow individual franchisees to use the Dunkin’ Donuts system, the franchise agreements created, through express language and by necessary implication, a duty owed to the franchisees collectively to take reasonable measures to support and enhance the brand. For example, it is up to the franchisor to police the network by taking reasonable means to root out the free-riders. With respect to the word “enhance,” the franchisor did not guarantee that the reputation of the brand would be enhanced but undertook to take reasonable means to that end and the trial judge did not say otherwise.

In sum, the trial judge made no revisable error in his identification of the obligational content of the franchise agreements.

2. \textbf{The Intensity of the Franchisor’s Contractual Obligations}

The Court of Appeal found that the trial judge both said and clearly meant that the obligation imposed on the franchisor was one of means, not of result. The trial judge was entitled to find that the franchisor’s violation of a contractual obligation of means caused 100% of the damages claimed if the evidence supported that view, without necessarily following that he imposed an obligation of result.

\begin{quote}
[92] \textit{The Franchisor is right to say that the contract did not impose an obligation on it to guarantee the Franchisees’ success or insulate them from competition. There is no disputing the fact}
\end{quote}

\textsuperscript{76} Appeal Judgment, Paragraph 74.

\textsuperscript{77} Appeal Judgment, Paragraph 75.

\textsuperscript{77} Appeal Judgment, Paragraph 77.
that the Franchisor’s obligation was limited to taking reasonable measures to protect and enhance the brand. But the judge rightly recognized this. In paragraph [62] of his reasons, he made plain his sense of the extent of the Franchisor’s duty to protect and enhance the brand: “Although not the insurer of the Franchisees nor the guarantor of their successes, ADRIC is nevertheless responsible to them for the harm caused by its civil faults”. The judge both said, and clearly meant, that the obligation imposed on the Franchisor was one of means, not of result.

[...]

[94] If the judge were to have made the mistake that the appellant attributed to him, he would have simply observed that the result was not met and held the Franchisor liable on that basis, without examining any of the measures it took, and leaving only a defence of superior force or force majeure open to the Franchisor. This is what is meant, in law, by “obligation of means” as against an “obligation of result.”


The Court of Appeal rejected the application of the Business Judgment Rule and found that it applied to matters relating to the personal responsibility of directors and officers and to shareholders and not as a means of exculpating a corporate contracting party from liability for fault under a contract with third parties.

4. **Evidence of the Franchisor’s Fault**

On the evidence of the franchisor's fault, the Court of Appeal found that same was based on two principal findings:

[112] *In essence, the reasoning of the judge on fault is based on two principal findings. First, the judge observed the relative inaction of the Franchisor between 1995 and 2000 when faced with the newfound competition, delinquent franchisees, the need for consultants in a position to assist the respondents and the like, and found that the effects continued into the period relevant to the cause of action. Second, the judge found that the Franchisor’s response, from 2000 onwards, came too late and was insufficient. It is important to note that these findings are linked. The response in 2000 might have proved adequate, measured against the standard of the Franchisor’s obligation of means, but for the accumulated difficulties that the Franchisees and the brand were feeling after what the judge described as years of relative neglect leading up to the response. The view he took of the insufficient measures taken between 1995 and 2000 is an essential feature of the judge’s finding of fault for the whole of the period.*

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78 Appeal Judgment, Paragraph 94.

79 Appeal Judgment, Paragraph 112.
The Court of Appeal found that these conclusions were related. The franchisor’s response to the franchisees’ demands in 2000 might have proved adequate, measured against the standard of the franchisor’s obligation of means, but for the accumulated difficulties that the franchisees and the brand were feeling after what the trial judge described as years of relative neglect leading up to the response, insufficient measures were taken between 1995 and 2000, an essential feature of the trial judge's finding of fault for the whole of the period.

The Court of Appeal concluded that:

[113] There is certainly evidence in the record to support this view. The testimony of the Franchisees’ experience as to the lack of meaningful measures taken following the St. Sauveur meeting is very striking in its precision and detail, as is the fact that no franchisee came forward to defend the position of the appellant. One telling example relates to the Franchisor’s background analysis for the marketing plan for 1999-2000 for the network. This document reveals that the Franchisor had become aware that its network was under threat at that time from the competition; it relates that the Dunkin’ Donuts ‘concept’ was growing old; that it had failed to develop new clients and that its appeal seemed limited to older customers; that Tim Hortons had a more substantial advertising budget; that perception of the quality of Dunkin’ Donuts product and service was in decline; and that standards of cleanliness and performance varied considerably from one store to the next. 

5. **Causation**

On the issue of causation, the trial judge found that there was evidence to support the argument that Dunkin’ Donuts’ failure to meet the competition head on and in a timely fashion caused the losses claimed. None of the externalities served to break the chain of causation and the franchisees were not negligent in the day-to-day management of their stores. Furthermore, the same causation analysis could apply across the network to all the Franchisees.

The Court of Appeal found that the conclusion on causation is a finding of fact and that the trial judge had committed no palpable and overriding error that would allow the finding of causation to be set aside.

6. **The Releases**

On ancillary issues, the trial judge ruled that, under the circumstances, the execution of certain releases had been obtained by the misrepresentation that the minimum critical mass of seventy-five remodeled stores would be or had been obtained, which vitiated consent and the releases given on this basis were thus null. The question as to whether a party provided valid consent to a contract is a finding of fact and the trial judge had committed no palpable and overriding error that would allow the Court of Appeal to intervene on this point.

E. **Damages**

1. **Damages for Lost Profits**

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80 Appeal Judgment, Paragraph 113.
Where the evaluation of damages depends on the appreciation by the trial judge of conflicting expert reports, an appellate court will generally not intervene in the absence of a palpable and overriding error of fact or an error of law.

The Court of Appeal was nonetheless convinced that the trial judge made two errors of calculation that called for a reduction in the amount of damages:

[172] With due respect for the judge, he made a first error in calculating the relevant dates for determining lost profits. But in fairness to him, the origin of the mistake can be traced back to the expert report filed by the Franchisees, which report estimated lost profits between January 1, 2000 and August 31, 2003.

[...]  

[175] The judge made a second error of calculation when he relieved the Franchisees from paying the royalties and other payments owed by them under the franchise agreements. In paragraph [116] quoted above, he denied the Franchisor’s counterclaim, citing the principle of exceptio non adimpleti contractus. In his view, the “fundamental breach” committed by the franchisor relieved the franchisees from paying the amounts it owed under the contract. With respect, this was a mistake in law.  

Beyond these two errors, the Court of Appeal found that the trial judge had made no overriding error in preferring the comparable method for evaluating lost profits. It was reasonable for the trial judge to adopt the comparable method using Tim Hortons as the comparable business for calculating lost profits.

However, in choosing the figure of 100% of Tim Hortons’ growth as the factor for determining the franchisees’ lost profits, the trial judge failed to take into account certain imponderables that potentially affect all businesses. The Court of Appeal agreed with the franchisor that the 100% figure failed to allow for the competition that Dunkin’ Donuts would have faced from Tim Hortons, even if the franchisor had not committed a fault. Not taking this into account was deemed to be a reviewable error.

The Court of Appeal therefore discounted the 100% growth rate used by the trial judge by reducing it to 75% in order to allow for the competition factor from Tim Hortons in the calculation of profits of the franchisees, including the competitive advantage of the drive-thru service. The Court of Appeal therefore revised the amount of lost profits from $7,360,000 to $4,372,472.

2. Damages for Lost Investments
The trial judge’s view of the evidence was that certain damages had been shown with respect to lost investments on the basis of evidence given by an ordinary witness. Given that the Franchisees had suffered lost investments, according to the trial judge, it was his duty to settle on an amount based on the evidence adduced. He expressed is limited reasons in the following terms:

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81 Appeal Judgment, Paragraphs 172, 173, 174, 175, 176, 177 and 178.
All of the Franchisees have lost their investments in their respective franchises. Their stores are all closed. Had ADRIC maintained its share in the Quebec fast food market, these Franchisees could have sold their stores as going concerns for “roughly 50% of annual sales”. A review of the financial statements of the Franchisees in the years immediately preceding the closing of their stores reveals that in most cases their investments in their franchises exceed what they could expect to receive for the sale of their stores using the formula of “50% of annual sales”. ADRIC should compensate the Franchisees at least to the extent of the loss of any opportunity to sell their stores at traditional values due to the collapse of the Dunkin’ Donuts “réseau” in Quebec.82

The Court of Appeal found that Dunkin’ Donuts had failed to demonstrate that the trial judge committed a palpable and overriding error on this point. The Court of Appeal recognized that the method used for fixing the quantum of damages lacked in precision. However, given that no effort has been made by Dunkin’ Donuts to show exactly where, in his reading of the financial statements, the trial judge went astray in his conclusion, the franchisor failed to convince the Court of Appeal that the trial judge had committed a reviewable error.

Dunkin’ Donuts also failed to convince the Court of Appeal that the lost profits and lost investment amounted to double compensation.

Nevertheless, two adjustments needed to be made:

Given the Court of Appeal’s conclusion that the amount of lost profits should be based on 75% rather than 100% of Tim Hortons growth, the amount used by the trial judge to determine lost investments should be reduced accordingly. Rather than using Tim Hortons’ 2005 results with a factor of 100%, the calculation should proceed using a factor of 75%. The lost investments were therefore reduced by the Court of Appeal by 25%.

Furthermore, the franchisees who renovated their stores and who received a contribution from the franchisor under the renovation plan should reimburse the franchisor for its contribution from the money they received as damages. Because the trial judge annulled the releases, the parties needed to be returned to the situation they were in prior to that arrangement. The franchisees having been awarded the full amount for the lost investment of a renovated store, the trial judge should have deducted the amount that the franchisor contributed to the cost of renovations for those franchisees who had signed releases to avoid a double payment for that latter amount.

The Court of Appeal thus reduced the amount of damages for lost profits from $9,047,143 to $6,536,041.25, allowing for the franchisor’s contribution to renovation of $249,316 to be refunded and calculating the total using 75% of the increase in sales in 2005.

Beyond these two adjustments, the franchisor had not convinced the Court of Appeal that the trial judge had committed a reviewable error.

82 Trial Judgment, Paragraph 111.
F. Key Lingering Questions and Application Outside of Quebec and Canada

On June 15, 2015, Dunkin’ Donuts filed an Application for leave to appeal to the Supreme Court of Canada. In support of its application, Dunkin’ Donuts submitted the three following questions:

Does the general obligation of good faith impose on franchisors implied duties to enhance the brand and stave off competition?

Can causation for the alleged breach of such duties be inferred simply by looking at the actual results, without having to consider whether a different conduct would have led to different results?

Does the aggregation of individual claims into a common trial alleviate or shift the burden of proof incumbent on plaintiff with respect to damages?

As of the date of filing of this paper, no decision on the application for leave to appeal had been rendered.

V. CONCLUSION

The ongoing relationship issues between franchisors and franchisees seem to be destined to remain complicated at times. Regardless of the efforts made by franchisors to draft carefully worded franchise agreements, and as the cases written about in this article demonstrate, it is impossible to account for every contingency that may occur in the future and assign liability in advance of such occurrences. Currently, there is no federal legislation that has been introduced that would replace the Small Business Franchise Act of 1999 and require franchise agreements to contain minimum standards of conduct (good faith, due care, and limited fiduciary duty) for each party to the franchise agreement. And as the case law illustrates, plaintiffs will continue to try to expand the relief offered by the covenant of good faith and fair dealing. Experienced counsel can help the parties prepare as much as possible, but as illustrated by the examples discussed in the paper, sometimes events occur that are the fault of no one, even if one party, or all parties, are damaged, and assigning liability will not necessarily repair the damage that was done. Further, even though damages may be real and quantifiable; they do not always result from intentional actions or inactions. Sometimes brands change drastically or "falter" as result of changing times and preferences, and sometimes making every effort to keep up with some changes simply is not enough to save a brand. In those circumstances, assigning liability can be extremely difficult if not impossible.

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83 Dunkin’ Brands Canada Ltd. v. Bertico Inc. et al., File number 36475.
Robert A. Lauer
Biography

Robert A. Lauer is a Partner in the Austin office of Haynes and Boone, LLP, and a member of the firm’s Franchise and Distribution Practice Group. Mr. Lauer’s practice focuses on all aspects of domestic and international franchise transactions. Mr. Lauer was named to Chambers, Global Franchising, Band 3, 2011, Band 4, 2012 and Band 3 2013 to 2015; Chambers USA, Franchising (Nationwide), Up and Coming, 2012 and Band 4, 2013 to 2015; the International Who's Who of Franchise Lawyers, Law Business Research, 2010 through 2015; The Best Lawyers in America® for Franchise Law in 2008 through 2015; and a “Texas Rising Star” by Law & Politics Magazine and Texas Monthly for 2005 and 2007 through 2012. Mr. Lauer is also the speaker for the Texas Bar Association's Ten Minute Mentor video tutorial on "What Every Texas Attorney Should Know About Franchise Law". He is a member of the ABA Forum on Franchising (and former member of the International Division’s Steering Committee from 2008 to 2011), and a former vice-chair of the franchise and distribution section of the Dallas Bar Association. Mr. Lauer is a 1997 cum laude graduate of the St. Mary's University School of Law where he served as an Associate Editor of the St. Mary's Law Journal, and a 1994 graduate of Trinity University in San Antonio, Texas. Mr. Lauer can be reached at rob.lauer@haynesboone.com
Stephanie Russ

Biography

Stephanie Russ is a Senior Attorney at Baker & McKenzie. Stephanie focuses her practice on transactional franchise and commercial matters and also serves as a franchise content expert in franchise-related litigation. Additionally, she is a qualified mediator.

Stephanie is licensed to practice in federal and state courts in Texas and before the U.S. Supreme Court. She received her law degree from Texas Wesleyan University School of Law, now known as Texas A&M School of Law, and her bachelor’s degree in finance from the University of Arkansas at Little Rock.
STÉPHANE TEASDALE
BIOGRAPHY

Stéphane Teasdale is a partner at Dentons Canada LLP, co-leads the Corporate and Commercial Law Group of Dentons’ Montreal office and chairs the Global Franchise and Distribution Law Group. He is renowned in Canada and abroad for his unique expertise in the area of domestic and international franchising.

Stéphane provides legal and strategic counsel in transactional and litigation matters dealing with corporate, commercial and business law, franchising, competition and intellectual property. He advises prominent Canadian franchise systems expanding internationally, as well as Canadian, American and foreign franchise and distribution systems wishing to establish themselves or expand in Canada and particularly in Québec. Stéphane also advises several Canadian networks, which have opened and expanded internationally to markets in Europe, the Middle East and Africa.

Actively involved in Canadian, American and international franchise associations, Stéphane is currently the Vice President and an executive committee member of the Québec Franchise Council. He is recognized in Canada, the United States and abroad as one of the few experts in franchise law in Québec and in Canada, an honour that has been repeatedly acknowledged by The Canadian Legal LEXPERT Directory, The Best Lawyers in Canada 2015, Who's Who Legal: Canada 2015 and more recently by Chambers Canada 2016.

In both domestic and international forums, Stéphane is a frequent lecturer on franchise and distribution matters related to markets locally, nationally and internationally. He is also an author of numerous published articles.

A graduate of the University of Ottawa Faculty of Law, the Université du Québec School of Business and Queen's School of Business, Stéphane was called to the Québec Bar in 1988, and is a member of the Canadian, American and International Bar Associations.