The Franchisor's Duty to Police the Franchise System

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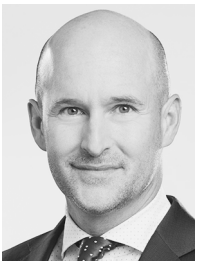

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The franchisor-franchisee relationship is unique.[1] From a financial perspective, franchisors may earn an initial fee arising from the purchase of the franchise, royalty fees based on a percentage of the franchisee's gross revenues (or fixed fees based on various parameters such as the territory and/or performance obligations), and other service fees.[2] Some franchisors may have developed other sales channels, most likely with a distinctive product and/or service offer, such as online distribution.[3] Franchisees, on the other hand, have as their first and only goal to maximize their own profits.[4] Thus, both parties rely fundamentally on the development and maintenance of a high demand for the franchised product or service.[5]

The viability of a franchise system relies notably upon a proven concept; the franchisor's support and assistance; favorable market conditions; constant innovation; and, finally, a reputable brand. The non-exclusive right to use these assets is, in effect, what the franchisee acquires when it pays the initial fee and, subsequently, the ongoing royalty fees. The franchisor also relies on the sustainability of these

1. Scott Makar, *In Defense of Franchisors: The Law and Economics of Franchise Quality Assurance Mechanisms*, 33:5 VILL. L. REV. 721, 725 (1988).
2. *Id.* at 722.
3. Theodore P. Pearce, Robert F. Salkowski & Kevin S. Reeve, *Making the Business Case for Franchise Standards Beyond* "Because I Said So," IFA LEGAL SYMPOSIUM at 4 (2014).
4. Makar, *supra* note 1, at 725.
5. *Id.* at 729.

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assets to generate revenues for its franchisees and, consequently, profits. A deficient franchise system, however, could result in a degradation of the concept's notoriety, free-riding franchisees, non-profitable unit operations, and a decreasing franchise network.[6] The combination of these declines could create a perfect storm that could enable an emerging competitor to grab that share of the market.

As opposed to a mere license business model, which is designed to provide the licensee with more operational autonomy and independence, the unique and distinctive nature of a franchise concept requires the franchisor to create, implement, and maintain an infrastructure capable of supporting the franchisee in operating its business.[7]

Taking into account the differences between U.S. and Canadian franchise law jurisdictions, this article aims to determine if a franchisor is not only responsible, but also legally exposed toward its franchisees for protecting its brand and maintaining sustainable franchise system operations. A franchisor typically gives itself broad powers in the franchise agreement to maintain standards and preserve the health of the franchise network.[8] Moreover, and according to the restrictive nature of a franchise agreement, only the franchisor can play that role.[9] That said, the express terms of a franchise agreement rarely compel a franchisor to take positive measures, such as responding to competitive threats and disciplining delinquent franchisees, to preserve the integrity of its franchise system. This article will explore whether such positive measures may be implied from the long-term nature of a franchise agreement and the restrictive, mandatory provisions it contains. This article will also discuss where such an implied duty might begin and end.[10]

I. The Franchisor's Duty to Police a Franchise System in the United States

U.S. case law to date reflects the general common law philosophy of contracts—to allow the parties the freedom to contract and limit their risks. Few courts have imposed a duty to police the franchise system. Those cases that have found franchisors liable generally do so based on state law agency principles, which require a fact-intensive finding of a master-servant relationship. This article will concentrate on the decisions addressing the imposition of direct, rather than vicarious, liability for a franchisor's failure to police the system.

6. *Id.* at 730.

7. *Dunkin' Brands Canada Ltd. v Bertico Inc.*, 2015 QCCA 624, J.E. 2015-692 (leave to appeal to the Supreme Court of Canada was dismissed with cost on Mar. 17, 2016).

8. Pearce et al., *supra* note 3, at 19.

9. Brian B. Schnell & Ronald K. Gardner, Jr., *Battle over the Franchisor Business Judgment Rule and the Path to Peace*, 35 FRANCHISE L. J. 167 (2015).

10. For the purpose of this article, the authors will refer to this potential duty as the "Duty to Police the Franchise System."

A. *The Duty to Police the Trademark*

In the United States, the Lanham Act[11] imposes a duty upon a franchisor, in its capacity as licensor of a trademark, to police a franchisee's use of the trademark.[12] The duty to supervise a franchisee as a trademark licensee results from the need to protect the public from being misled about the quality and consistency of the products or services under the franchisor's trademark.[13] In the absence of a franchisor's control, franchising would create the danger that products and services bearing the same name may have diverse qualities.

> If the licensor is not compelled to take some reasonable steps to prevent misuses of his trademark in the hands of others the public will be deprived of its most effective protection against misleading uses of a trademark. [U]nless the licensor exercises supervision and control over the operations of its licensees the risk that the public will be unwittingly deceived will be increased[.]"[14]

In the case of *Mini Maid Services Company v. Maid Brigade Systems, Inc.*,[15] the Eleventh Circuit discussed the limits of a franchisor's exposure for its franchisee's use of trademark. The parties were both franchisors of residential cleaning services. A franchisee of Maid Brigade acquired assets, including the telephone number, of a former Mini Maid franchisee. The telephone listings purchased by the Maid Brigade franchisee associated the telephone number with the Mini Maid trademark. Instead of suing the franchisee, Mini Maid sued the franchisor. Potential customers calling the Mini Maid number reached the Maid Brigade franchisee. Mini Maid demanded that Maid Brigade stop the franchisee from using the telephone number. On the advice of counsel, Maid Brigade could not convince the franchisee to cease use of the number and would not subject itself to a wrongful termination claim. Mini Maid sued the Maid Brigade franchisor only, obtaining a preliminary injunction, ultimately a jury advisory verdict, and a statutory award by the U.S. District Court for the Northern District of Georgia. The district court held that a franchisor can be held liable for its failure to exercise reasonable diligence to prevent a franchisee from violating the trademark laws. The jury decided that the franchisor failed to exercise its contractual right to control the disputed telephone number or terminate the franchise. Maid Brigade appealed to the Eleventh Circuit.

11. The Lanham Act's abandonment provisions, e.g., 15 U.S.C. § 1064(5)(A) (2015), specify that a registrant's mark may be cancelled if the registrant fails to control the licensee's use of the mark. *See also* Joseph Schumacher, Edward Wood Dunham & G. Adam Schweichert III, *Retaining and Improving Brand Equity by Enforcing System Standards*, 24:1 FRANCHISE L. J. 10 (2004).

12. *See*, *e.g.*, Matusalem & Matusa, Inc. v. Matusalem, 872 F.2d 1547, 1551 (11th Cir. 1989).

13. Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368, 387 (5th Cir. 1977); *see also* Theodore P. Pearce, Steven Feirman & Eric Yaffe, *Supply and Distribution Issues*, IFA LEGAL SYMPOSIUM, vol. 2, tab 17 (2004).

14. Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 367 (2d Cir. 1959); *see also* Pearce et al., *supra* note 13, at 9.

15. 967 F.2d 1516 (11th Cir. 1992).

The Eleventh Circuit vacated and remanded, holding that the law imposes no duty upon a franchisor to diligently prevent the independent acts of trademark infringement that may be committed by a single franchisee:

> But the licensor's duty to control a licensee's use of the licensor's trademark cannot be blindly converted into a duty to prevent a licensee's misuse of another's trademark. Such a wholesale conversion would impose responsibility upon a franchisor not for failing to maintain the integrity of its own trademark, but for failing to prevent another entity's violation of the law. We can discern no reason to impose such a burden upon a party that is, at best, secondarily responsible for any trademark infringement.[16]

The appellate court explained that the Lanham Act is intended to ensure the integrity of registered trademarks and is not intended to create the federal law of agency. "The duty does not give a licensor control over the day-to-day operations of a licensee beyond that necessary to ensure uniform quality of the product or service" and does not "automatically saddle the licensee with the responsibilities under state law of a principal for his agent."[17] Remarking that a trademark owner's failure to control a mark does not expose an owner to tort liability, the Eleventh Circuit held that the duty to police one's own mark does not create a similar obligation on a franchisor to police a franchisee's appropriation of other marks. The court distinguished the franchise agreement language granting franchisor's control of its own mark from an obligation to control its franchisee's use of another's mark.

The Eleventh Circuit also described circumstances where a franchisor could be liable for contributory trademark infringement. Citing *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.*,[18] the court held "with respect to a franchisor's liability for the independent infringement of its franchisees, we hold that the franchisor may be accountable only if it intentionally induced its franchisees to infringe another's trademark or if it knowingly participated in a scheme of trademark infringement carried out by its franchisees."[19]

The Mini Maid case is instructive as to the scope of liability of franchisors for the trademark infringement of its franchisees. One lesson learned is the importance of drafting the franchise agreement to clarify whether the franchisor is able to police not only its trademark, but also the misuse of others' trademarks within its system. An ambiguous franchise agreement may impose a power to police trademarks never intended by the parties and expose the franchisor to liability to a competitor.

B. *Duty to Police the Brand*

In *Cullen v. BMW of North America, Inc.*,[20] the Second Circuit held that the franchisor owed the customers of its franchisees a legal duty to safeguard

16. *Id.* at 1517.
17. *Id.* at 1520 (citing Oberline v. Martin Am. Corp., 596 F.2d 1322, 1327 (7th Cir. 1979)).
18. 456 U.S. 844 (1982).
19. *Mini Maid*, 967 F.2d 1518.
20. 691 F.2d 1097 (2d Cir. 1982).

their funds, but found that the franchisor could not be liable because the injuries were not foreseeable. The plaintiff had purchased a vehicle from the franchisee, Bavarian. The president of Bavarian, Hans Eichler, embezzled and absconded with the plaintiff's money, and the plaintiff never received the purchased vehicle or a refund of the purchase price. The plaintiff sued BMW as franchisor, claiming that BMW negligently permitted Bavarian to continue as a BMW dealer, even though BMW was aware of Bavarian's troubled financial condition. The U.S. District Court for the Eastern District of New York held that the franchisor owed its franchisee's customers a legal duty to "reasonably police the authorized use of the BMW name and supervise the operation of its franchisee."[21] The court reasoned that, where a franchisor had the opportunity to "reduce the risk of foreseeable injury,"[22] such a franchisor could be held liable for negligence when it failed to terminate the franchise or take other appropriate action. The Second Circuit reversed, holding that BMW could not have reasonably foreseen Eichler's criminal activity and therefore could not be liable for plaintiff's injury. The Second Circuit left undisturbed the district court finding that the franchisor has the duty to reasonably police the BMW name.

C. *Duty to Police System Standards*

Rarely is a franchisee able to require the franchisor to uphold or police system standards. System standards are express expectations that a certain level of desired quality, cleanliness, achievement, performance, success, or operation be achieved or maintained. Cases brought by franchisees seeking to impose franchisor liability for failure to maintain standards are based on contractual theories. Either the franchise agreement allows the franchisee to have third-party beneficiary status to claim damage from the failure to enforce another's franchise agreement, or the franchisor breached an express provision in the franchise agreement allowing the franchisee to prove damages.

In *Creel Ltd. v. Mr. Gatti's*,[23] a Mr. Gatti's pizza franchisee claimed that the franchisor injured its business by failing to require de-identification of two closed shops and resolve a bug infestation at a third. The court denied the plaintiff's claims for emotional distress and other damages, holding that the mere inclusion in a franchise agreement that a franchisee will uphold standards is not an obligation to enforce standards owed to other franchisees in the system. The court failed to find an express contract or third party beneficiary agreement sufficient for the plaintiff to establish a duty breached sufficient to recover damages.

In contrast, where a franchisor represents it will "continue its efforts to maintain high and uniform standards in all stores," a claim for breach of con-

21. *Id.* at 1100.
22. *Id.* at 1101.
23. Bus. Franchise Guide (CCH) ¶ 9825, at 22,239 (N.D. Ala. 1990), *aff'd*, 933 F.2d 1022 (11th Cir. 1991).

tract is cognizable.[24] However, damages are very difficult to prove. In *Yankee Enterprises, Inc. v. Dunkin' Donuts, Inc.*,[25] a franchisee that operated a store in Beaumont, Texas, brought suit in 1994, alleging that Dunkin' Donuts had breached the franchise agreement and violated the Deceptive Trade Practices Act for, among other things, failure to maintain standards. A jury awarded Yankee $747,723, and the Fifth Circuit reversed after finding insufficient evidence of causation. The court focused on the conclusion of the expert witness that the reduced standards of cleanliness in the West impacted the plaintiff's sales in the Northeast, even though plaintiff operated well above standards. The demise of the case was the expert's concession on cross-examination that the alleged diminution of sales predated the breach by Dunkin', and the expert could not rule out other potential causes such as management skills, advertising volume, and market penetration.[26]

II. The Franchisor's Duty to Police a Franchise System in Canada

A. *General Principle*

There is no such duty called a "Duty to Police a Franchise System" in Canadian franchise law at the moment—not to say that there is no equivalent obligation for the franchisor. Decisions of Canadian courts that have considered whether a franchisor is liable toward its franchisees as a result of a disregard of the franchise system were more likely to rely on the franchisor's duty of good faith.

Fundamentally, the common law of contracts generally places great weight on the freedom of contracting parties to pursue their individual interests. To be consistent with that basic principle, any franchisor duty should be an express term of the franchise agreement or of the law. Canadian common law has recognized for many years several rules and doctrines that rely upon the notion of good faith in the contractual performance of a franchise agreement, and as such, that a duty of good faith may arise out of (1) the nature of the relationship, (2) the circumstances created by the other party, or (3) provincial franchise legislation.[27]

Six Canadian provinces, namely Ontario,[28] Alberta,[29] Prince Edward Island,[30] New Brunswick,[31] Manitoba,[32] and British Columbia (not yet in

24. Dunkin' Donuts, Inc. v. Patel, 174 F. Supp. 2d 202, 212 (D.N.J. 2001).
25. Bus. Franchise Guide (CCH) ¶ 11, at 211 (5th Cir. 1977).
26. *Id.* at 29,692–93.
27. 978011 *Ontario Ltd.* v *Cornell Engineering Co.* (2001), 53 O.R. (3d) 783 at paras 35–37, 2001 CanLII 8522 (ON CA).
28. *Arthur Wishart Act (Franchise Disclosure)*, SO 2000, c 3 (Ontario).
29. *Franchises Act*, RSA 2000, c F-23 (Alberta).
30. *Franchises Act*, RSPEI 1988, c F-14.1 (Prince Edward Island).
31. *Franchises Act*, SNB 2014, c 111 (New Brunswick).
32. *The Franchises Act*, CCSM c F156 (Manitoba).

force),[33] have enacted franchise legislation. These statutes are substantially similar, each imposing a duty of fair dealing in the performance and enforcement of every franchise agreement, which includes the duty to act in good faith and in accordance with reasonable commercial standards.[34]

As for the Canadian civil law jurisdiction, the *Civil Code of Québec* recognizes a general and stand-alone duty of good faith that extends to the formation, performance, and termination of a contract and includes an express prohibition forbidding the abuse of contractual rights.[35]

B. *Duty of Good Faith as the Source of the Franchisor's Implied Duty to Police the Franchise System*

1. Duty of Good Faith in Common Law Jurisdictions

Based on the unequal bargaining principles (or the test) outlined in the landmark Supreme Court case *Wallace* v. *United Grain Growers Ltd (c.o.b. Public Press)*,[36] and which Justice Iacobucci, for the majority, relied on to recognize an undeniable good faith obligation in employment contracts, the Ontario Court of Appeal confirmed in *Shelanu Inc. v Print Three Franchising Corp.*[37] that a duty of good faith applies in a franchisor-franchisee relationship. As such, the court listed the principal characteristics leading to imbalance in the franchisor-franchisee relationship: (1) the franchisee is unlikely to be in a position of being equal in bargaining power to the franchisor; (2) the franchisee's inability to negotiate more favorable terms in cases where the franchise agreement's provisions were drawn up and imposed by the franchisor will likely result in key clauses not being freely negotiated; and (3) the franchisor imposes significant and continuing restrictions on its franchisees as to how to operate and manage the franchised business for the purpose of maintaining uniform standards of quality and a strong brand across the franchise system.

Although the *Shelanu* decision recognized a franchisor's duty of good faith as a positive obligation to exercise its powers arising from the franchise agreement in an honest, fair, and reasonable manner,[38] the question that most franchisors ask is "where does it end?"

First, under Canadian common law, no fiduciary duty applies in a franchisor-franchisee relationship.[39] Although the duty of good faith and a fiduciary duty are very similar, they remain two very different obligations. If it is true that the franchisor must consider the interests of the franchisees before exercising any

33. *Franchises Act*, SBC 2015, c 35 (British Columbia) (not yet in force).
34. *See*, *e.g.*, Section 3 of the *Arthur Wishart Act*.
35. Arts. 6, 7 & 1375 *Civil Code of Québec*, CLQR c. CCQ – 1991.
36. [1997] 3 S.C.R. 701, 1997 CanLII 332 (SCC).
37. 64 O.R. (3d) 533 at para 66, [2003] O.J. No. 1919, [*Shelanu*]; *Kentucky Fried Chicken Canada v Scott's Food Services, Inc.*, 41 BLR (2d) 42, 1998 CanLII 4427 (ON CA) (1998).
38. *Shelanu*, *supra* note 37, at para 70.
39. *Jirna Ltd v Mister Donut of Canada Ltd*, [1971] 1 O.R. 251 (C.A.), confirmed by [1975] 1 R.C.S. 2.

powers, it must not act "only" in accordance with the franchisees' interests. If the franchisor deals honestly and reasonably with one franchisee and then prefers its own interests or those of the franchise network more generally, the franchisees' interests might not be paramount.[40]

As also stated by now Chief Justice Strathy of the Ontario Court of Appeal in *Fairview Donut Inc.*,[41] the duty of good faith has been expressed in Canadian common law to ensure that neither party substantially nullifies the bargained objective or benefit for which the other party has contracted or acts in a way that causes significant harm to the other party. Where a franchisor is given discretion under the franchise agreement, the franchisor must exercise such discretion reasonably and with a proper motive and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.[42] As such, it is possible under Canadian common law to conclude that one party failed to comply with its duty to act in good faith, even if it strictly complied with the provisions of the franchise agreement. On the other hand, the law does not consider every breach of an agreement a breach of the duty of good faith.[43]

Shelanu raises some interesting points regarding whether a franchisor breached a duty of good faith and to what end. The court concluded, for example, that the franchisor (Print Three) breached its duty of good faith when it denied a payment owed under the terms of the franchise agreement to gain leverage or bargaining advantage.[44] On the other hand, the court rejected the franchisee's claim for damages based on the franchisor's alleged misrepresentations and breach of its duty of good faith. The franchisee claimed that the franchise agreement contained representations that Print Three was an expanding organization, that it had committed itself to continue to introduce leading-edge technologies and systems in document reproduction technology, that it would continue to develop the credibility and presence of the Print Three name and logo, and that it would continue to improve and change the expertise it had developed. The court held that there had been no misrepresentation as to what Print Three was to provide in exchange for royalty payments and furthermore that Print Three had met the minimum requirements in order to discharge its contractual obligations.[45] In essence, the court concluded that the franchisor did not have a duty of competence.

40. *Shelanu*, *supra* note 37, at para 69; *1117304 Ontario Inc.* (*c.o.b. Harvey's Restaurant) v Cara Operations Ltd.*, [2008] O.J. No. 4370 at para 68; *Spina v Shoppers Drug Mart Inc.*, [2012] O.J. No 4659, at para 149.

41. *Fairview Donut Inc. v TDL Grp. Corp.*, 2012 ONSC 1252, [2012] O.J. No. 834, [*Fairview*].

42. *Fairview*, *supra* note 39, at para 502; *Shelanu*, *supra* note 37, at para 96; *Landsbridge Auto Corp. v Midas Canada Inc.*, 2009 CanLII 13628 (ON SC) at para 17, [*Landsbridge*].

43. *Shelanu*, *supra* note 37, at para 76.

44. *Id.*

45. *Id.* at para 107.

2. General Duty of Honesty Under Canadian Common Law

Strongly criticizing the piecemeal, unsettled, and unclear application of the Canadian common law duty of good faith, Justice Cromwell, for the majority of the Supreme Court of Canada, concluded in the more recent case *Bhasin v Hrynew* that it was time to take two steps to broaden the scope of the duty of good faith and make it more coherent and consistent with reasonable commercial expectations: (1) acknowledge that good faith contractual performance is a general organizing principle of the common law of contract and (2) acknowledge that there is a common law duty that applies to all contracts to act honestly in the performance of contractual obligations.[46]

Although the Court in *Bhasin* recognized the existence of an active and actual debate on a general common law duty of good faith in the performance of contracts, this question was expressly avoided because the matter at hand did not require the Court to address it, leaving the door wide open for a future Supreme Court of Canada case to answer this question. As for the courts that suggest there is a general duty of good faith, they have relied on good faith obligations as an implied contractual provision to establish minimum standards of acceptable commercial behavior. As for the duty's detractors, the concern is often that the recognition of a general duty of good faith would undermine the freedom of contract concept and lead to the creation of an uncertain commercial climate.[47]

Quoting Professor John McCamus,[48] who based his explication on the many cases that have examined the duty of good faith's application in the performance of a contractual relationship, the Court in *Bhasin* attempted to identify three situations where a duty of good faith in the performance of a contract existed in a common law jurisdiction: (1) where the parties must cooperate in order to achieve the objectives of the contract, (2) where one party exercises discretionary powers under the contract, and (3) where one party seeks to avoid its contractual obligations.[49] Although these are helpful tools to understand the current state of law, it remains unclear whether a good faith obligation is being imposed as a matter of law, as a matter of contractual terms implied by law or facts, or as a matter of interpretation of the contract. Nonetheless, the Court recognized that the implied terms of contract at common law, whether implied by the terms of the law or as a matter of fact, play a functionally similar role to the doctrine of good faith in civil law jurisdictions by filling in the gaps in the written agreement of the parties, mainly in classes of contracts where there is a power imbalance between the parties.[50]

46. 2014 SCC 71, [2014] 3 SCR 494, [*Bhasin*], paras 33, 66.
47. *Id.* at paras 38–39.
48. John McCamus, The Law of Contracts 804–05 (2005).
49. *Bhasin*, *supra* note 46, at para 47; Shannon K. O'Byrne, *The Implied Term of Good Faith and Fair Dealing: Recent Developments*, 86:2 Canadian B. Rev. 197–200 (2007).
50. *London Drugs Ltd. v Kuehne & Nagel International Ltd.*, [1992] 3 S.C.R. 299, 1992 CanLII 41 (SCC) at p. 459.

Although the exact source of the good faith obligations remains unclear, and no Canadian common law courts can rely for the moment on a stand-alone and floating duty of good faith, the Supreme Court of Canada in *Bhasin* nonetheless adopted new "organizing principles of good faith." As a manifestation of such organizing principles, a duty of honest performance now applies to all contracts.[51] While the commercial parties in a longer-term, relational contract, which depends on trust and cooperation, are entitled to expect a minimum level of honest conduct and good faith in contractual dealings,[52] the duty of honest performance shall serve to better assess the scope of the duty of good faith.[53]

3. Duty to Police the Franchise System Under Common Law

Although the extent of any Duty to Police the Franchise System remains unclear, but it is indisputable that Canadian common law courts have recognized, for several years now, a common law and statutory duty of good faith in a franchisor-franchisee relationship. More recently, and even while it has refused to rule on whether the common law duty of good faith is a stand-alone obligation or a duty to be applied (or not) sporadically by the courts on a contextual basis, the Supreme Court of Canada ruled in *Bhasin* that there is a uniform duty to perform contracts honestly. However, without disputing that most parties to a contract expect a certain level of honesty from the other party, what is the scope of this stand-alone obligation of "honesty"? And at what point does it become a franchisor's Duty to Police the Franchise System?

The Supreme Court of Canada in *Bhasin* reminds us that a duty to perform contracts honestly will stand as a general standard to be weighted differently depending on the context.[54] As to the meaning of "honestly," it refers to an obligation of the parties to not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract. In all cases, this does not impose on a party a duty of loyalty or require a party to forego advantages flowing from the contract.[55] Therefore, and as long as the contract does not oblige a franchisor to comply with specific performance obligations toward the franchise system, the circumstances where a franchisor will be held liable for not performing its obligations honestly as a result of not enhancing its brand or not sustaining the viability of its franchisees operations will likely be very limited. Deciding otherwise would likely lead to the creation of a duty of competence for the franchisor.

By accepting that the duty of honest performance has to be weighted in its particular context, it is inevitable, however, that the long-term contract of

51. *Bhasin*, *supra* note 46, at para 93.
52. *Id.* at para 66.
53. *Id.* at para 69.
54. *Id.* at para 64.
55. *Id.* at para 73.

mutual cooperation involved in a franchisor-franchisee relationship may create situations where the franchisor's duty of honest performance could impose affirmative obligations, despite the lack of any such obligations within the express terms of the franchise agreement.[56]

It seems accepted, therefore, that a franchisor's good faith obligations require, at the most basic level, that the franchisor shall not deprive a franchisee of the benefit of its bargain under the franchise agreement.[57] The essence of such bargain is the integrity of the franchisor's brand, which in turn may be affected by the quality of the infrastructure and standards the franchisor defines from time to time. The franchisees depend on this minimal obligation to maintain brand integrity as a means of making any profit; yet, it is the franchisor that typically has broad discretionary power under the franchise agreement, including how it will create a favorable infrastructure and viable unit operations. Without imposing on the franchisor a duty of competence, the duty of honest performance requires nonetheless a franchisor to make minimal efforts to create a viable operating environment for its franchisees.

4. Duty of Good Faith in Civil Law Jurisdictions (Province of Québec)

The duty of good faith in the Québec civil law jurisdiction has been codified under articles 6, 7, and 1375 of the *Civil Code of Québec*. In fact, the implementation of the concept of good faith in the performance of contracts in Québec had been a central point of prior important decisions that led to the concept's codification.[58]

Article 1434 of the *Civil Code of Québec* provides that a validly formed contract binds the parties that have entered into it not only to what they have expressed in it but also to what is incident to it according to its nature and in conformity with usage, equity, or law. Such provisions impose on each party a duty to deal with each other honestly and fairly so as not to harm the rights of the other contracting party at all times during negotiation, performance, and enforcement of the contract.

While the foregoing provisions of the *Civil Code of Québec* apply to any type of contract, including franchise agreements,[59] the Québec Court of Appeal issued two major decisions over the past twenty years, which, although very fact-specific, have defined the obligations arising out of franchisor-franchisee relationship in light of the duty to act in good faith. In the absence

56. In *Shelanu*, the Ontario Court of Appeal compared the franchisor-franchisee relationship to that of an employer-employee relationship and created what appears to be a floating guardian obligation based on the duty of good faith for the benefit of franchisees. *See supra* note 37, at para 5.

57. *Katotikidis v Mr. Submarine Ltd.*, [2002] O.J. No 1959 (S.C.J.) at para 72; *TDL Grp. Ltd. v Zabco Holdings Inc.*, [2008] M.J. No 316 (Q.B.) at para 272.

58. *Houle v Canadian Nat'l Bank*, [1990] 3 SCR 122, 1990 CanLII 58 (SCC); Nat'l Bank v Soucisse et al., [1981] 2 SCR 339, 1981 CanLII 31 (SCC).

59. *Provigo Distribution, Inc. v Supermarché A.R.G. Inc.*, 1997 CanLII 10209 (QC CA), AZ-98011010, [*Provigo*].

of a specific franchise law, these two cases are now acknowledged as landmark rulings in franchise law in Québec.

a. Supermarché ARG v Provigo

In *Supermarché ARG v Provigo*,[60] the Québec Court of Appeal was asked to rule whether Provigo failed to abide by its contractual obligations toward its franchisee as a result of its decision to launch a new low-cost concept, which had the perverse effect of having the new stores compete directly with its franchisees. Although the court noted in its decision that the franchise agreement contained no explicit obligation on the franchisor to refrain from directly or indirectly competing against its franchisees, the court pointed out that a contract is not limited to the obligations that are specifically provided for therein and that it would consider obligations implied from the nature of the contract itself in accordance with usage, equity, or law. For example, if a franchisor decides to compete with its franchisees, whereas no contrary provision exists in the franchise agreement, the franchisor should nonetheless and concurrently take steps to avoid depriving the franchisee of its opportunity to maintain viable franchise operations as the result of such competition.

According to the court, once the parties execute a franchise agreement, the duty of good faith to which the franchisor and the franchisee are legally bound in the performance of their contract creates a partnership and collaboration commitment toward each other.[61] Thus, one of the fundamental obligations underlying this general duty of partnership and collaboration is the franchisor's obligation of technical and commercial assistance toward its franchisees. The franchisor must, in consideration of its duty of good faith, provide its franchisee with the tools or means by which the franchisee can legitimately and honestly maintain the relevance of both parties' rights in the franchise agreement.[62] On the other hand, a franchisor's actions that result in an unreasonable increase in a franchisee's contractual burden or that alter the nature of the contract are actions in breach of the franchisor's duty of good faith. As set forth in *Provigo*, the considerations seem to involve the same considerations under the duty of honest performance recently adopted by the Supreme Court of Canada in *Bhasin*.

b. Bertico v Dunkin' Brands

Based on the lessons of *Provigo*, the Québec Court of Appeal recently ruled on the concept of an implied duty of good faith in the *Dunkin' Brands* case.[63] The court confirmed the ruling of the trial court April 15, 2015, and ordered Dunkin' Brands Canada Ltd. to pay an amount totaling $10.9 million

60. *Id.*
61. *Id.* at p. 30.
62. *Id.* at p. 31.
63. *Dunkin'*, *supra* note 7. On June 15, 2015, Dunkin' Brands Canada Ltd. filed an application for leave to appeal to the Supreme Court of Canada, raising an issue of public importance that must be addressed by the Court: whether general obligation of good faith imposes on franchisors

(plus interests and costs) to a group of franchisees for lost investments and profits. The court found that the franchise agreements between Dunkin' and its franchisees included both explicit and implied obligations to provide the franchisees with continuous collaboration and support that they legitimately expected in order to protect and enhance the brand, maintain high and uniform standards within the franchise system, and generally preserve the integrity of the franchise system as a whole.[64]

To better understand the position adopted by the Québec Court of Appeal, it is pertinent to reiterate the factual situation that led to that case. Until the mid-1990s, Dunkin', with more than 200 stores, was a leader in the fast-food industry in Québec. However, Dunkin's fortune declined when Tim Hortons, also a quick service provider of coffee and donuts, asserted its presence in Québec. During a meeting in 1996 to respond to this new challenge, Dunkin' franchisees complained about insufficient support and collaboration from their franchisor as well as its inappropriate tolerance of underperforming franchisees.[65] In early 2000, the situation worsened, and a group of these franchisees wrote a formal letter reiterating their concerns and complaining about the breach of the franchisor's obligations, including the failure to invest the required money, time, and resources to protect and increase the brand's image and value in Québec.

As a potential solution to those complaints, Dunkin' presented a renovation program under which the franchisees that committed to invest $200,000 to renovate their restaurants and comply with some additional conditions would receive a $46,000 subsidy from the franchisor in return. The renovation program failed to stave off increasing competition from Tim Hortons. By 2003, Dunkin's market share in Québec had plummeted while Tim Hortons captured the growth in the coffee and donut quick service market.

In May 2003, a group of twenty-one franchisees operating thirty-two locations filed a lawsuit against the franchisor claiming damages for breach of contract. The franchisees alleged that the franchisor had failed to meet its contractual obligations to adequately protect and enhance the Dunkin' brand in Québec. The trial judge agreed to award damages of $16.4 million to the franchisees for lost investments and lost profits under the agreements. The Court of Appeal agreed with the trial judge but reduced the total award to $10.9 million (plus interest and costs) and found that the franchise agreements imposed, either expressly or implicitly, an obligation to protect and enhance Dunkin's brand in Québec. The decision outlined the elements that franchisors should consider when developing their franchise systems and establishing a collaborative approach in their relationships with their franchisees.

duties to enhance their brands and stave off competition. This application was dismissed with costs on March 17, 2016.

64. *Dunkin'*, *supra* note 7, at paras 77–88.

65. *Id.* at paras 23–26.

The 1992 franchise agreements in *Dunkin'* contained performance provisions that said Dunkin' would "continue efforts to maintain high and uniform standards of quality, cleanliness, appearances and service at all DUNKIN' DONUTS SHOPS, thus protecting and enhancing the reputation of DUNKIN' DONUTS CANADA."[66] The 2002 franchise agreement included a recital in which the franchisee acknowledged the importance of high standards and specifications regarding quality, cleanliness, appearance, and service to increase the efficacy of the system.[67] The agreement also contained provisions pursuant to which the franchisor expressly undertook to assist and support the franchisee for the entire term of the franchise contract, including an ongoing advisory relationship, operational revisions, and administration of the franchise owners' advertising fund.

In addition to the above-mentioned explicit performance obligations, the court concluded that the long-term nature of the franchise agreement, along with the legal duty of the franchisor to act in good faith, implicitly established ongoing cooperation and collaboration between the franchisor and its franchisees. Considering the explosive mix resulting in the application of Dunkins' extraordinary contract provisions, the implied duty of good faith, and the very particular factual context of that case. But, as a result, the Québec Court of Appeal in *Dunkin'* identified various considerations within the scope of the franchisor's duty of good faith, such as an implied and affirmative obligation of the franchisor to protect and enhance the brand in the face of competition, which go much further than any common law counterpart and far beyond what has been previously decided by any other Québec courts.

For example, the court recognized that the franchisor-franchisee relationship imposes on franchisors a duty to ensure adequate supervision of the franchise system, which occasionally could require the franchisor to terminate the contractual relationship with weaker franchisees (such as underperforming franchisees that fail to meet uniform standards, thereby tarnishing the brand and negatively impacting the franchise system).[68] Pointing out that toleration of free riders could undermine the value of the franchise[69] and franchisees lack discretionary power to act against franchisors, in such cases, the court noted that they rely on the franchisor to undertake the appropriate measures to protect the integrity of the franchise system.[70] Considering the foregoing, the court concluded that *Dunkin'*s franchisees were entitled to rely on the franchisor to take reasonable measures to protect them from the challenges and competition offered by Tim Hortons and to respond and adjust to new market conditions.[71]

66. *Id.* at para 52.
67. *Id.*
68. *Id.* at para 62.
69. *Id.* at para 83.
70. *Id.* at paras 83–85.
71. *Id.* at para 66.

Discussing what seems to be a bitter and harsh decision for numerous franchisors, the Québec Court of Appeal noted that a franchisor does not have an obligation to outperform the competition or guarantee the profitability of its franchisees. However, it does have an obligation to undertake positive actions to protect its franchisees from competitors and support the brand.[72] The court further stated that if Dunkin' had taken reasonable measures to counter Tim Hortons' expansion, protect, and enhance its brand, even if "Tim Hortons or another competitor had encroached on some of the Franchisees' market,"[73] the franchisees would probably not have had any basis for their complaint. Ultimately, this result is not that dissimilar to the result in *Shelanu* under Canadian common law—weighing the franchisor's minimal efforts to determine if it complied with its good faith obligations.[74]

One can also conclude, in Dunkin's case, that the franchisor's breach of its obligation weighed more heavily because the breach was not the result of a single act or omission, but rather multiple, systemic failures over the course of its contractual relationship with its franchisees. The court, in fact, noted that during the period when Tim Hortons was gaining an important foothold in Québec, Dunkin's strategy was essentially one of "business as usual"—with only minor adjustments being made. This was not enough for the court, and the evidence supported a finding of fault that caused the group of franchisees to lose significant amounts in profits and investments. For the court, this egregious, blind-eye behavior justified the damages award of $10.9 million.[75]

Finally, it is important to take into account that the *Dunkin'* decision is a logical follow up to the *Provigo* case, and as such, it did not create new obligations for franchisors in Québec. The Québec Court of Appeal reported

72. *Id.* at para 72.
73. *Id.* at para 93.
74. *Shelanu*, *supra* note 37, at para 107.
75. Without trying to argue the extent of Dunkin's case finding in a civil law jurisdiction and whether the Québec Court of Appeal meant to create a universal stand-alone obligation to protect and enhance the brand outside a specific set of facts, the Amercan co-author queries whether the express language of Dunkin's franchise agreement would have supported a good faith obligation under U.S. law. U.S. law would not imply a performance obligation absent express language benchmarking the performance. For example, how would a court determine whether the franchisor had earmarked and expended sufficient marketing funds or support for a franchisee absent an express formula in the contract? Another way to look at the equation is whether during the performance of the contract the franchisees could have sought specific performance of the franchisor's obligation, the failure of which ultimately resulted in damages. In other words, if the performance expected under the contract was too indefinite to enforce during the period of operations, how could the parties eliminate or mitigate damages during the period of operations and why reward with damages the indefiniteness of the obligation that the plaintiffs failed to enforce during the period of operations? If the franchisor is charged with the policing of franchisees, only the performance articulated in the contract should be enforced rather than the extreme consequence of the aspirational goal of having all franchisees meet or succeed system standards.

that the outcome in the *Dunkin'* case was well founded and merely involved the "application of established law to a new set of facts."[76]

5. Duty to Police the Franchise System Under Civil Law

Although the *Dunkin'* decision has great significance for franchisors in Québec, it is important to remember that the ruling by the trial judge, and supported by the Court of Appeal, was very fact-oriented and influenced by the extraordinary terms of the franchise agreement. Moreover, the use of highly debatable wording by the Québec Court of Appeal when describing a franchisor's duty—including an "obligation of means to protect and enhance the brand;"[77] a "duty, in cooperation with its franchisees, to respond and adjust to new market condition;"[78] and a "duty to assist and cooperate with the franchisees by taking certain active measures in support of the brand"[79]—may certainly have induced an implied duty to take affirmative measures to avoid abandoning the franchisees in a sinking ship. In any event, the court does not specify exactly when and how those affirmative measures should come into play.

Does this case establish a stand-alone obligation to protect and enhance the brand and a Duty to Police the Franchise System? Likely not. Rather, in determining the scope of a franchisor's duty of good faith, the only general applicable rule in Québec franchising law on which one can rely is the general duty of partnership and collaboration.

In the view of the authors, it was the very particular and significant circumstances, and the wording suggested by the franchise agreement itself, that drove the Québec Court of Appeal in *Dunkin'* to call the actual franchisor's duty of partnership and collaboration a duty to enhance and protect the brand. The conclusion suggests to the entire franchise world that, at least in Québec, there is an increased contractual burden on a franchisor in favor of its franchisees. Regardless of how broadly this so-called duty to enhance and protect the brand was applied in *Dunkin'*, in the future, courts should look only to whether a franchisor has behaved in (1) a non-excessive and reasonable manner and (2) with respect to its obligation of partnership and collaboration toward its franchisees. If not, the application of this broad and generic duty would remain too vague and uncertain for most cases that will lack the substantial and severe circumstances found in *Dunkin'*.

6. Is There a Duty to Police the Franchise System Arising from the Reconciliation of the Common Law and the Civil Law?

Although interpreted with few differences, both Canadian common law and civil law jurisdictions appear to recognize an implied good faith obliga-

76. *Dunkin'*, *supra* note 7, at para 76.
77. *Id.* at para 64.
78. *Id.*
79. *Id.* at para 72.

tion on the parties in the performance of their contracts, but a Duty to Police the Franchise System has yet to be recognized. As much as there is a somewhat uniform law since *Bhasin* related to Canadian good faith obligations and the duty of honest contractual performance, any Duty to Police the Franchise System remains highly uncertain. Thus, until the courts bring a level of certainty as to what type of affirmative measures a franchisor must take to discharge a theoretical Duty to Police the Franchise System, the recognition of such duty would inevitably and erroneously lead to a duty of competence on behalf of the franchisor, which would undermine the very purpose of the duty of good faith.

III. Business Judgment Rule

In discussions of the implied duty of good faith in the United States, a significant exception may even threaten to swallow the rule: the business judgment rule, which permits a company (or franchisor) to make discretionary decisions that may conflict with the interests of other parties, including franchisees, as long as the decision was reached as product of rational business judgment. Because of the impact of this rule and its potential ability to prevent any Duty to Police the Franchise System from ever developing under U.S. law, the authors address it briefly.

A. *Implied Duty of Good Faith and Fair Dealing and the Business Judgment Rule in a Franchising Context in the United States*

In the United States, every contract or duty within the Uniform Commercial Code (UCC) (and very often without) creates an obligation of good faith in its performance and enforcement.[80] Such obligation has been given legislative effect in all fifty states by the adoption of portions of the UCC,[81] although each state is free to adopt its own version of such duty. Nonetheless, both at common law and under the UCC, U.S. courts recognize that the duty of good faith is not an abstract and independent term of the contract. If the parties have complied with the express terms of the agreement, the duty of good faith has no role to play.[82] It merely conditions the exercise of discretion, but even that limited role can still create liability.

Therefore, many franchisors in the United States seek to incorporate the business judgment rule into their franchise agreements to temper discretionary decisions and displace any implied duty of good faith.[83] The business judgment rule, thus incorporated in the franchise agreement, allows a franchisor to exercise its rights on the basis of its "reasonable business judgment."[84] It typically provides that as long as the franchisor exercises reason-

80. Unif. Commercial Code § 1-304 (2001).
81. *Bhasin*, *supra* note 46, at para 84.
82. *See*, *e.g.*, Burger King Corp. v. Holder, 844 F. Supp. 1528 (S.D. Fla. 1993).
83. *Id.* at 167.
84. *Id.* at 168.

able business judgment when making discretionary decisions, the good faith obligation will be satisfied,[85] even if there are other reasonable or arguably preferable options, and even if the decision benefits the franchisor itself, provided that the decision is intended to promote or benefit the franchise system generally.[86]

B. *Business Judgment Rule in Canada and Its Application to the Franchisor-Franchise Relationship*

In *Peoples Department Stores*,[87] the Supreme Court of Canada confirmed the existence of a business judgment rule in Canada. The Court examined the decision of the Ontario Court of Appeal in *Maple Leaf Foods Inc. v Schneider Corp.*[88] to determine the scope of the rule.[89] *Maple Leaf Foods* held:

> The law as it has evolved in Ontario and Delaware has the common requirements that the court must be satisfied that the directors have acted reasonably and fairly. The court looks to see that the directors *made a reasonable decision not a perfect decision*. Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination. *As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision [. . .]. This formulation of deference to the decision of the Board is known as the "business judgment rule."*

The business judgment rule is therefore useful in providing the directors of a corporation with a defense to liability while exercising their functions. It also allows the courts to defer to the decisions reached by the directors of a corporation acting fairly and in good faith, with an appropriate degree of prudence and diligence.[90]

Two issues differentiate the application of the business judgment rule in Canada from comparable application in the United States. In accordance with the Canadian business judgment rule, directors' decisions must be in the interest of the corporation and not in the interest of shareholders or creditors (even if these groups have to be treated fairly), which is contrary to the U.S. business judgment rule, where, if the directors' decision is "rational," it protects the directors from any liability without more. In Canada, directors' decisions must be "reasonable," but the test to determine if they have reached a proper decision is different than the test in the United States.[91]

No court of justice in Canada has ruled to effect the business judgment rule in a franchisor-franchisee relationship. In fact, only the Québec Court

85. *Id.* at 168–69.
86. *Id.*
87. 2004 SCC 68, [2004] 3 SCR 461, [*Peoples*].
88. 42 O.R. (3d) 177 at 192, [1998] CanLII 5121 (ON CA).
89. *Peoples*, *supra* note 87, at para 65.
90. *Id.* at para 61.
91. Osler, Hoskin & Harcourt LLP, *Directors' Responsibilities in Canada*, at p. 11 (Oct. 2014), https://www.icd.ca/getmedia/581897ca-d69d-4d4f-a2a2-ca6b06ef223b/5467_Osler_Directors_Responsibilities_-Canada-FINAL.pdf.aspx.

of Appeal in *Dunkin'*[92] addressed that potential application because the franchisor raised it as a possible defense. The court, considering whether the business judgment rule applied to the franchisor's actions and prevented the court from intervening and second-guessing Dunkin's business decision, refused to give any merit to such argument.[93] According to the court, the franchisor failed to consider that rule in its proper meaning by trying to avoid ordinary liability for breach of contract. The business judgment rule usually applies to matters regarding the personal responsibility of directors or officers of a corporation to shareholders and not in a way of "*exculpating a corporate contracting party from liability or fault under a contract with third parties.*"[94] The court thus found it unusual and inconsistent with Canadian law to shield a franchisor from contractual liability in circumstances where the franchisee would otherwise be entitled to remedies for breach of contract.[95] The court dismissed the franchisor's proposed application of the rule as out of step with its purpose and stated its finding was consistent with a prior decision by the court in *Videotron v Bell ExpressVu*.[96]

As a result of the foregoing, application of the business judgment rule in a Canadian franchisor-franchisee relationship appears to be an unsuitable means to achieve a balance between a franchisor's interests and the sometimes conflicting interests of its franchisees or of the system as a whole. Under Canadian law, the business judgment rule as a discretionary standard does not mesh well with the application of a duty of good faith, in part because they serve different objectives. And, the result has the potential to create confusion for the parties with regard to the performance of contractual obligations. Although in the United States it is possible to waive the implied covenant to engraft the business judgment rule into a specific clause in the franchise agreement,[97] this result is unlikely in Canada.[98]

92. *Dunkin'*, *supra* note 7.
93. *Id.* at paras 97–102.
94. *Id.* at para 101.
95. *Id.* at para 102.
96. *Vidéotron, s.e.n.c. v Bell ExpressVu, l.p.*, 2015 QCCA 422 at para 71, JE 2015-446.
97. Schnell & Gardner, *supra* note 9, at 185.
98. In the common law, the obligation of fair dealing appears immune to entire agreement clauses. *See generally Landsbridge*, *supra* note 40, at para 25. In Québec, the implied good faith obligation under both articles 1375 and 1434 of the Civil Code of Québec cannot be excluded by agreement. *See generally* Didier Lluelles & Benoît Moore, Droit des Obligations 1118–19 (Montréal: Éditions Thémis 2d ed., 2012). Finally, statutory obligations cannot be excluded. *See generally Franchises Act*, RSA 2000, c F-23; *Arthur Wishart Act (Franchise Disclosure)*, SO 2000, c 3; *Franchises Act*, RSPEI 1988, c F-14.1; *Franchises* Act, SNB 2014, c 111; *The Franchises Act*, CCSM *Franchises Act*, CCSM c F156.