DICKINSON WRIGHT'S

FRANCHISE & DISTRIBUTION NEWS

July 2015

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A VIEW FROM TWIN PEAKS

by Paul R. Fransway, Ann Arbor Office

Quick. Define Twin Peaks. Other than the obviously now dated TV show, up until a couple of weeks ago, the only other definition of Twin Peaks was a restaurant chain that featured double entendre advertising, scantily clad women servers and "man food." Now Twin Peaks has a new definition; Twin Peaks means a mass gunfight that left a number of people dead, a lot injured, more than 150 people arrested with a 1,000 weapons seized, and incidentally, a terminated franchisee who had invested more than $1,000,000 to open their restaurant and a franchisor trying to figure out how to do damage control. Those of us in the franchise business immediately recognized a franchised system's nightmare and watched from afar to see how the franchisor and franchisee would handle the disaster. The consensus of many seems to be "not very well." The important question, however, is what lessons are there to be learned from the Twin Peaks debacle.

The short answer to the question that a franchisor, as the leader of a franchise system, has to be prepared in advance of a public relations disaster, not only from a legal standpoint but also from a public relations standpoint. The reason is simple. It is not a question of *if* a franchise system will be faced with this type of situation but *when* it will happen. Only through assuring that the franchise agreement contains terms that allow the franchisor to take action against the franchisee if necessary and merited, and by having a disaster response plan in place that can limit damage to the brand, can a franchise system endure and recover to continue to be successful.

Legal issues. What a franchisor can legally do in situations like the Twin Peaks shootout is obviously dependent upon what the franchise agreement provides. When the news broke that Twin Restaurant Franchise, LLC, the franchisor, had almost immediately terminated the franchise agreement of the Waco franchisee, curiosity prompted the question "I wonder what their franchise agreement says" because franchisors often do not have clear contractual rights to terminate the franchise agreement in situations like the Waco incident. Most franchise agreements provide that the agreement can be terminated if the franchisee is convicted of a felony, and a majority also provide that the franchisor has the right to terminate if the "franchisee commit[s] any other act which may adversely affect or be detrimental to us, other franchisees, or any of our rights in and to the [marks]."[1] In some cases, the franchise agreement is drafted in such a way as to require

some causal connection between the criminality and the damage to the brand. The problem in the Twin Peaks situation was that, based upon the publicly known facts, the franchisee was not convicted, or even charged with a felony, and it is subject to question whether the franchisee's acts in Waco are what led to the damage to the brand.[2] The first lesson to be learned, therefore, is to look at your franchise agreement and consider whether changes are necessary. Examples of possible changes include assuring that the criminal acts / damage to the brand are independent defaults and that the language does not appear to require a causal connection between the crime and the damage to the brand, the grant to the franchisor of the right to make the determination of what conduct or omissions by the franchisee impair the brand and the grant to the franchisor of the right to terminate without cure if the franchisor reasonably determines that a threat or danger to public health or safety is likely to result from franchisee's acts or operation.[3] Clarity is the key and to the extent possible, the agreement should be clarified with anticipated risks in mind.[4]

We are a good corporate citizen. In the aftermath of what was obviously a difficult situation, it was hard not to get the impression that the franchisor and the franchisee were both pointing fingers in different directions attempting to deflect responsibility.[5] From a franchise law perspective, we can all understand that instinct since the franchisee is an independent contractor and is ultimately responsible for what occurs at their location. This is particularly true in an evolving legal environment where efforts are being made to ignore the franchisor/franchisee distinction and too much involvement by the franchisor will be cited as evidence of control exposing the franchisor to liability. Even *so, we* understand the franchisor/franchisee distinction. The public does not. They have even less understanding where the public safety and health are put at risk (as was the case here) and both franchisor and franchisee are "passing the buck." The unfortunate truth is that the public is going to hold *both* the franchisor and the franchisee responsible regardless of the legal distinctions and the franchisor has the responsibility to limit the damage to the system as much as possible. This requires having a team in place with authority at the highest level to serve as the public face for the franchise system. Retention of a good public relations firm and designation of the internal disaster management team *before* the crisis happens is essential. The immediate response should be to have franchisor personnel with experience interacting with the media on the ground to answer questions as soon as possible and to tell the story from the system's side. This should include responses on social media where much of the negative publicity today is spread. At the very least, they should be there to make it clear that the company cares about the event, that it finds the event unacceptable and will do whatever it can to resolve the situation and to regain the public trust (including the termination of the franchise agreement if necessary.)

This response team cannot be limited to the franchisor. A franchisor should also provide training for franchisees about how to deal with crisis management. In the Twin Peaks case, it appeared that the police were blaming both the franchisor and the franchisee, the franchisor blamed the franchisee and immediately terminated their franchise agreement and the franchisee was making public statements that termination was not merited and that they did nothing wrong. While these approaches make sense from a legal perspective, all they did was cement the thinking in the public's mind that there was plenty of blame on both sides. Certainly, where, as here, public officials express concern, this concern should be taken seriously and proactively addressed even if there is increased exposure from the franchisor and franchisee working together. At the very least, every effort should be made to define possible risks, to put communications personnel and others with authority in place to respond before the need arises, to assure communication lines between the franchisor and franchisees are well defined and to make it clear that public officials recommendations are always followed.[6] Twin Peaks clearly did not have these elements in place, and there are a number of public relations consultants that point to the Twin Peaks situation as an example of what not to do.[7]

What is apparently overlooked in the Twin Peaks situation is the criminal behavior that led to the crisis. Even though the crisis may not be of their own creation, franchisors are well advised to proactively look at steps that can limit any damage when the crisis occurs.

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[1] A review of franchise agreements of many of the larger franchisors disclose both of these provisions, some with variations, such as the addition of conviction of misdemeanors involving moral turpitude, violation of anti-terrorism laws and similar provisions.

[2] Such as the criminal acts of others. The franchisee appears to be taking this position in their public announcements. http://www.kxxv.com/story/29092329/corporate-revokes-twin-peaks-waco-license-franchisee-disputes-police-account-of-shooting.

[3] There are obvious restrictions on the right of franchisors to terminate in states with franchise relationship laws and under non-contractual theories, such as the duty of good faith and fair dealing. The author submits it is better to have the language in the franchise agreement to argue the point than not have it. Also, in this context, often the equities will favor the franchisor who must take action to protect the system under egregious facts.

[4] A franchisor may take the approach of "I'll terminate first and figure it out later" but it is certainly better not to expose yourself to a possible claim of improper termination by the franchisee.

[5] See http://blogs.wsj.com/riskandcompliance/2015/05/26/crisis-of-the-week-biker-shootings-put-twin-peaks-in-crisis-spotlight/.

[6] Some thought should be given to including a provision in the franchise agreement that requires the franchisee to notify the president of the franchisor of a "crisis management event" and that defines duties when one occurs. Since the franchisor here already knew of the public safety concerns, it wouldn't have helped in this case, but it might be of assistance to allow the most rapid professional response possible.

[7] *See* Wall Street Journal blog and http://www.ehandersonpr.com/twin-peaks-shooting/.

A NEW PARADIGM IN CANADIAN FRANCHISE LAW

The Dunkin' Donuts Case

by Ned Levitt, Toronto Office

In *Dunkin' Brands Canada Ltd.*,[1] the Quebec Court of Appeal upheld the trial court decision which held the franchisor liable for failing to protect its brand, but reduced the damages awarded to franchisees. The Quebec Court of Appeal rejected the franchisor's argument that the trial judge had imposed a new unintended obligation to protect and enhance the brand, outperform the competition and maintain

market share. It concluded that the trial decision applied, rather than extend the franchisor's duty of good faith.[2] The Quebec Court of Appeal made the following conclusions:

Express Terms of the Agreement

Explicit terms in the franchise agreements obliging the franchisor "to protect and enhance" its brand were not merely a "hoped-for result" but a binding contractual obligation.[3] While "the franchisor did not guarantee that the reputation of the brand would be enhanced, it undertook to adopt reasonable measures to that end."[4]

Implied Obligations Incidental to the Nature of the Franchise Agreements

The franchisor's "obligations were based not just in the text of the franchise agreements but also on duties that it had implicitly assumed in respect of the whole network of franchisees."[5] 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."[6] In other words, "the character of the specific franchise arrangement was an on-going one in respect of a system that the parties agreed to sustain as critical to the success of the brand."[7] Given the role the franchisor assigned to itself in "overseeing the on-going operation of the network" and the uniform system of standards, the Quebec Court of Appeal held that it was fair to hold that the franchisor had implicitly agreed to undertake reasonable measures to help the franchisees, over the life of the arrangement, to support the brand.[8] This included "a duty to assist them in staving off competition in order to promote the on-going prosperity of the network as an inherent feature of the relational franchise agreement."[9]

Implied Obligation of Good Faith

The Quebec Court of Appeal confirmed that a franchisor's obligation of good faith "is not confined to the circumstances of franchisors that compete unfairly with their franchisees."[10] Rather, a franchisor owes an obligation of good faith and loyalty to its franchisees requiring a franchisor, by reason of "superior know-how and expertise" upon which the franchisees rely, to support individual franchisees and the whole of the network through its on-going assistance and cooperation.[11] This duty is "not on the basis of the duty to perform contracts in good faith but rather on the distinct theory of implied obligations" from the nature of the franchise agreement and equity.[12] The nature of the agreement and equity "provide two distinct normative justifications for this implied obligation of good faith."[13]

Implied Obligations owed by the Franchisor to the Network of Franchisees

The franchisor also had a duty to assist and co-operate that includes an obligation to take reasonable measures to protect them from the new market challenges presented by the entry of an aggressive competitor into the market. Beyond the duty not to take actions that would wrongfully cause them harm, the franchisor assumed, on the basis of this implied duty of good faith, a duty to assist and cooperate with the franchisees by taking certain active measures in support of the brand.

The 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. 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. It is up to the franchisor to enforce the authority it has given itself under the franchise agreement. The undertaking to take reasonable measures to protect and enhance the network, can best be thought of as an implicit duty in each contract upon which an individual franchisee can take action in the event of breach.

Conclusion

Continuing to adopt a business as usual approach in the face of a competitive threat is not sufficient to satisfy the franchisor's contractual obligations. The franchisor did not take reasonable measures, in particular, to protect and enhance the brand in the face of the competition. Had the franchisor taken proper measures to protect and enhance the brand and, notwithstanding those efforts, a competitor had encroached on some of the franchisees' market share, the latter would have had no basis for complaint. It remains to be seen if this case, decided under the Civil Code in Quebec, will influence the evolution of the common law in the other provinces. Given the numerous cases which have firmly established the concept of good faith and fair dealing in the Common Law, as it applies to franchising, it would seem a safe bet that the Dunkin' Donuts case will, in some form or other, work its way into the Common Law.

[1] 2015 CarswellQue 3066, 2015 QCCA 624, J.E. 2015-692, EYB 2015-250660.
[2] *Ibid* at para 76.
[3] *Ibid* at para 44.
[4] *Ibid* at para 86.
[5] *Ibid* at para 59.
[6] *Ibid* at para 62.
[7] *Ibid* at para 63.
[8] *Ibid* at para 64.
[9] *Ibid.*
[10] *Ibid* at para 69.
[11] *Ibid* at para 71.
[12] *Ibid* at para 70.
[13] *Ibid* at para 71.

WATCH THE EXTRA STEP… WHEN CROSSING THE RESALE EXEMPTION PATH

by Andrae J. Marrocco, Toronto Office

Section 5(7)(a)(iv) of the *Arthur Wishart Act* (Franchise Disclosure), 2000 ("AWA"), states that disclosure obligations do not apply to a franchisor in circumstances where there is a grant of a franchise by an existing franchisee to another person if the grant of the franchise is not effected

by or through the franchisor (the "Resale Exemption"). For greater certainty, Section 5(8) of the AWA provides that a grant is not effected by or through a franchisor merely because, (a) the franchisor has a right, exercisable on reasonable grounds, to approve or disapprove the grant; or (b) a transfer fee must be paid to the franchisor in an amount set out in the franchise agreement or in an amount that does not exceed the reasonable actual costs incurred by the franchisor to process the grant. In other words, the resale exemption is intended to operate in circumstances where an existing franchisee sells its franchise business to a prospective franchisee with minimal involvement from the franchisor.

Three recent decisions dealing with the Resale Exemption have reaffirmed the court's narrow interpretation and application of the Resale Exemption. In each case, the court held that the franchisor's role in the resale extended beyond that of a "passive participant" (as stipulated by the jurisprudence), disqualifying the franchisor from being able to rely on the Resale Exemption.

In *Brister v 2145128 Ontario Inc.*, the Applicant franchisee (the newly admitted franchisee) called into question the Respondent franchisor's reliance on the resale exemption. The Court reiterated jurisprudence that in order for a franchisor to rely on Section 5(7)(a)(iv) of the AWA, a franchisor must not be an active participant in the grant of the franchise and should essentially confine its role to merely exercising its right to consent to the transfer.

The Ontario Superior Court of Justice determined that the Respondent franchisor had in fact been an active participant in the grant of the franchise because it had required the Applicant franchisee (prospective franchisee at the time) to:

- successfully pass an interview conducted by the Respondent franchisor prior to obtaining approval;
- agree to undergo training from both the then-existing franchisee and the Respondent franchisor;
- assume the rights and obligations of the then-existing franchisee under the premises lease as sole tenant in place of the Respondent franchisor; and
- enter into a general security agreement in favour of the Respondent franchisor.

Importantly, the then-existing franchisee had not been required to execute a general security agreement. This requirement included something that went beyond the then-current arrangement with the then-existing franchisee.

A similar outcome arose in *2147191 Ontario Inc. v Springdale Pizza Depot Ltd.* The Ontario Court of Appeal upheld the summary judgement preventing the franchisor from relying on the Resale Exemption. The Court of Appeal found that the franchisor's course of conduct could not be construed as merely passive participation, but rather went beyond the bounds of the existing relationship:

- The franchisor met with the prospective franchisee on a number of occasions;
- The franchisor and prospective franchisee discussed the possibility of a fresh grant of a franchise right (although it was determined that the transfer was the preferable avenue in the end); and
- The franchisor required the prospective franchisee to sign and provide an acknowledgement providing additional comfort and protection to the franchisor that was not found in the original franchise agreement.

In 2256306 *Ontario Inc. v Dakin News Systems Inc.*, the Ontario Superior Court of Justice rejected the Defendant franchisor's arguments that the resale exemption applied. In this case, the existing franchisee was operating on a month to month basis after the original franchise agreement had expired. Nonetheless, the existing franchisee transferred the franchise business to a prospective franchisee. Subsequent to such transfer, the Defendant franchisor discovered that the original franchise agreement had expired and sought to have the Plaintiff prospective franchisee sign a franchise agreement for the continued operation of the franchise. This requirement went beyond a passive role on part of the Defendant franchisor and was enough to render the Resale Exemption inapplicable.

The approach of the courts has been consistent. The Resale Exemption will only apply in circumstances where franchisors remain "passive participants" in any grant or transfer transaction whereby an existing franchisee conveys the franchise business to a new franchisee. The plain example is where a franchisor does nothing more than provide its approval for the transaction. Particularly where a franchisor imposes additional requirements of the prospective franchisee, the franchisor is clearly no longer passive. Franchisors should tread very carefully when considering a reliance on the Resale Exemption.

ALBERTA CHANGES ITS LAWS ON GUARANTEES

With the coming into force of Alberta's *Notaries and Commissioners Act* (Alberta), effective April 30th, 2015, the *Guarantees Acknowledgement Act* (Alberta) is amended in several ways important to franchisees and franchisors. The amendments provide, inter alia, that any guarantee from an individual not obtained in compliance with the following rules is unenforceable:

1. each individual that provides a guarantee must appear before an active practicing lawyer and sign a certificate in a prescribed form in the presence of such lawyer acknowledging that such person has signed the guarantee. Signing in front of a student-at-law or notary public is no longer sufficient; and
2. the lawyer must be satisfied and certify that the individual

guarantor is aware of, and understands, the contents of the guarantee.

The *Notaries and Commissioners Act* (Alberta) also removes the limitation on the fees to be provided for such services, which was previously capped at $5.00.

These amendments are relevant to franchisors and franchisees as franchise agreements often require the principal of a corporation, where the franchisee is a corporation, to personally guarantee the corporate franchisee's obligations under the franchise agreement. Franchisors should update any existing acknowledgement certificate they use in respect of guarantees from individuals and make any corresponding amendments to their franchise disclosure document.