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A WORLD OF TROUBLE: HOW TO LIMIT LIABILITY EXPOSURE IN INTERNATIONAL FRANCHISE EXPANSION

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I. INTRODUCTION

Numerous businesses utilize the franchise business model to attract competent business partners with adequate capital and the ability to help them grow their businesses, often rapidly, and expand into new and diverse markets. However, expanding into international markets presents unique challenges and risks that may expose the franchisor to liability in various scenarios. Franchisors embarking on an international expansion should be aware of the risks that legislative acts and judicial decisions from certain key international markets can impose on their businesses so that they can properly take steps to mitigate such risks. Indeed, some recent legislative acts, government investigations, and judicial decisions appear to require franchisors to take new or enhanced actions to avoid liability for the failure, actions, and even the financial difficulties encountered by their foreign franchisees. This paper will explore selected foreign laws, government investigations, and international judicial decisions where franchisors have been held liable (or are otherwise exposed to liability or reputational damage) for the failures, actions or omissions of foreign franchisees, and identify potential solutions franchisors can take to limit their exposure to liability.[1]

II. TRADITIONAL WAYS FRANCHISORS HAVE BEEN EXPOSED TO LIABILITY AND ACTIONS THEY HAVE TAKEN TO MITIGATE SUCH RISKS

While the franchising model has been successful in helping brands expand both domestically and internationally, the growth and opportunities available through international franchising are accompanied by uncertainties and risks that must be carefully considered. It is commonly understood that franchisors face potential liability arising from their own actions and under their contracts with their international franchisees. Typical examples include franchise disclosure violations, false or misleading statements in connection with franchise sales, and failure to provide promised support to franchisees in accordance with the terms of their franchise agreements (with franchisors traditionally being guided by their express support

[1] The authors wish to thank associate attorney Nia Newton at Nixon Peabody LLP for her assistance in preparing the Australia-based sections of this paper. The views expressed in this paper do not necessarily reflect the views of any of the employers or clients (or any of their respective affiliates) of the authors.

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obligations and not implied obligations). Franchisors typically mitigate these risks by understanding local legal requirements, hiring competent counsel, and training employees properly in connection with the franchise sales and disclosure process. Further, franchisors can minimize risk by implementing a properly-designed sales, support and termination process, thus making it more likely their organization complies with its obligations under the franchise agreement and applicable law.

Franchisors may also face the risk of potential liability for the acts or omissions of their franchisees as a result of the operation of principles of vicarious liability and similar legal doctrines. Such liability frequently arises under principles of agency law when (i) as a result of the significant level of control a franchisor possesses over a franchisee (especially related to day-to-day control), the franchisee and/or its employees are deemed to be the agents of the franchisor, often using "the traditional master/servant 'control or right to control' test'"[2] (actual agency) or (ii) as a result of the actions of the franchisor, a reasonable person would conclude that the franchisee and/or its employees are the agents of the franchisor and such person acts in reliance on such belief (apparent agency)[3].

The risk of vicarious liability regularly arises because of the nature of the franchisor-franchisee relationship: Franchisors have a critical business interest in protecting their brand by maintaining uniformity throughout the franchise system, ensuring compliance with system standards, and protecting their registered trademarks from inappropriate or misleading uses to reduce the risk of trademark abandonment or cancellation[4]; however, if a franchisor exercises a degree of control over a franchisee's business (especially in areas relating to day-to-day control) that is found to be excessive[5], then under principles of vicarious liability a franchisor may be held liable for the acts or omissions of its franchisees and/or their employees. In addition, franchisors face potential legal liability for the actions of franchisees in other areas, including:

- Employment-related law (e.g., joint employer and wage and hour claims)[6];
- Cybersecurity / data privacy;
- *Foreign Corrupt Practices Act* violations;
- Tort and similar liability; and
- Statutory claims[7].

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[2] *See Kerl v. Dennis Rasmussen, Inc.*, 682 N.W.2d 328, 337 (Wis. 2004); *see generally Hayman v. Ramada Inn, Inc.*, 357 S.E.2d 394, 397 (N.C. Ct. App. 1987) and *Hart v. Marriott International, Inc.*, 758 N.Y.S.2d 435, 438 (2003).

[3] *See Johnson v. Marriott Int'l, Inc.*, 2017 U.S. Dist. LEXIS 72283, at *13-16 (W.D. Wis. May 11, 2017); *see also Crinkley v. Holiday Inns, Inc.*, 844 F.2d 156 (4th Cir. 1988).

[4] *See* 15 U.S.C. § 1064(5)(A) (2006).

[5] The level of control that is sufficient to impose vicarious liability on a franchisor for the acts or omissions of a franchisee and/or its employees varies among jurisdictions and is beyond the scope of this paper. However, for an in-depth discussion and analysis of vicarious liability and case law involving franchised businesses, please see ALEJANDRO BRITO, JENNIFER E. CONSTANTINOU AND BARRY M. HELLER, VICARIOUS LIABILITY IN DEVELOPING AREAS: DAMNED IF YOU DO AND DAMNED IF YOU DON'T, (Nov. 2-4, 2016) [hereinafter *Vicarious Liability in Developing Areas*], https://www.americanbar.org/content/dam/aba/images/franchising/annual16/course-materials-16/w9-vicarious-liability.pdf.

[6] *See, e.g., Browning-Ferris Industries of California,* d/b/a *BFI Newby Island Recyclery*, 362 NLRB No. 186 (2015) and *Roman v. Jan-Pro Franchising Int'l, Inc.*, 2017 U.S. Dist. LEXIS 79967 (N.D. Cal. May 24, 2017).

Franchisors utilize various methods to mitigate the risk of liability arising from franchisee actions, such as (i) incorporating express language in the franchise agreement requiring the franchisee to comply with all applicable laws, often expressly referencing the *Foreign Corrupt Practices Act* and other critical statutes and (ii) utilizing well-designed controls, monitoring (e.g., audits) and regular inspections to increase the likelihood of franchisee compliance, while at the same time taking care not to exercise too much control over their franchisees' independent businesses. In addition, franchisors also typically incorporate the following in their franchise agreements and related documents to further reduce the risk arising from franchisee actions:

(i) a requirement for their franchisees to comply with all applicable laws,

(ii) comprehensive indemnity language in the franchise agreement requiring the franchisee to indemnify and hold harmless franchisor and its affiliates,

(iii) insurance coverage requirements for franchisee that are sufficient to cover the franchisee's business and the franchisor (with an obligation to name the franchisor as an additional insured on the relevant insurance policies)[8], and

(iv) a separate guaranty of the franchisee's obligations under the franchise agreement executed by a financially viable affiliate or principal of the franchisee for the benefit of the franchisor.

As a final backstop, franchisors should also carry their own robust insurance policies protecting them from liability arising from the operation of the franchised business.

III. DO RECENT LEGISLATIVE ACTS, GOVERNMENT INVESTIGATIONS, AND JUDICIAL HOLDINGS REPRESENT A CHANGING LANDSCAPE?

While the above discussion provides a high-level introduction to the traditional risks faced by franchisors (including the risk of vicarious liability for franchisee actions when a franchisor exercises significant control over a franchisee's business), the selected foreign laws, government investigations, and international judicial decisions discussed below may require franchisors to reconsider their risk mitigation strategies because they appear to require franchisors to take actions above and beyond what has traditionally been required in order to avoid liability. These laws, government investigations, and judicial decisions seemingly obligate franchisors to protect their franchisees against normal commercial risks (e.g., competition from entrenched or new competitors, site selection risk, inability to comply with development requirements, etc.), to provide assistance beyond what the parties' contract requires, or to actively monitor

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[7] *See, e.g., Magee v. McDonald's Corporation*, No. 16-CV-05652 (N.D. Ill. Nov. 14, 2017) (order granting plaintiff leave to file a second amended complaint in a lawsuit in which plaintiff alleged that the practice of certain McDonald's restaurants to lock their doors at night and continue to sell food to customers through the drive-through violates the Americans with Disabilities Act) and *Thomas v. Taco Bell Corp.*, 582 F. App'x 678 (9th Cir. 2014) (holding that Taco Bell Corporation could not be held liable for a text message sent to a consumer as part of a promotion conducted by the Chicago area Taco Bell owners association because plaintiff was unable to show that she had reasonably relied on any apparent authority of Taco Bell Corporation in connection with the text message and because Taco Bell Corporation did not ratify the text message).

[8] *Vicarious Liability in Developing Areas*, *supra* note at 29.

franchisee compliance with local law – and, if franchisors do not do so, they could be found liable for franchisee failures, acts or omissions. This is particularly concerning given the risk a franchisor potentially assumes under agency law when it takes an overly active role in the business of its franchisees.

A. Significant Government Investigations and Judicial Decisions.

Australia

1. Australia's 7-Eleven Wage Scandal

The meticulously documented, and widely publicized, 7-Eleven Australian wage scandal, culminating in an extensive 2016 Australian government ombudsman's report, demonstrates that significant vicarious liability risks exist for a national franchisor/master franchisee for the improper labor actions of its franchisees. Moreover, these risks spilled over into considerable reputational risk to franchisor 7-Eleven, the world's largest operator, franchisor, and licensor of convenience stores.

Background. In June 2014, the Fair Work Ombudsman ("FWO"), an industrial relations tribunal created by the *Fair Work Act 2009* ("FWA 2009") as part of government reforms to industrial relations in Australia, began an inquiry into allegations of rampant underpayment of staff and violations of the FWA 2009 at 7- Eleven's 620 franchised stores in Australia.[9] The Australian franchised convenience stores operated under franchise agreements granted by the Australian franchisor, 7-Eleven Australia Pty Ltd., which in turn had been granted a license by franchisor 7-Eleven approximately 40 years ago.

According to the FWO, the Australian 7-Eleven system had a recorded history of non-compliance that dated back to 2008, when franchisees' 7-Eleven employees first began complaining of underpayment. A majority of these 7-Eleven employees were foreign students, working in the country on visas with certain work conditions that prohibited students from working more than 40 hours every 2 weeks. Nevertheless, complaints to the FWO revealed that foreign students faced a "campaign of deception, fear-mongering, intimidation and even actual physical violence,"[10] worked significantly longer hours than the wage records recorded by management reflected, and were threatened by employers (who coerced students into working longer hours than their visas allowed) with deportation for visa work violations when they mentioned or complained about underpayment. In early 2014, allegations arose that inconsistent wage records were not an accident, but appeared to be something much more calculated in the Australian franchise system as a whole.[11] In August 2015, a joint *Four Corners* and Fairfax Media investigation all but confirmed this, as their review into 7-Eleven's time sheets and rosters uncovered systematic wage fraud across the 7-Eleven

[9] Commonwealth of Australia, "A Report of the Fair Work Ombudsman's Inquiry into 7-Eleven: Identifying and Addressing the Drivers of Non-Compliance in the 7-Eleven Network" April 2016.

[10] Paul Karp, 7-Eleven Workers Beaten and Forced to Pay Back Wages, Senate Inquiry Hears, The Guardian, available at https://www.theguardian.com/australia-news/2016/feb/05/7-eleven-workers-beaten-and-forced-to-pay-back-wages-senate-inquiry-hears, February 4, 2016.

[11] Matthew Dunckley, "How 7 Eleven is Ripping Off Its Workers" available at https://www.smh.com.au/interactive/2015/7-eleven-revealed/

chain in Australia, including falsification of payroll records, understated wage bills, doctored time sheets and records, and other illegal practices like "half pay scams," where employers who were 7-Eleven franchisees paid foreign workers half the pay for double the hours of work.[12] Internal documents obtained by the *Four Corners* and Fairfax Media investigation also revealed that in a review of 225 stores, conducted by 7-Eleven's head office through July and August 2015, 69% of stores had payroll compliance issues with the FWA 2009.[13] As a result of the FWO inquiry and the *Four Corners* and Fairfax Media investigation, between 2009 and 2017, the FWO took legal action against nine 7-Eleven franchisees[14] in the Federal Circuit Courts resulting in:

a) court-imposed penalties that surpassed AUD $1,000,000;

b) One (1) Enforceable Undertaking (written agreement between FWO and employers who are violators of Australian workplace law that ensures the employers fix violations and take steps to prevent future violations);

c) Twenty (20) Letters of Caution (formal notice from FWO to violating employers, which FWO may rely on in the future if violations occur again);

d) 14 Infringement Notices (a notice, similar to an on-the-spot fine, issued by FWO to an employer who does not follow its record-keeping and pay slip obligations under Australian workplace laws);

e) 3 Compliance Notices (a notice issued by FWO which requires an employer to fix a breach of an Australian workplace law); and

f) over AUD $293,500 recovery for workers.[15]

While the FWO ultimately took no action against the Australian franchisor or its foreign franchisor, the egregious conduct by 7- Eleven franchisees turned a spotlight on the potential culpability of the Australian franchisor.

***The 7-Eleven Model*.** When franchisees of 7-Eleven were asked why wage fraud was being committed on such a large scale, some responded "to save money."[16] In fact, a group of insiders asserted that 7- Eleven's head office was complicit with such fraud, alleging that 7-Eleven would have "experienced franchisees" train new owners in wage manipulation and record falsification, an allegation never proven.[17] Many pointed to the 7-Eleven franchise model as the catalyst for bad behavior, putting franchisees into an almost impossible situation with financially unviable agreements, arguably forcing

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[12] Adele Ferguson, Sarah Danckert and Klaus Toft, "7-Eleven: A Sweatshop on Every Corner" The Age, available at https://www.theage.com.au/business/careers/7eleven-a-sweatshop-on-every-corner-20150827-gj8vzn.html August 28, 2015.

[13] *Id*.

[14] Davide Chau, "7-Eleven Court Penalties for Exploiting Workers Tops $1million, says Fair Work Ombudsman, ABC News, *available at* http://www.abc.net.au/news/2017-07-25/7-eleven-court-penalties-now-top-1-million/8740706, July 24, 2017.

[15] Commonwealth of Australia, "A Report of the Fair Work Ombudman's Inquiry into 7-Eleven: Identifying and Addressing the Drivers of Non-Compliance in the 7-Eleven Network" April 2016.

[16] Adele Ferguson, Sarah Danckert and Klaus Toft, "7-Eleven: A Sweatshop on Every Corner" The Age, *available a*t https://www.theage.com.au/business/careers/7eleven-a-sweatshop-on-every-corner-20150827-gj8vzn.html August 28, 2015.

[17] Laura Regan, "Time for Change at 7-Eleven: Workplace Responsibility of Upper Management" *available at* http://www.mondaq.com/australia/x/519812/employee+rights+labour+relations/Time+for+change+at+7Eleven+workplace+responsibility+of+upper+management August 17, 2016.

franchisees to underpay workers and engage in fraudulent acts to remain solvent. Under the franchise agreements at the time, the head office in Australia took 57% of gross profits and franchisees received the remaining 43%, of which they were supposed to "pay wages, superannuation, cleaning, landscaping, store supplies, merchandise, business licenses, tax, and miscellaneous store expenses."[18] While FWO ultimately concluded that the 7-Eleven Australian franchisor was not legally responsible for entitlements payable to employees of franchisees, it indicated that the Australian franchisor did hold "moral and ethical responsibility," and was capable of preventing the fraudulence from occurring again. FWO published several recommendations in its final report on steps that the 7-Eleven franchisor should take to protect its system from widespread underpayment of 7-Eleven employees.[19]

***Unforeseen Consequences*.** While 7-Eleven's Australian head office was not ultimately found to be liable for the action of its franchisees in the wide-spread wage fraud, the scandal did raise questions about the company's system standards and processes. In February 2018, it was announced that an Australian law firm was filing, and dozens of 7-Eleven franchisees were expected to join, a class action suit against 7-Eleven's Australian franchisor and ANZ bank over the way the Australian 7-Eleven head office lent money to franchisees to buy franchises.[20] Franchisees assert that 7-Eleven and ANZ violated the code of banking practices by agreeing to provide loans to potential franchisees who would not ordinarily meet the loan criteria, under conditions that were not clear or obvious.[21] This class action also makes a loose connection to the 7-Eleven wage fraud; 7-Eleven Franchisees suggest that 7-Eleven committed a "de facto ethnic selection of franchisees" purposely targeting and providing loans to individuals from India or South Asia with limited business experience and knowledge of local labor laws and who would be less likely to report wage fraud issues.[22] Arguably the class action lawsuit may not have been filed if not for the wage fraud scandal and may be an example of how things can go awry when franchisors do not have proper mechanisms in place to detect and address fraudulent practices of their international franchisees.

***Ways to Prevent Fraudulent Practices*.** 7-Eleven's approach to workplace matters in Australia, at least before 2016, did not adequately detect or address deliberate and brazen fraud throughout the system, which exposed the company to potential liability for the actions of their franchisees. To limit risk exposure in the future, the FWO concluded that there are a number of ways 7-Eleven (and other franchisors who hope to learn from the 7-Eleven scandal and avoid similar situations) can prevent such fraudulent practices, including[23]:

[18] Matthew Dunckley, "How 7 Eleven is Ripping Off Its Workers" available at https://www.smh.com.au/interactive/2015/7-eleven-revealed/.

[19] Commonwealth of Australia, "A Report of the Fair Work Ombudman's Inquiry into 7-Eleven: Identifying and Addressing the Drivers of Non-Compliance in the 7-Eleven Network" April 2016.

[20] AAP "7-Eleven to 'vigorously defend' lawsuit," Perth Now The Sunday Times, available at https://www.perthnow.com.au/news/crime/lawsuit-to-hit-anz-after-7-eleven-scandal-ng-s-1829776, February 16, 2018.

[21] *Id*.

[22] Justin Sungil Park, "Lawsuit Targets ANZ over 7-Eleven Scandal," SBS.com *available at https://www.sbs.com.au/yourlanguage/korean/en/article/2018/02/16/lawsuit-targets-anz-over-7-eleven-scandal*, February 17, 2018.

[23] *See* supra note 19.

- Ensuring compliance with all relevant laws through governance arrangements that specifically address: line management accountabilities; mechanisms for identifying, escalating and addressing potential non-compliance; development of transparent and verifiable payroll systems; business and financial training of franchisees; awareness and understanding by franchisees, employees and third party providers such as payroll and human resources providers of workplace and migration laws, specifically addressing issues of accessorial liability;

- Analyzing the company's operating model to ensure compliance with workplace laws is achievable, practicable, and fair;

- Regularly reviewing the company's profit sharing arrangements and the financial viability and legal exposure of its franchise agreements;

- Maintaining and monitoring accurate wage records through implementation of biometric time recording systems for all employees and franchisees that 7-Eleven would have access to; requiring weekly submissions of store rosters; requiring photographic identification of all employees; and owning and operating all security cameras and systems in 7-Eleven franchises and preventing franchisees from accessing video recordings without franchisor's prior approval;

- Engaging third parties to conduct annual audits of compliance with the FWA 2009, or any other applicable laws; appointing senior personnel to conduct internal auditing of time and payroll data, permitting them to identify irregularities or inconsistencies in wage records; and identifying high risk franchisees and conducting closer financial forensic investigations into the records of those franchisees;

- Establishing a hotline for employees, franchisees, and members of the public that has the capacity to respond to and manage complaints made anonymously, and hiring a seasoned human resources specialist with the responsibility of monitoring those allegations, trends, and concerns;

- Establishing a "guarantee" reserve fund maintained by the franchisor to cover payments to underpaid employees of franchisees, when franchisees who are required to rectify the underpayment fail to do so;

- Providing prospective franchisees with information outlining the applicable minimum wage, loadings, penalty rates and overtime rates of pay for full time, part time, and temporary employees, and (if applicable) providing details of a specific store's income and expenditure data for a period of two years;

- Modifying the company's online employee training materials to include information about the hotline, how to provide necessary information to the franchisor anonymously, training and requirements that all training is paid, information about "half-pay" scams and their prohibition, and information on a franchisee's responsibilities in respect to compliance with visa requirements and workplace laws; and

- Initiating compliance commitment agreements with franchisees, in which they certify that their directors, officers, and managers (i) understand their obligations to comply with the law (ii) will not require or accept payments from employees' wages, acknowledging that such conduct is unlawful, and (iii) agree to report to the franchisor periodically how each of franchisee's employees is hired and engaged, and the terms and conditions of such engagement.[24]

2. The YUM!/Pizza Hut "Value Strategy" Litigation

Background. In November 2017, the Federal Court of Australia released an appeal decision regarding a representative action by a franchisee who challenged the decision by the Australian franchisor affiliate of YUM! brands ("Yum") to implement a retail price reduction strategy for Australian Pizza Hut franchisees (the "Value Strategy").[25] The Value Strategy involved reducing the range of pizzas available to two ("Classic") and "Favourites") and reducing the prices within those ranges. Yum exercised its right under the International Franchise Agreement with the franchisees to set maximum prices. The franchisees contested the Value Strategy, claiming they could not survive financially if it was implemented. The franchisees argued that, among other claims, Yum breached its contractual duties by implementing the Value strategy.

In the original decision, the court found in favour of Yum, holding that Yum had carefully considered the maximum price before implementing the Value Strategy, and that there had been no dishonesty and bad faith in Yum's conduct. Further, the court held that Yum acted in the face of market competition (price reductions by Domino's) and that Yum "rightly or wrongly but reasonably" believed that it had no choice but to implement the Value Strategy.

Decision on Appeal: The franchisees appealed the lower court decision, arguing that the lower court judge ought to have found that Yum failed to act reasonably in adopting the Value Strategy and setting the maximum prices. In reviewing the decision, the appeal court examined whether Yum complied with the "duty of good faith and reasonableness" in its enforcement of the contract, and determined that the primary judge had not erred in her finding in favour of Yum. The appeal court also refused to imply a contractual promise of profitability in respect of the International Franchise Agreement.

Take-Away. The *Yum* litigation in Australia resulted in helpful pro-franchisor jurisprudence, as the franchisor's right to implement broad changes in response to market conditions was upheld. However, the concerns raised by the franchisees in *Yum* are similar to those raised in other foreign jurisdictions, and franchisors should be

[24] *Id*.
[25] *Virk Pty Ltd. (in liq) v. YUM! Restaurants Australia Pty Ltd*. [2017] FCAFC 190 ("*Yum*").

careful to ensure that they are able to establish processes that provide evidence of good faith consideration before implementing serious system changes. In Canada, Tim Hortons, an international coffee and donuts franchisor brand, dealt with similar litigation when addressing the implementation of a par-baked goods system and the introduction of a lunch menu. As with *Yum* in Australia, Tim Hortons was successful in resisting the franchisees' legal challenge, as the court noted that Tim Hortons' moves were "a rational business decision made by Tim Hortons for valid economic and strategic reasons, having regard to both its own interests and the interests of its franchisees."[26] Along this line of reasoning, international franchisors should ensure that they can establish economic and strategic reasons and rationale for significant decisions they intend on implementing on their franchise systems.

Canada

3. **The Dunkin' Donuts Franchisee Action**

Background. 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 because, among other reasons, 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

[26] *Fairview Donut Inc. v. The TDL Group Corp*., 2012 ONCA 867 (CanLII), <http://canlii.ca/t/fv39k> at para. 6 ("*Tim Hortons*").

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 underestimation 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[27] 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 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.

The Trial Decision. On June 21, 2012, the Superior Court of Quebec issued its judgment in the case of *Bertico Inc. et al v. Dunkin' Brands Canada, Ltd.,*[28] concluding that Dunkin' Donuts was liable 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."[29] 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 […]*

[27] Unlike the rest of Canada, the province of Quebec is a civil law, rather than common law, jurisdiction.

[28] Trial Judgment in *Bertico Inc. et al*. v. *Dunkin' Brands Canada Ltd.* (formerly Allied Retailing International (Canada) Ltd., 2012 QCCS 2809, June 21, 2012 ("*Bertico Trial Judgment*").

[29] *Bertico Trial Judgment*, paragraph 54.

> *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, ainis 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; […]*[30]

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; 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'." [31] 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."[32]

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 vitiated.[33]

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[30] *Bertico Trial Judgment*, paragraphs 15 and 18.
[31] *Bertico Trial Judgment*, paragraph 55.
[32] *Bertico Trial Judgment*, paragraph 56.
[33] *Bertico Trial Judgment*, paragraph 69.

Having found the franchisor liable, the judge considered both the franchisees' damages claims for lost profits and lost investments and the counterclaim for unpaid royalties and other amounts by the franchisor.[34] 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.[35]

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."[36] 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; and (g) 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."[37]

The Appeal. On April 15, 2015, the Quebec Court of Appeal issued its long-awaited decision on appeal, confirming the trial court's finding on liability but reducing the damages and granted the Dunkin' Donuts' counterclaims.[38]

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

> *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*

[34] *Bertico Trial Judgment*, paragraphs 70-122.
[35] *Bertico Trial Judgment*, paragraph 112.
[36] *Bertico Trial Judgment*, paragraph 54.
[37] *Bertico Trial Judgment*, paragraph 56.
[38] Appeal Judgment, *Dunkin' Brands Canada Ltd*. vs. *Bertico Inc. et al.*, 2015 QCCA 624, April 15, 2015 ("*Bertico Appeal Judgment*.").

> *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. Supermaché A.R.G. Inc., decided by this Court eighteen years ago and generally recognized as the leading authority in Quebec law since that time.*[39]

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.*[40]

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,[41] 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.*[42]

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

(a) Contractual Obligations under 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

[39] *Bertico Appeal Judgment*, paragraph 8.
[40] Civil Code of Quebec, S.Q. 1991, c.64.
[41] *Provigo Distribution Inc.* v. *Supermarché A.R.G. Inc.* [1998] R. J. Q. 47 (C.A).
[42] *Supra* Note 31.

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 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 entirety 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.[43]

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.[44] 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, advising franchisees at the start of the venture, and 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 removed. 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.[45]

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. The Court found important that the trial judge held as important the recognition that the character of these specific franchise arrangements was an "ongoing" one in respect of a "system" that the parties agreed to

[43] *Bertico Appeal Judgment*, paragraph 48.
[44] Civil Code of Quebec, S.Q. 1991, c.64.
[45] *Bertico Appeal Judgment*, paragraph 62.

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.[46]

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.[47] 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, in line 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.[48]

The Court of Appeal revisited the notion of implied obligation of good faith analysed at length in *Provigo*[49] and found as follows:

> *The judge was correct to rely on Provigo 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 Provigo is not confined to the circumstances of franchisors who compete unfairly with their franchisees.*[50]

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*

[46] *Bertico Appeal Judgment*, paragraph 63.
[47] *Bertico Appeal Judgment*, paragraph 64.
[48] *Bertico Appeal Judgment*, paragraph 66.
[49] Supra Note 41.
[50] *Bertico Appeal Judgment*, paragraph 69.

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.[51]

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."[52] 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 similar to the one the Court found in *Provigo*.[53]

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.[54] 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

[51] *Bertico Appeal Judgment*, paragraph 71.
[52] *Bertico Appeal Judgment*, paragraph 72.
[53] *Bertico Appeal Judgment*, paragraph 72.
[54] *Bertico Appeal Judgment*, paragraph 73.

C.C.Q.)[55] 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 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.[56]

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.[57]

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.[58]

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 reversible error in his identification of the obligational content of the franchise agreements.

[55] Supra, Note 51.
[56] *Bertico Appeal Judgment*, paragraph 74.
[57] *Bertico Appeal Judgment*, paragraph 75.
[58] *Bertico Appeal Judgment*, paragraph 77.

b) 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.

> *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 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.*
>
> **[…]**
>
> *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.*[59]

c) The Application of the Business Judgment Rule

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.

d) 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:

> *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*

[59] *Bertico Appeal Judgment*, paragraph 94.

> *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.*[60]

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:

> *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.*[61]

[60] *Bertico Appeal Judgment*, paragraph 112.
[61] *Bertico Appeal Judgment*, paragraph 113.

e) 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.

(f) 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 and void. 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.

Damages. 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:

> *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.*
>
> *[…]*
>
> *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.*[62]

[62] *Bertico Appeal Judgment*, paragraphs 172, 173, 174, 175, 176, 177 and 178.

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.

Additionally, 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 his limited reasons in the following terms:

> *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.*[63]

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 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.

[63] *Bertico Trial Judgment*, paragraph 111.

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:

(a) 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%; and

(b) 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.

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.[64] In support of its application, Dunkin' Donuts submitted the three following questions:

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

(b) 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?

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

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[64] *Dunkin' Brands Canada Ltd.* v. *Bertico Inc. et al.*, File number 36475.

The Supreme Court of Canada ultimately denied Dunkin' Donuts' application and it is clear that the Court of Appeal decision now represents the state of the law in the province of Québec. But many still question its application in the rest of Canada for a number of reasons. First, Québec is the only Canadian province governed by Civil law and its Civil Code. The decisions both at trial and on appeal are rooted in the principles of Civil law. Second, the case is very fact specific if only because of the explicit terms of the franchise agreements which lay the foundation for the *ratio decidendi* of the judgments at trial and on appeal. Third, many questions remained unanswered by the Court of Appeal. For instance, to what extent is a franchisor required to take reasonable measures to protect franchisees from market challenges? The Court clearly expressed that the franchisor's obligation is one of means but provided no true insight to assist franchisors in determining the extent of that obligation.

In the end, outside the province of Québec, the Dunkin' Donuts decision should be seen much more as "food for thought" rather than *stare decisis.* This has been reflected by the fact that the decision has generally not been cited in franchise decisions in Canada's common law jurisdictions.

4. **Raibex Canada Ltd. v. ASWR Franchising Corp.**

Background. On January 25, 2018, the Ontario Court of Appeal released the closely-followed decision in *Raibex Canada Ltd. v ASWR Franchising Corp*. The decision provided much-needed clarity on the pre-contractual disclosure obligations imposed on franchisors under the *Arthur Wishart Act (Franchise Disclosure), 2000* (the "*Wishart Act*").[65] This clarity was a welcome development for domestic and international franchisors, who had to grapple with the uncertainty arising from the lower court (Ontario Superior Court of Justice) decision, which released in late 2016. The lower court had granted the franchisee's statutory rescission claim due to inadequate disclosure of material facts concerning the franchise, and concluded that it would be "premature" for a franchisor to provide disclosure and enter into a franchise agreement if potentially material facts about the franchise, such as the location, had yet to be determined. This uncertainly was particularly evident in dealing with executing franchise agreements when there was no lease entered into yet for a franchise location.

The Court of Appeal's decision granting the franchisor's appeal and setting aside the rescission of the franchise agreement clarified that the disclosure obligations under the *Wishart Act* must be interpreted practically and with reference to the commercial realities of the circumstances surrounding the grant of the franchise and the terms of the franchise agreement. The post-agreement location selection process employed by the franchisor, which is common in the industry, was not found to be offside of the *Wishart Act*'s disclosure regime. As such, the Court of Appeal clarified that franchise parties can, in certain circumstances, enter into a franchise agreement without having entered into a lease beforehand.

[65] *Raibex Canada Ltd. v. ASWR Franchising Corp.*, 2016 ONSC 5575.

In 2012, the plaintiff franchisee, Raibex Canada Ltd. (“Raibex"), entered into a franchise agreement with ASWR Franchising Corp. (“AllStar”) for the operation of a new “AllStar Wings & Ribs” franchise in Mississauga. Prior to entering into the agreement, Raibex received a comprehensive 190+ page franchise disclosure document (“FDD”) as required by section 5 of the Wishart Act. The franchise agreement allowed for the location of the franchise to be determined after the franchise agreement was signed, at which point the franchisor would sublease the chosen location to the franchisee.

If a suitable location was not found within 120 days, the franchise agreement provided an “opt-out” clause allowing the franchisee to terminate the franchise agreement and receive a refund of its initial fee. After touring several locations with the franchisor’s real estate agent, Raibex decided to pursue a location formerly home to another restaurant which it would convert into an AllStar franchise. At the time this location was selected, the opt-out clause was available to Raibex but not exercised.

After completing construction and a few months of operating the franchise, the franchisee served a notice of rescission in response to the impending termination of its franchise agreement due to non-payment of over $200,000 owing for rent and amounts owed to contractors. AllStar and its related entities and principals, named as co-defendants, moved to dismiss the entire action, including the franchisee’s claims under sections 3 and 7 of the Wishart Act, and for judgment on its own breach of contract claim arising from the termination of the franchise agreement. Aside from the quantification of damages, the motion judge resolved the entire action on summary judgment, granting the rescission claim and dismissing the plaintiffs’ claims under sections 3 and 7.

Decision on Summary Judgment. On the summary judgment motion, the lower court granted the franchisee’s claim for rescission asserting that the franchisor ought to have ‘waited’ until a copy of the head lease for the location was available. That court did so despite the fact that the location would not be selected by the franchisor and franchisee until some 6 months after the franchise agreement was signed.

The motion judge also found that AllStar failed to disclose estimates of development costs sufficiently tailored to that location. The estimates provided were in relation to a “shell” and not a conversion of an existing restaurant. In doing so, the motion judge suggested that a franchisor in such a situation is "not yet ready" to disclose and "must wait” until all “material matters” are known before delivering a disclosure document. This decision caused confusion for franchisors in Ontario, many of whom followed the longstanding and common practice of selecting a location after the franchise agreement is signed using a location selection process set out in the franchise agreement.

Decision on Appeal. In granting AllStar’s appeal and dismissing Raibex’s cross-appeal, the Court of Appeal restored clarity and commercial sense to the interpretation of the disclosure requirements and rescission remedies set out in the *Wishart Act*. This clarity will hopefully assist franchisors, franchisees and franchise law practitioners alike in understanding what properly needs to be included in a disclosure document and how decisions to rescind or not ought to be made.

In its reasons on appeal, the Court clarified the crucial distinction between rescission for "deficient disclosure" under section 6(1) of the Wishart Act, which must be exercised within 60 days of receiving a disclosure document, and rescission under section 6(2), which is available within two years of signing a franchise agreement and where the franchisor "never" provided a disclosure document. Much of the jurisprudence on the rescission remedy has focused on whether and to what extent a deficient disclosure document can be sufficiently non-compliant as to render it tantamount to no disclosure at all and ground a claim for rescission under section 6(2). The much needed clarity that this decision brings is that, in order for a disclosure document to amount to no disclosure at all, the franchisee must effectively be deprived of the opportunity to make an informed investment decision to acquire the franchise. The Court of Appeal added that this determination must be made with reference to the terms of the franchise agreement and all relevant surrounding circumstances of the grant of the franchise.

With respect to the motion judge's findings regarding the non-disclosure of the head lease, the Court found that the motion judge's failure to consider the terms of the franchise agreement, and in particular the location selection and opt-out clauses within that agreement, was an error of law. The Court noted that all parties involved knew that the proposed franchise location had not yet been selected at the time the agreement was signed and that the franchisor and franchisee would work collaboratively to find a site, as set out in the agreement. The franchisor's contractual obligation to use "reasonable best efforts" in selecting a location acted as a constraint on the franchisor's ability to enter into a lease without considering the franchisee's legitimate interests. Had the franchisee found the terms of the lease to be objectionable, it had the ability to reject the location or opt out and receive its money back. The presence of these contractual safeguards were found to be a complete answer to the franchisee's claim that the non-disclosure of the head lease was a material disclosure failure entitling rescission under section 6(2). It distinguishes *Raibex* from prior case law that considered non-disclosure of leases for locations that existed and were known at the time the franchise was granted.

With respect to the disclosure of development costs, the Court of Appeal found that the detailed "shell" cost estimates provided in the FDD were sufficient to put Raibex on notice of the costs and risks associated with a "conversion" opportunity. The Court highlighted the strong warning in the FDD that conversion costs may vary greatly depending on the location and that franchisees should maintain a significant contingency reserve. Given the variance in costs for prior conversions of AllStar franchises, the Court very practically held that disclosing a separate estimate based on those costs, as the franchisee suggested ought to have been done, would not have improved the franchisee's ability to make an informed investment decision. The shell estimate which was disclosed, on the other hand, did provide a useful reference point and an accurate reflection of the franchisee's actual costs.

Importantly, the Court of Appeal's decision clarified that the *Wishart Act* does not impose a requirement on *when* a franchisor may provide disclosure (other than the requirement that it be provided at least 14 days before the execution of a franchise agreement or payment of consideration by the prospective franchisee), rather, it defines *what* must be disclosed. From the Court's reasoning, it can be inferred that the scope of that disclosure does not extend to material facts that are not known or do not exist at the time the franchise agreement is signed.

Where the selection of a location is left to be decided after the execution of a franchise agreement, it is sufficient to disclose, as AllStar did, the details of the location selection process along with an estimate of the likely leasing and development costs associated with establishing the franchise. Such an interpretation accords with common sense and commercial realities, and does not interfere with common arrangements employed by franchisors in Ontario.

The cross-appeal by Raibex, seeking to reverse the dismissal of the section 3 and 7 claims, and the unsuccessful grounds for rescission regarding the certificate in the disclosure document, was also dismissed by the Court of Appeal who found no error in the motion judge's decision on those issues. The Court did find, however, that AllStar's damages for unpaid rent should be reduced to reflect the benefits that may have been received from its post-termination operation of the location, and remitted this issue to be quantified by the lower court.

Key Take-Aways. This case provides franchisors and franchisees with the knowledge that, so long as an otherwise compliant disclosure document provides a prospective franchisee with material facts sufficient to make an informed investment decision, the disclosure document will not support a claim for rescission by the franchisee under section 6(2) of the *Wishart Act*. This moves the decision as to what will or will not constitute a claim for rescission away from dogmatic adherence to earlier authorities and towards the commercial and practical reality of what was important to the parties viewed on a case-by-case basis and having regard to the terms of the franchise agreement and all of the surrounding circumstances of the grant of the franchise.

In a broader sense, the decision in *Raibex* provides a warning to international franchisors to ensure that before they engage in franchising in a foreign market, they should ensure that they retain local counsel to make them aware of recent case law developments and judicial interpretations of local statutes. Thankfully for franchisors, the Ontario Court of Appeal corrected a lower court decision that would have been harmful, if not entirely antithetical, to existing commercial practices within the franchise industry. However, had the original decision instead been confirmed by the Court of Appeal, the practice in the province of Ontario would have been significantly different that regular practice in the United States of America and other jurisdictions, and uninformed franchisors could have found themselves in breach of the *Wishart Act* and subject to expensive rescission claims.

France[66]

5. The Paul Bakery Case: The Duty of Loyalty to the Franchisee

In a decision announced in March 2017 (the "Paul Bakery case"), the Court of Cassation applied a duty of loyalty owed by a franchisor to a master franchisee under French civil law following franchisor's termination of a Memorandum of Understanding (development agreement) with its master franchisee and non-renewal of certain related franchise agreements after the master franchisee failed to achieve its development schedule on account of financial difficulties., which the court found were caused by joint decisions of franchisor and master franchisee[67] The court affirmed in part the judgment of the Paris Court of Appeal, which had held that the franchisor breached its duty of loyalty to the master franchisee by terminating the Memorandum of Understanding instead of negotiating and proposing acceptable terms and conditions to address the serious financial difficulties encountered by the master franchisee.[68]

***Background*.** The Paul Bakery case involved the termination of a Memorandum of Understanding that was executed by a franchisor and master franchisee in June 2004 and which obligated the master franchisee to open 18 franchised Paul Bakery stores over a term of five years. The master franchisee initially opened five Paul Bakery locations but by 2005 encountered financial difficulties. As a result of correspondence between the parties, the franchisor informed the master franchisee in March 2006 that it would visit the master franchisee's operations team and work with KPMG, the master franchisee's auditor, to assess the status of the business. KPMG reported in its audit that the master franchisee was not viable unless it could renegotiate its outstanding debt borrowings.[69]

Following receipt of the audit results, in May 2006 franchisor proposed to the master franchisee a settlement agreement which included, among other terms, that (i) franchisor would waive the franchise fees to which it was entitled for the year 2006, (ii)

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[66] The authors would like to thank Grégoire Toulouse of Taylor Wessing in Paris, France for his assistance with the France section of this paper, including his assistance providing research and case law resources regarding the Paul Bakery case and other relevant cases.

[67] Cour de cassation [Cass.] [supreme court for judicial matters], com., Mar. 15, 2017, Bull. Civ., No. 15-16406 (Fr.), *available at* https://www.legifrance.gouv.fr/affichJuriJudi.do?oldAction=rechJuriJudi&idTexte=JURITEXT000034217969&fastReqId=376144864&fastPos=1 (Fr.).

[68] *Id*. It should be noted that the Court of Cassation held that the Paris Court of Appeal erred when it held the franchisor liable to the master franchisee for damages in an approximate amount of €2,000,000 for losses suffered by the master franchisee as a result of franchisor (i) providing insufficient financial data and estimates in connection with the pre-contractual disclosure document and (ii) not correcting the master franchisee's provisional income statements that did not take into account all operating expense and other relevant items (since such statements were based at least in part on the insufficient financial data provided by franchisor). Although the Court of Cassation recognized the fault of franchisor, it reversed the damages award of the Paris Court of Appeal because, in such instances of insufficient pre-contractual disclosure, damages are "constituted by the loss of opportunity not to contract or to contract under more advantageous conditions, and not by the losses suffered."; *see also* GRÉGOIRE TOULOUSE AND FLORIANE CADIO DE KERMAINGUY, Franchise and Distribution Networks Newsletter, No. 12, 3rd Quarter 2017, pgs. 1-2, Taylor Wessing, https://france.taylorwessing.com/documents/get/1155/franchise-distribution-networks-newsletter-n12-3rd-quarter-2017.pdf. (last visited April 3, 2018) [hereinafter *Taylor Wessing*] and RAPHAEL MELLERIO AND BERTRAND BAHEU-DERRAS, Franchisors' duty of loyalty and unfair termination, Aramis Law Firm, https://www.lexology.com/library/detail.aspx?g=13d3026b-1ec7-4276-8735-82549aac4b49 (last visited April 15, 2018) [hereinafter *Aramis*].

[69] Cour de cassation [Cass.] [supreme court for judicial matters], com., Mar. 15, 2017, Bull. Civ., No. 15-16406 (Fr.), *available at* https://www.legifrance.gouv.fr/affichJuriJudi.do?oldAction=rechJuriJudi&idTexte=JURITEXT000034217969&fastReqId=376144864&fastPos=1 (Fr.)..

franchisor would receive one share in each of the master franchisee's sub-franchisee entities that had signed individual franchise agreements, (iii) franchisor would be entitled to enhanced information and reporting on the state of the master franchisee and the business as well as approval rights over certain decisions by the sub-franchisee entities, (iv) an agreed recovery plan and the blocking of certain accounts, and (v) a requirement for the master franchisee to sell the shares of the sub-franchisee entities if the recovery plan objectives were not met. The master franchisee subsequently informed the franchisor that the terms of the proposed settlement were not acceptable.[70]

Following the failure of the settlement discussions, the franchisor sent a formal notice of termination to the master franchisee requesting that it fulfill all terms and conditions of the Memorandum of Understanding (including the opening of all franchised locations in accordance with the development schedule) and, if the master franchisee did not comply within 30 days of such notice, the Memorandum of Understanding would be terminated automatically. In the notice of termination the franchisor also noted the non-participation of certain key personnel of the master franchisee and further indicated that the necessary relationship of trust between franchisor and the master franchisee had been undermined and no longer existed. While the master franchisee disputed these facts in a subsequent letter to franchisor, the franchisor proceeded to terminate the Memorandum of Understanding and thereafter decided not to renew the franchise agreements for the five Paul Bakery locations that the master franchisee had previously opened.[71]

Following the termination and non-renewals, the master franchisee was forced into liquidation and the franchisor sued the master franchisee for failure to complete the obligations under the Memorandum of Understanding. In response, the master franchisee brought counterclaims against the franchisor for (i) unfair termination of the Memorandum of Understanding and (ii) breach of the pre-contractual duties of disclosure.[72]

Holding. The Court of Cassation affirmed the ruling of the Paris Court of Appeal that the franchisor was liable for a breach of the franchisor's duty of loyalty to the master franchisee. Specifically, the court noted that if the objectives of the Memorandum of Understanding proved difficult to achieve, the franchisor owed the master franchisee a duty of loyalty that required the franchisor to negotiate with the master franchisee and to propose acceptable conditions.[73] In support of its holding, the court indicated that the agreed development schedule in the Memorandum of Understanding could only be achieved through the collaboration and cooperation of the parties and that the opening of new franchised locations was also critical to the franchisor's financial success. Importantly, the court specifically noted that under the Memorandum of Understanding the franchisor retained "complete freedom to approve or not to approve the sites selected by the master franchisee….to validate or not the feasibility study per site which would have been presented to it."[74] Therefore, given that new store openings under the

[70] *Id.*; *see also Aramis.*
[71] *Id.*
[72] *Id.*; *see also Taylor Wessing.*
[73] *Id.*
[74] *Id.*

Memorandum of Understanding "were the result of joint decisions and initiatives", and since franchisor knew the operating companies of the master franchisee were facing significant financial difficulties, the franchisor acted in bad faith and without loyalty by terminating the Memorandum of Understanding. As a result, the Court of Cassation affirmed the award of €150,000 to the master franchisee on account of this breach of the franchisor's duty of loyalty.

Additionally, although the Court of Cassation held that the Paris Court of Appeal erred when it awarded the master franchisee damages of approximately €2,000,000 on account of the master franchisee's claim of a breach of franchisor's pre-contractual disclosure obligation, the court affirmed the trial court's ruling that the franchisor did in fact breach its pre-contractual duty to the master franchisee (i) when the franchisor, upon receipt of the master franchisee's projected financial statements, did not draw to the attention of the master franchisee expenses or items that were omitted from the master franchisee's projections (e.g., lease expenses, insurance, etc.) and (ii) by providing financial data and projections based on its own experience, which experience was not comparable to the local market where the master franchisee was obligated to open franchised locations. The court affirmed the trial court's ruling of a breach of the franchisor's pre-contractual disclosure obligation despite the fact that the manager of the master franchisee was accomplished and experienced in the restaurant and franchise industries. Noting the franchisor's involvement in the preparation of such projections and the fact that the franchisor failed to call the forecasting errors to the attention of the master franchisee, the court held that the franchisor breached its duty of loyalty to the master franchisee.

The Takeaway. The holding by the Court of Cassation in the Paul Bakery case is particularly remarkable given (i) the Memorandum of Understanding expressly provided franchisor with the right to terminate the agreement if the master franchisee did not open the agreed 18 franchised locations in accordance with the development schedule and (ii) the franchisor actively engaged in negotiations with the master franchisee and proposed commercial terms that were ultimately rejected by the master franchisee. Nevertheless, in affirming the ruling of the Paris Court of Appeal, the Court of Cassation held that because the Memorandum of Understanding provided the franchisor an express approval right over each proposed franchised location, the franchisor was constrained by the duty of loyalty to make additional efforts to cooperate and propose solutions to the master franchisee (although the Court of Cassation did not highlight specific efforts the franchisor should have taken other than to propose "acceptable conditions")[75]. The court noted that despite the master franchisee's rejection of the proposed settlement terms, it was attempting to comply with the development schedule even though it was facing serious financial difficulties (which the court implies were partially the responsibility of franchisor). Consequently, the franchisor did not have the right to terminate the Memorandum of Understanding for a failure by the master franchisee, given franchisor's right to partially control (i.e., the right

[75] It should be noted that the Paris Court of Appeal did suggest that franchisor should have assisted the master franchisee in overcoming its financial difficulties by, for example, (i) reducing the rent paid by the master franchisee pursuant to a commercial lease concluded with an affiliate of the franchisor or (ii) amending a supply agreement that had been entered into between the master franchisee and an affiliate of franchisor. *See Aramis*.

to approve each site).[76] Moreover, in holding that the franchisor should have informed the master franchisee of certain errors in the master franchisee's projected financial statements (which were based on, at least in part, financial information provided by the franchisor), the Court of Cassation's decision appears to require franchisors to take a more active role in analyzing their franchisees' projected financial results and other forecasts, especially to the extent the franchise agreement permits (or requires) collaboration between the franchisee and franchisor in connection with such forecasts or other accounts. This is particularly troubling given the underlying principle that the franchisor and franchisee are independent businesses and because, in almost all other instances, franchisors should avoid unduly interfering or interposing themselves in the business of their franchisees.

In summary, the Paul Bakery case should serve as an important reminder to both franchisors and franchisees of certain key principles. First, in the context of a franchise transaction in France that is governed by French civil law, franchisors should carefully consider that courts will likely recognize and hold the parties accountable for complying with a duty of loyalty, especially when a franchisee or master franchisee encounters financial or other difficulties.[77] Second, even if the terms of a franchise agreement or development agreement provide for an express termination right by a franchisor, depending on the facts and circumstances underlying a potential default by franchisee, a franchisor should carefully consider the impact of this duty of loyalty in examining its course of action. In summary, franchisors must carefully consider how and when to assist their franchisees in overcoming operational, financial and other issues facing their businesses before proceeding to terminate the relationship.

6. <u>The Royal Kids Case: The Obligation to Continue to Assist the Franchisee</u>

In a decision issued in November 2015 (the "Royal Kids case"), the Limoges Court of Appeal held that a franchisee was justified in terminating a franchise agreement on account of franchisor's failure to provide sufficient advice and assistance to the franchisee, including in connection with the development of a commercial strategy to counter rising competition.[78] The court noted that the franchise agreement required the franchisor to be available to assist franchisee and that, despite this obligation, the franchisor (i) provided insufficient assistance to the franchisee regarding the design of the franchised location, (ii) only visited the location three times in two years, and (iii) failed to assist franchisee with a strategy to face rising competition. The court awarded the franchisee damages for costs it incurred to change its name and modify the site to remove all references to the franchisor and its system.[79]

[76] *Id.*; *see also Taylor Wessing.*
[77] *See Aramis.*
[78] Cour d'appel, Limoges, Chambre civile, 5 Nov. 2015, No. 13/01241.
[79] *Id.* It should also be noted that the court also awarded damages to franchisor based on its counterclaim against an affiliate of franchisee ("Parc Limoges Nord") based on franchisor's claim of unfair competition arising from the termination of a reservation contract that gave Parc Limoges Nord the option to open a second playground under a franchise agreement to be executed between the parties. Under the reservation contract, if the option to open a second playground was not exercised, Parc Limoges Nord was prohibited from engaging in any similar or identical activity (i.e., a children's playground) throughout France for a period of two years following termination. In connection with Parc Limoges' termination of its franchise agreement with

Background. In June 2010 Parc Limoges entered into a franchise agreement with Royal Kids Sarl ("Royal Kids"), a franchisor of children's play parks. However, the development of the children's play park and the relationship between the franchisor and franchisee quickly deteriorated. On October 13, 2012, Parc Limoges notified Royal Kids that it was terminating the franchise agreement on grounds that franchisor had breached the franchise agreement by, among other things, (i) failing to assist with the design and completion of its franchised location, (ii) organizing only three visits to the franchised location in over two years, and not providing constructive advice or feedback during this time, and (iii) not developing a commercial strategy to assist franchisee in facing new competition in its sector of activity, as another company had opened a competing children's park. Following the termination of the franchise agreement, franchisor brought an action against franchisee in the Limoges Commercial Court. The trial court held that the termination of the franchise agreement was justified based upon the failure of franchisor to satisfy its obligations under the franchise agreement; however, the trial court awarded Royal Kids the sum of €9,600, representing an amount equal to 50% of royalties due and owing to franchisor from franchisee.[80] The franchisor appealed the decision to the Limoges Court of Appeal.

Holding and Analysis. After considering the actions (and omissions) of franchisor in connection with franchisee's termination of the franchise agreement, the Limoges Court of Appeal reversed in part the trial court's ruling and held that franchisee was justified in terminating the franchise agreement. Specifically, the court noted that the franchise agreement was based on the principles of independence and loyalty between the parties, included an obligation for the franchisor to remain available to assist franchisee upon request, whether for information or other documentation, and to generally assist franchisee with launching its children's playground and related center. In addition, the franchise agreement required franchisor to provide various means of assistance to franchisee, including by providing a hotline to answer questions, arranging periodic visits, providing advertising materials and an opening guide, and generally assisting with design of the franchised location.[81]

The court went on to remark that franchisee was justified in terminating the franchise agreement because, despite the obligations of loyalty and assistance owed by the franchisor to the franchisee, (i) the franchisor arranged only three visits to franchisee's site during a two year period (which the court deemed insufficient although the franchise agreement did not specify a required number of visits), (ii) the franchisor did not provide constructive feedback, solutions or advice to franchisee in connection with its franchised location and (iii) although the franchise agreement obligated franchisor to be available to assist the franchisee, no commercial strategy was developed by franchisor to assist the franchisee in facing new competition in the market. The court then reversed the trial court's award of damages to the franchisor on account

franchisor, Parc Limoges Nord also terminated the reservation contract and opened a playground under an alternate name. The court held that Parc Limoges Nord actions were in breach of the reservation contract and awarded franchisor damages in an amount that was almost identical to the damages award to franchisee on account of franchisor's failure to assist and support under the franchise agreement.

[80] *Id*. The trial court also ordered Parc Limoges Nord to pay franchisor the sum of €8,970 on account of Parc Limoges Nord's breach of the territorial non-compete contained in the reservation contract.

[81] *Id*.

of the termination of the franchise agreement and instead ordered franchisor to pay to the franchisee the sum of €4,962.85 on account of costs incurred by franchisee to change its name and modify the franchised location to remove all references to Royal Kids.[82]

The Royal Kids case is instructive and interesting because it provides insight into the potential obligations that courts (at least in France for franchise agreements governed by French law) place upon franchisors as a result of the duty of loyalty and assistance owed to franchisees. Franchisors should carefully consider the provisions of their franchise agreements that impose an obligation to assist the franchisee, especially any potentially open-ended promises of assistance, as it appears that many French courts will broadly interpret such duties, especially in situations where a franchisee is encountering difficulties. Indeed, despite the clear understanding that franchisor and franchisee are independent businesses, the Royal Kids case illustrates that franchisors may be required to provide extra assistance to franchisees encountering design, operational or competition issues.

7. <u>The Rapid'Flore Case: The Obligation To Assist a Franchisee Seeking to Relocate</u>

In a decision issued in March 2015 (the "Rapid'Flore case"), the Rouen Court of Appeal held that a franchisor breached its obligation of assistance to its franchisee under the franchise agreement because, after initially offering franchisee limited financial assistance in connection with a relocation of the franchised business, it failed to respond promptly and with diligence to several requests for assistance from the franchisee to visit a potential relocation site.[83] The site was ultimately sold to a third party and the franchisee was consequently unable to relocate.

Background. In January 2007 the franchisor and franchisee entered into a franchise agreement for the operation of a franchised Rapid'Flore outlet selling self-service cut flowers in Saint-Raphael, France. Soon after opening the franchised location, the franchisee complained to the franchisor of various operating difficulties in connection with the business, including that the location of the franchised business made it impossible to achieve the forecasted financial results referenced in the pre-contractual disclosure document. The franchise agreement included a general obligation for the franchisor to assist the franchisee throughout the term of the contract, including by communicating commercial and management methods and providing assistance with commercial development of the franchised business. [84]

After several years of continued discussions, on May 12, 2010 the franchisor and franchisee entered into a document entitled "Transaction" (the "Settlement Agreement") to address and resolve certain disputes between them. Under the Settlement Agreement, the parties agreed upon mutual concessions, including a reduction of

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[82] *Id.*
[83] Cour d'appel, Rouen, Chambre civile et commerciale, 19 Mar. 2015, No. 14/03019.
[84] *Id.*

royalties from 5% to 1% for a period of six months in exchange for an extension of the term for an additional six months, and in the Settlement Agreement further agreed to "put an end to the dispute between them and waive any action that would be caused by the conclusion or execution of the franchise agreement."[85]

However, the franchisee continued to encounter difficulties, including in respect of the location of the franchised business. In September 2009 (before the execution of the Settlement Agreement), franchisor advertised financial assistance in an amount up to €35,000 in connection with a relocation of the franchised business. The franchisor and franchisee later corresponded between February 2011 and July 2011 regarding a new site location proposed by franchisee. In emails addressed to franchisor in April and June 2011, the franchisee requested that the franchisor visit the new proposed site with the franchisee and requested confirmation from the franchisor of the availability of the previously advertised relocation financial assistance. The franchisor did not affirmatively respond to the franchisee. Thereafter, in an email to franchisor dated July 4, 2011, the franchisee informed franchisor that the proposed premises had been sold to a third party, making the proposed relocation impossible.[86]

In June 2013 the franchisee and its principal brought a claim against the franchisor in the Commercial Court of Rouen alleging that the franchisor breached its legal and contractual obligations under the franchise agreement, including its obligations relating to pre-contractual disclosure and the duty of assistance. The trial court dismissed the claims of the franchisee and its principal, ordering that they pay costs and specified damages to the franchisor in connection with the legal action. The franchisee appealed the decision to the Rouen Court of Appeal.[87]

Holding and Analysis. In addressing the franchisee's claims relating to pre-contractual disclosure and inducement of the franchise agreement, the Rouen Court of Appeal noted that a settlement agreement is a valid means to terminate or prevent a dispute from continuing and that in such agreement the parties can make "reciprocal concessions regardless of their relative importance."[88] Noting that there was no evidence to conclude that the Settlement Agreement was procured through fraud or violence (which would have been grounds to avoid its effect under French law)[89], the court held that the franchisee's claims based on facts after the date of the Settlement Agreement remained admissible.

The court then examined the franchisee's other claims alleging a breach of the franchise agreement by the franchisor, including the franchisee's claim that the franchisor breached its duty of assistance. While the court ultimately affirmed the trial court's dismissal of nearly all of the franchisee's claims[90], the court held that the franchisor's offer of site relocation assistance *was not* barred by the Settlement

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[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *Id.;* CODE CIVIL [C. CIV.] art. 2044 (Fr.).
[89] *See* CODE CIVIL [C. CIV.] arts. 1112 and 2052 (Fr.).
[90] Cour d'appel, Rouen, Chambre civile et commerciale, 19 Mar. 2015, No. 14/03019. The court affirmed the ruling of the trial court dismissing franchisee's claims, which included, among other things, (i) contractual breach of supply, (ii) general lack of follow up and assistance, and (iii) failure to provide network communications and related internet updates.

Agreement and instead continued to exist under the franchisor's express duty of assistance under the franchise agreement.[91] After describing in detail the facts involving the correspondence of the franchisor and franchisee relating to the proposed relocation of the franchised business in mid-2011, the court held that the franchisor's failure to respond to the repeated email inquiries and requests for financial assistance demonstrated a lack of diligence by franchisor. Moreover, the court held that the franchisor's failure to respond to the franchisee's inquiries caused the franchisee to lose the opportunity the relocate the franchised business and improve its financial condition. While acknowledging that such breach by the franchisor would not justify a termination of the franchise agreement, given the seriousness of the breach and the adverse effect on franchisee, the court ordered franchisor to pay franchisee the sum of €50,000 for franchisee's loss of opportunity and to pay franchisee's principal the sum of €5,000 for "moral damage".[92]

The Rapid'Flore case is noteworthy because it highlights the critical importance of carefully considering the potential impact of commonplace franchise agreement provisions that expressly (or impliedly) obligate the franchisor to assist the franchisee in connection with its business as well as general offers to assist a franchisee during the course of the franchise relationship. Complying with this duty of assistance becomes especially critical when the franchisee is encountering business difficulties. Moreover, at least for franchise and similar agreements governed by French law, the case is instructive on the level of engagement and diligence courts may require franchisors to exhibit in order to fulfill any duty of assistance undertaken by the franchisor in the underlying franchise agreement.

B. <u>Foreign Franchise Laws That Could Create Liability</u>

<u>Australia</u>

1. <u>Fair Work Amendment (Protecting Vulnerable) Act 2017</u>

On September 15, 2017, the Fair Work Amendment (Protecting Vulnerable) Act 2017 ("FW Amendment") took effect, amending the FWA 2009 (collectively, "Amended FWA 2009").[93] The FW Amendment increases penalties for "serious contraventions" of workplace laws; expressly prohibits employers from requesting "cashback" from employees or prospective employees; increases penalties for violations of record-keeping and pay slip obligations; requires employers to disprove wage claims made in a court when they fail to meet record-keeping or pay slip obligations without reasonable excuse; increases the authority of the Fair Work Ombudsman to conduct investigations

[91] *Id*. It should also be noted that the court made this ruling despite the fact that franchisor's offer of relocation assistance appears to have been given during the time period prior to the execution of the Settlement Agreement.
[92] *Id*.
[93] Fair Work Ombudson, "Changes to Help Protect Vulnerable Workers" available at https://www.fairwork.gov.au/about-us/news-and-media-releases/website-news/changes-to-help-protect-vulnerable-workers#what-are-the-changes.

and collect evidence; and introduces new penalties for giving FWO false or misleading information, or obstructing or hindering FWO investigations.[94]

The most important change is arguably that the FW Amendment creates new liabilities for franchisors and holding companies. The FW Amendment shifts the burden to franchisors to demonstrate that they have taken reasonable steps to prevent a franchisee or subsidiary from contravening the FWA, and holds franchisors responsible if their franchisees or subsidiaries do not follow workplace laws, if the franchisor or holding company knew of the contravention (or *could have reasonably known*), and could have prevented it.[95] Workplace laws include and are related to the National Employment Standards; modern awards (legal documents that outline the minimum pay rates and conditions of employment); enterprise agreements; methods and frequency of paying wages; deductions from pay and cashback schemes; guarantees of annual earnings; sham contracting; record-keeping requirements; pay slip requirements; an equal enumeration wage order; a workplace determination; and a national minimum wage order.[96] The FWO reserves the right to commence civil proceedings against and/or impose fines of up to AUD$630,000 per breach, on franchisors who fail to prove reasonable preventative actions were taken to avoid violations of Australia's workplace laws. Although it is too early to say to what extent workplace violations reach up the franchise ladder to a foreign franchisor, FWO has described reasonable steps as those that ensure franchisor has systems in place, such as declarations, audit programs and risk assessments, to ensure third parties comply with relevant workplace.[97]

To avoid liability under the Amended FWA 2009, in addition to the "Ways to Prevent Fraudulent Practices" section above, franchisors must take reasonable steps to prevent their franchisees from contravening their obligations by enabling, supporting, and monitoring franchisees' compliance with workplace laws.[98] To enable compliance, franchisors should ensure their contracts expressly require franchisees to comply with workplace laws and that the franchisor's business model accounts for the cost of employing staff. FWO also recommends franchisors incorporate FWO's Fair Work Handbook into franchisor's operations manual or provide a copy of the handbook as a standalone resource for franchisees.[99] Franchisors can support compliance of its franchisees by keeping abreast of updated workplace laws and obligations, directing franchisees to FWO online pay tools and the "outline learning centre" to help franchisees understand their obligations under the Amended FWA 2009, and assisting (not controlling) franchisees to resolve workplace disputes with employees.[100] FWO suggests that regular audits of wage records, requiring franchisees to conduct self-audits and report the results, requiring franchisees to notify franchisors if an employee has requested FWO's assistance or if FWO is investigating the franchisee, and

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[94] *Id*.
[95] *Id*.
[96] *Id*.
[97] Human Resources Director, "Legislation to Protect Vulnerable Workers: What you need to know" available at https://www.hcamag.com/hr-news/legislation-to-protect-vulnerable-workers-what-you-need-to-know-243199.aspx, November 2, 2017.
[98] *See* supra note 22.
[99] *Id*.
[100] *Id*.

encouraging franchisees to cooperate with dispute resolution processes and investigations and audits, are all reasonable ways of monitoring franchisee compliance.[101]

Russian Federation[102]

2. **Franchisor Liability in Respect of Third Party Claims for Franchisee's Insufficient or Improper Quality of Goods or Services.**

Despite ongoing political and diplomatic uncertainty, the franchise business model continues to thrive in the Russian Federation. Utilizing franchising, numerous foreign franchisors have continued to rapidly expand their brands and franchise systems throughout the Russian Federation.

The Russian Civil Code includes a specific chapter that regulates the franchisor-franchisee relationship[103], and the legal regime relating to many critical franchise issues is generally well-developed, with Chapter 54 of the Russian Civil Code specifically including legal provisions governing franchise existence and relationships (e.g., requirements for registration of the franchise or license contemplated by the underlying agreement, franchisor's and franchisee's duties and obligations, employment-related risks, etc.).[104] One such provision addresses franchisor's liability for claims filed against the franchisee by third parties. Consequently, franchisors should be aware of certain risks that may arise as a result of the failures or actions of their franchisees under Russian franchise laws.

Specifically, Article 1034 of the Russian Civil Code provides the following in respect of the liability of a franchisor (right holder) to third parties for the actions (or omissions) of the franchisee (user):

> "Article 1034. The Right Holder's Liability for Claims Addressed to the User.
>
> The right holder shall bear subsidiary liability for the claims made to the user for the inconsistency of the quality of the goods (works, services), sold (performed or provided) by the user under the contract of commercial concession.

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[101] *Id.*

[102] The authors would like to thank Sergey Medvedev of Gorodissky & Partners in Moscow, Russian Federation for his assistance in preparing the Russian Federation section of this paper, including his assistance in providing background information regarding the relevant provisions of Russian Federation law.

[103] GRAZHDANSKII KODEKS ROSSIIKOI FEDERATSII [GK RF] [Civil Code] Part II, ch. 54 (Russ.), *available at* http://www.wipo.int/wipolex/en/text.jsp?file_id=277714.

[104] For example, the laws of the Russian Federation (i) require that the license to use the franchisor's trademarks under the franchise agreement, in addition to the franchisor's trademark rights themselves, must be formally registered with the Federal Service for Registration of Intellectual Property (Rospatent) and (ii) specify that an employment relationship (i.e. employer and employee) may only exist when there is a labor agreement, as opposed to a de facto labor agreement akin to a joint-employer relationship. *See generally* TRUDOVOI KODEKS ROSSIIKOI FEDERATSII [TK RF] [Labor Code] art. 15 (Russ.) and Sergey Medvedev, "Franchising in Russia", Gorodissky & Partners (Jan. 19, 2018), http://www.gorodissky.com/publications/articles/franchising-in-russia-lexology-navigator-2018/ (last visited April 2, 2018).

Under claims made to the user as the manufacturer of the products (goods) of the right holder, the latter shall be jointly liable with the user."[105]

Therefore, under Article 1034 of the Russian Civil Code, if a customer of the franchisee brings a claim alleging that the quality of the goods or services sold or delivered by the franchisee are insufficient or improper, the franchisor faces the risk of subsidiary liability for such quality violations.[106] With respect to such subsidiary liability, in accordance with the provisions of Article 399(1) of the Russian Civil Code, if the franchisee refuses to satisfy the claim of the customer, or the customer has not received, within a reasonable time, a response to the claim, then the claim may be filed by the customer directly against the franchisor.[107]

Moreover, under Article 1034 of the Russian Civil Code, if a customer of the franchisee brings a claim of insufficient quality of goods that are *manufactured* by the franchisee, in such instance the franchisor faces the risk of joint and several liability (together with the franchisee) for such product quality violations.[108] With respect to such joint liability, in accordance with the provisions of Article 323 of the Russian Civil Code, the customer has the right to present the claim to the franchisor and the franchisee jointly, and also to each of them separately (either with the purpose of recovering the entire debt amount (or a portion thereof)).[109] The franchisor and franchisee remain jointly liable until the entire obligation has been satisfied.[110]

In the event of a claim arising under Article 1034 of the Russian Civil Code, a customer that has received goods of insufficient or improper quality has the right to demand various legal remedies (at the customer's option) available under Russian law, including: (i) a proportionate reduction in the purchase price, (ii) a removal of the defects in the goods at no charge and within a reasonable time, (iii) compensation of the customer's expenses incurred in connection with the removal of the defects from the goods, (iv) if the defects in the goods cannot be remedied or the violation is repeated, replacement of the defective goods with goods of an appropriate quality, or (v) repudiation of the contract and a refund of the purchase price.[111]

Although there is relatively little case law involving the application of Article 1034 of the Russian Civil Code, it is likely that the potential liability of franchisors under the statute is mandatorily required by law and cannot be avoided via affirmative provisions included in the franchise agreement.[112] Therefore, as with other risks arising from the

[105] GRAZHDANSKII KODEKS ROSSIIKOI FEDERATSII [GK RF] [Civil Code] art. 1034 (Russ.), *available at* http://www.wipo.int/wipolex/en/text.jsp?file_id=277714.
[106] *Id.*
[107] GRAZHDANSKII KODEKS ROSSIIKOI FEDERATSII [GK RF] [Civil Code] art. 399 (Russ.), *available at* http://www.wipo.int/wipolex/en/text.jsp?file_id=277714.
[108] GRAZHDANSKII KODEKS ROSSIIKOI FEDERATSII [GK RF] [Civil Code] art. 1034 (Russ.), *available at* http://www.wipo.int/wipolex/en/text.jsp?file_id=277714.
[109] GRAZHDANSKII KODEKS ROSSIIKOI FEDERATSII [GK RF] [Civil Code], art. 323 (Russ.), *available at* http://www.wipo.int/wipolex/en/text.jsp?file_id=277714.
[110] *Id.*
[111] GRAZHDANSKII KODEKS ROSSIIKOI FEDERATSII [GK RF] [Civil Code], arts. 475 and 503 (Russ.), *available at* http://www.wipo.int/wipolex/en/text.jsp?file_id=277714.
[112] *See* Thomas Mundry, "Franchising in Russian Federation: Overview", Noerr OOO, https://uk.practicallaw.thomsonreuters.com/4-632-8184?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1 (last visited April 2, 2018).

franchisor-franchisee relationship, it is highly recommended that franchisors take appropriate steps to mitigate such risks.

For example, franchisors should (i) insist upon the inclusion of a carefully drafted indemnity provision in the underlying franchise agreement, (ii) ensure that both franchisor and franchisee have appropriate insurance coverage (with a requirement that the franchisee name the franchisor as an additional insured on its coverage), and (iii) require that a creditworthy guarantor guarantee the franchisee's indemnity and other obligations under the franchise agreement.

Other Various Countries

3. **Asian Countries With Franchise Sales/Relationship Laws**

There are 10 countries in Asia (including Australia) that have some form of franchise sales laws or franchise relationship laws. These countries are Australia, China, Indonesia, Japan, Kazakhstan, Macau, Malaysia, South Korea, Taiwan, and Vietnam. Except as discussed above in respect of Australia, our review of these laws shows no provisions of these laws that would make a foreign franchisor liable for the actions of its in-country franchisees.

European Union

4. **Competition Law/Antitrust Complaints**

In 2017, several European consumer groups filed complaints with the French, Italian and German competition law authorities in respect of McDonald's franchise practices in those countries. The allegations included: (a) McDonald's abusing its market position to require franchisees to charge higher prices than those owed at corporate locations; (b) McDonald's charged excessive rents for franchise locations, and (c) McDonald's imposed contractual non-competition terms that prevented franchisees from moving to other brands.[113]

IV. CONCLUSION

International franchising can be a boon for domestic franchisors, particularly when there is already significant domestic competition and there is a desire to grow and expand the franchise system. However, as addressed above, international franchisors must be careful when embarking on foreign expansion as the unique judicial and legislative frameworks across the world make for a potential minefield for the nascent global franchisor. Franchisors should retain either international counsel or experienced domestic counsel to ensure that the risks inherent in international franchising are understood and weighed against the benefits before engaging with foreign business partners or seeking to conduct the expansion themselves.

[113] Chee, Foo Yun. "*McDonald's Faces Complaints In Europe Over Franchise Terms*." Reuters, April 4, 2017. https://www.reuters.com/article/us-eu-mcdonalds-complaints-idUSKBN1761NV