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The implied duty to act in good faith in franchise agreements: the takeaways from the Canadian case *Bertico Inc v Dunkin's Brands Canada Ltd*

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Dunkin' Brands ordered to pay nearly $18M to some of its Quebec (Canada) franchisees

On 15 April 2015, in a unanimous decision, the Court of Appeal of Quebec has issued an important judgment in *Bertico Inc v Dunkin's Brands Canada Ltd*[1] (hereinafter '*Dunkin*') pertaining to a franchisor's duty to act in good faith and its related implied obligations to its franchisees.

In a unanimous decision released on 15 April 2015, the Court of Appeal confirmed the judgment of the trial court and ordered Dunkin' Brands Canada Ltd (hereinafter 'Dunkin' Donuts') to pay a total of CA$10.9m (plus interests and costs) to a group of franchisees for lost investments and profits. The Court found that the franchise agreements between Dunkin' Donuts and its franchisees included both explicit and implied obligations to provide franchisees with the continuous collaboration and support that they legitimately expected in order to protect and enhance the brand, maintain high and uniform standards within the franchise system and generally preserve the integrity of the franchise system as a whole.

However, on 15 June 2015, Dunkin' Donuts filed an application for leave to appeal to the Supreme Court of Canada. According to Dunkin' Donuts, this appeal raises an issue of public importance that must be addressed by the Court, that is, whether the general obligation of good faith imposes on franchisors duties to enhance their brands and stave off competition.[2] Therefore, the highest court of the land might shortly discuss the issue of the implied obligations imposed on a franchisor under a franchise agreement. Should it agree to do so, the upcoming judgment will undoubtedly rank among the most significant franchise law decisions in Canada.

Background and decision of the trial court

Up until the mid-1990s, Dunkin' Donuts was a leader in the fast-food industry in Quebec with more than 200 stores across the province. The decline in the fortunes of Dunkin' Donuts began when Tim Hortons – which also was in the quick-service coffee and doughnuts market – started asserting its presence in Quebec. During a meeting convened in 1996 in response to this new challenge, Dunkin' Donuts franchisees complained about insufficient support and collaboration from their franchisor, as well as its inappropriate tolerance of underperforming franchisees. Facing a worsening situation in early 2000, a group of these franchisees wrote a formal letter reiterating their previous concerns and complaining about a breach of the franchisor's obligations to them, including the failure to invest the required money, time and resources as appropriate to

protect and increase the brand's image and value in Quebec.

The key feature of Dunkin' Donuts' response was a renovation programme pursuant to which the franchisees that committed to investing CA$200,000 to renovate their restaurant and comply with some others conditions would in return receive a CA$46,000 subsidy from the franchisor. However, the renovation programme did little to stave off the increasing competition from Tim Hortons. By 2003, Dunkin' Donuts' market share in Quebec had plummeted to 4.6 per cent from its peak of 12.5 per cent in 1995. Tim Hortons captured the lion's share of the growth in the coffee and doughnut fast food market, going from 60 stores in 1995 to 308 by 2005.

In May 2003, a group of 21 franchisees operating 32 locations filed a lawsuit against their franchisor claiming, among other things, damages for breach of contract. The franchisees alleged that the franchisor had failed to meet its contractual obligations to adequately protect and enhance the Dunkin' Donuts brand in Quebec. The judge of the Superior Court of Quebec agreed and awarded damages totalling CA$16.4m to the franchisees for lost investments and lost profits under the agreements.

Highlights of the Court of Appeal's decision

In a unanimous decision, the Court of Appeal agreed with the trial judge but reduced the total award to CA$10.9m, in addition to costs and interests. The Court found that the terms of the franchise agreements expressly and implicitly imposed an obligation to protect and enhance the Dunkin' Donuts brand in Quebec.

The decision outlined key elements to be considered by franchisors in developing the infrastructure of their franchise system and establishing a collaborative relationship with their franchisees as more fully discussed below.

The duty to act in good faith and its related implied obligations

The franchise agreements in *Dunkin' Donuts* contained performance provisions referring to 'efforts' that Dunkin' Donuts had to undertake for 'protecting and enhancing the reputation' of the brand. The agreements also contained provisions pursuant to which the franchisor was undertaking to assist and support the franchisee for the entire term of the franchise contract, including an ongoing advisory relationship, operational revisions and the administration of the franchise owners advertising fund. In connection with the long-term and collaborative relationship that the parties had established, these explicit provisions demonstrate that Dunkin' Donuts agreed to make sustained and continuous efforts to protect and enhance the brand.

However, and as is often the case in long-term arrangements, not all of the terms need to be spelled out in the franchise agreement. In *Dunkin' Donuts*, in addition to the above mentioned explicit performance obligations, the long term nature of the franchise agreement, along with the legal duty of the franchisor to act in good faith as provided by section 1375 of the Civil Code of Québec, implicitly established ongoing cooperation and collaboration between the franchisor and its franchisees. This relationship not only imposes on franchisors a duty to assist their franchisees and ensure adequate supervision of the franchise system, which occasionally requires terminating the contractual relation with the weaker links in the chain of franchisees, as underperforming franchisees who fail to meet uniform standards may tarnish the brand and negatively impact the franchise system.

Based on the franchisor's ongoing obligation to assist and support its franchisees for them to succeed in their operations, the franchisees were entitled to rely on Dunkin' Donuts to take reasonable measures to protect them from the market challenge and competition presented by Tim Hortons.

The obligation is one of means

While rejecting Dunkin' Donuts' arguments, the Court of Appeal noted that the franchisor's obligation to its franchisee is one of means, not of result. In other words, a franchisor does not have an obligation to outperform the competition or guarantee the profitability of its franchisees; however, it does have an obligation to take positive actions to protect its franchisees from competitors. Had Dunkin' Donuts taken reasonable measures to counter Tim Hortons' expansion, even if 'Tim Hortons or another competitor had encroached on some of the Franchisees' market',[3] the franchisees would have had no basis to complain.

The Court found that Dunkin' Donuts' breach was not the result of a single act or omission, but rather failures over the course

of a decade. During the crucial period when Tim Hortons was increasingly gaining a foothold in Quebec, Dunkin' Donuts' strategy was essentially one of 'business as usual', with only minor adjustments being made. For the Court, this was not enough and the evidence supported a finding of fault. The Court found that Dunkin' Donuts' inaction caused the group of franchisees to lose a significant amount in profits and investments and awarded them a total of CA$10.9m, in addition to interests and costs.

The implied obligations of assistance and support

The *Dunkin'* decision does not create new obligations for franchisors in Quebec. It is the logical follow-up to the 1997 Court of Appeal decision in the *Provigo* case,[4] which is recognised as the leading authority in franchise law in Quebec. As provided by the Court of Appeal in *Provigo*, due to its obligation of good faith and loyalty to its franchisees, a franchisor must offer them technical assistance and collaboration and find ways to maintain the relevance of the contract binding them to ensure that the considerations which motivated the affiliation at first are not rendered obsolete and ineffective.[5] Therefore, the Court of Appeal in Dunkin' was well founded to point out that this case was 'merely an application of established law to a new set of facts'. It is nevertheless an important decision insofar as the Court of Appeal clarifies the extent of the implied obligations of a franchisor.

Like many other law jurisdictions, section 1375 of the Civil Code of Québec has, since 1994, been imposing on franchisors a duty to act in good faith and, as ruled in *Provigo*, an obligation to assist and support the franchisee in its operations. While a franchisor is justified in imposing on its franchisees significant restrictions as to how to operate and administer their franchise business for the purpose of maintaining uniform standards of quality and a strong brand across the franchise system, the franchisor must, in return, provide its franchisees with the appropriate infrastructure to support the performance of these requirements. Accordingly, the franchisor's obligation to take reasonable measures to protect and enhance the brand constitutes an implied term in most franchise agreements.

The decision in context

Although the *Dunkin's* decision has great significance for franchisors in Quebec, it is important to remember that the ruling by trial judge, supported by the Court of Appeal, was very fact-specific and based on the particular terms of the franchise agreements. The facts demonstrated that the franchisor needed to take significantly more positive actions to counteract the increasing threat of a competitor. Failing to do so made it liable for damages.

As such, the extent of the obligations imposed on other franchisors will not necessarily be the same as the one of Dunkin'. The context of each case and the language of each agreement will dictate the actions that a franchisor is required to take in order to meet its explicit or implied contractual obligations.

Duty of good faith worldwide

Quebec is not the only jurisdiction where legislative principles and case law governing good faith exist. In the rest of Canada and in others countries, this is an area undergoing constant evolution. The duty of good faith in Québec is clearly established under Articles 6, 7 and 1375 of the Civil code of Québec. This concept has been the essence of many decisions of importance in the past.[6] Without overlooking the impact of the *Provigo* decision on the franchise industry, franchise law experts can see the impact of the *Dunkin'* decision in the rest of Canada and in foreign countries, especially common law jurisdictions.

Rest of Canada (common law provinces)

As recently stated by Cromwell J in the latest decision of the Supreme Court of Canada dealing with the concept of good faith, *Bhasin v Hrynew*,[7] 'the notion of good faith has deep roots in contract law […] Nonetheless, Anglo-Canadian common law has resisted acknowledging any generalized and independent doctrine of good faith'.[8] Thus, Cromwell J ruled it was time to take two steps forward to make Canadian common law more coherent. On one hand, it had to be acknowledged that good faith in contractual performance is a general organising principle of the common law of contract and on the other hand, there is a common law duty which applies to all contracts to act honestly in the performance of contractual

obligations.[9] As such, while performing its obligations under the contract, a party must consider the legitimate interests of the other party and refrain from undermining those interests in bad faith.

Although the Court in *Bhasin v Hrynew* ruled on the duty of good faith in the context of performing a contract, it remained silent as to how much such duty may apply in the context of the pre-contractual period. As recognised by authors in regards civil law: 'In the common law, the contract is based on offer, acceptance and consideration and no contract exists until these elements are met. As a result, the common law does not import good faith obligation in pre-contractual relationships […] because […] no legal relationship exists until there is a contract'.[10] Therefore, the duty of good faith in pre-contractual relations remains an issue to be resolved by common law courts.

Nonetheless, and as so eloquently expressed in the decision in *Bhasin*, the concept of good faith (including statutory duties of good faith and fair dealing) has been recognised in the Canadian franchise legislation.[11] Consequently, the decision in *Bhasin* has no immediate impact on the current state of franchise law.[12] Furthermore, the duty of fair dealing is defined in the Arthur Wishart Act,[13] an Ontario franchise disclosure law, as a duty to act in good faith and in accordance with reasonable commercial standards.[14] Every franchise agreement, under section 3 (1) of the Wishart Act, should impose on each party a duty of fair dealing in the enforcement and performance of the contract[15]. Such duty of fair dealing can also be found in franchise statutes adopted in other Canadian provinces. However if some Canadian provinces[16] prescribed a definition of the duty of fair dealing similar to that in the Wishart Act, other provinces, such as Alberta, have not and therefore rely on common law principles. Despite the adoption of these franchise statutes, it remains that, contrary to the situation under civil law in Quebec, the duty of good faith does not apply to pre-contractual relations.

Nonetheless, and in view of the foregoing, we believe that the courts will in the near future demonstrate willingness to broaden the scope of the duty of good faith in long-term contractual agreements, such as franchise contracts.

France

The concept of good faith is well established in the Civil Code of France, which provides in Article 1134 that agreements lawfully entered into shall constitute the law between the parties and, as such, must be performed in good faith. If at a certain time the interpretation of this provision imposed a duty to act in good faith in the performance of the contract only, the French courts have since gradually imposed a duty to act in good faith in the pre-contractual negotiations, when entering into the contract itself and upon its termination.[17]

Section L330-3 of the Code de Commerce of France (formerly first section of the *Loi Doubin* of 31 December 1989) and its implementation decree (4 April 1991), originates from this principle of good faith in pre-contractual negotiations between the franchisor and the franchisee, by codifying an obligation for the franchisor to provide a pre-contractual information document prior to entering into a franchise contract with its potential franchisee.

The French courts have also recognised, based on the theory of the implied obligation of good faith, that the terms of section 1134 should not only be interpreted in a literal manner, but that the franchisor has from the training of the franchisee up until the end or termination of the franchise agreement, the continuous obligation to support the franchisee with technical and commercial assistance.[18]

United Kingdom

Traditionally, English law has not recognised a general duty of good faith in contracts, particularly because of the uncertainty that such a concept might bring into contractual relations, as well as for fear of undermining the commercial liberty of the parties, who are free to negotiate the written terms of their contract. The concept of good faith is underlying a certain standard of commercial morality and then is inherently inconsistent with the belief that a party is free to pursue its own interest.[19]

However, the *Yam Seng* case[20] was a significant decision and a tremendous step forward for English courts in the evolution of the concept of good faith in contractual matters. This judgment may become the key decision for franchisees wishing to

assert a franchisor's obligation to act in good faith during the performance of the franchise agreement.

In *Yam Seng*, Leggatt J explained how English law imposes an implied duty of good faith in the context of 'relational' contracts, which establish long term contractual relations between the parties, based on cooperation, loyalty and trust, and a high degree of communication as found in franchise and distribution agreements. Leggatt J also stated that the test of good faith is an objective rather than subjective one, such as an honest person placed in the same circumstances would consider the conduct of the defaulting party as commercially unacceptable.

Since the *Yam Seng* case, some other decisions have recognised the existence of an implied duty of good faith under specific circumstances, especially in the case of *Emirates Trading Agency LLC*.[21] The *Bristol Groundschool Ltd's* case[22] also followed the analysis of Leggatt . in *Yam Seng* and agreed with the test of the honest person in similar circumstances, as well as to the implied duty to act in good faith existing in the presence of a relational contract (or a relationship of trust between the parties).

Despite these recent decisions, which may suggest an important turning point in the traditional trend of English courts as to the application of an implied duty of good faith underlying the terms of a contract, the United Kingdom nonetheless seems to keep 'swimming against the tide'.[23] For now, English courts resist turning away from the traditional and restrictive approach respecting good faith, which is implied only in complex commercial agreements, in specific circumstances where there is an absence of bad faith or dishonesty by a defaulting party, and only as long as the implied duty of good faith does not contradict the explicit terms of the agreement.[24]

Australia

Until recently, Australia did not have legislative instrument forcing parties to negotiate in good faith in the context of commercial contracts, namely, franchise agreements. However, section 51AC of the Trade Practices Act 1974 (now the Competition and Consumer Act 2010) was allowing a party to raise a good faith 'standard' in order to assess whether a person or corporation conducted itself in an unconscionable manner during the negotiation of the agreement. As such, the parties had the opportunity to include in the agreement an express disposition forcing them to act in good faith among themselves in the performance of the agreement. The essence of the problem was then the absence of such express disposition, and how Australian courts could infer from the terms of the agreement an implied duty of good faith since the law was remaining unclear in that respect.

Even the Franchising Code of Conduct (hereinafter the 'FCC') made under the Competition and Consumer Act 2010, which regulated the conduct of the parties in the context of franchise relations, did not stipulate a duty of good faith in the franchisor/franchisee relation.

It was only in 2013 that the Australian government requested an independent report as to how the FCC could be amended to reflect the best practices of this flourishing industry, which is very profitable to the Australia economy.

In response to the recommendations of the report, on 1 January 2015 the FCC was replaced by an amended Franchising Code of Conduct[25] (hereinafter the 'Amended Code'), a mandatory code made under section 51AE of the Competition and Consumer Act 2010, which is introducing a statutory duty of good faith and fair dealing and, more importantly, financial penalties and infringement notices to franchisors for serious breaches to the Amended Code imposed by the Australian Competition and Consumer Commission.[26] Those financial penalties, which may reach AUS$51,000 per breach, will no doubt constitute a powerful incentive for franchisors to comply.

Notwithstanding the fact that the Amended Code does not clearly specify what a duty of good faith is, it does however reflect the historic evolution of common law on the duty to act in good faith in contractual matters by establishing certain determining standards as to whether a party acted honestly, cooperatively and not arbitrarily to achieve the purpose of the agreement. Moreover, the statutory duty to act in good faith now applies to every aspect of the franchisor/franchisee relationship, particularly: (1) during the pre-contractual period, (2) while performing the agreement, (3) during dispute resolution, and (4) at the end or termination of the agreement. However, although the parties cannot waive (either contractually or otherwise) their duty to act in

good faith, the Amended Code does prevent the franchisor and the franchisee from acting in its commercial legitimate interests.

Of course, only the passing of time will make it possible to assess the true impact of the provisions of the Amended Code in Australia, and its influence in other countries.

United States

Generally the duty of good faith is implied in every agreement in the United States.[27] First, section 1-203 of the Uniform Commercial Code (UCC) provides that every contract or duty – falling under its scope – imposes an obligation of acting in good faith in its performance or enforcement, and secondly, the Restatement (Second) on Contracts section 205, a legal treatise on general principles applicable to contracts and commercial transactions which is routinely used by lawyers and the courts, provides that: 'Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement'.

Despite these general principles, franchising law in the United States is a complex matter. The franchise industry is governed by federal and state laws. Although the Federal Trade Commission (FTC) Franchise Rules apply everywhere in the United States, it does not impose a duty to act in good faith. Each state is, in turn, free to put its own version of the duty to act in good faith into law, which inevitably results in inconsistencies. As mentioned by Justice Alito, in the *Northwest v Ginsbert* decision,[28] 'while most States recognize some form of the good faith and fair dealing doctrine, it does not appear that there is any uniform understanding of the doctrine's precise meaning'. Furthermore, as stated in the *Norwest* case,[29] states like Minnesota, Alabama, Arizona, Connecticut, Delaware and New York prevent a party from waiving an obligation of good faith and fair dealing without facing the risk of seeing the contract being void for absence of mutuality. However there are some other states, such as California, South Dakota or Idaho that allow a party to contractually exclude itself from implied covenants such as good faith. Justice Alito especially states that 'while some States are said to use the doctrine to 'effectuate the intentions of parties or to protect their reasonable expectations' […], other States clearly employ the doctrine to ensure that a party does not violate community standards of decency, fairness, or reasonableness'.[30] To that extent, if a party benefits from a certain discretion to act it may not exercise such discretion in bad faith, unreasonably or in a manner that is inconsistent with the reasonable expectations of the parties. However, this implied obligation does not create an independent legal duty in itself.[31]

Thus, it is possible to conclude that there is the existence of an implied duty of good faith in the performance and enforcement of the franchise agreement[32] in the United States. If not specifically provided for in state legislation, an analogy may be drawn from the Restatement (Second) on Contracts section 205 and the provisions of the UCC (if the particular franchise agreement is not directly falling under the scope of the UCC).[33]

A look ahead

In light of the clarifications made by the Court of Appeal respecting the concept of assistance and support to franchisees, we may reasonably expect that other components of the infrastructure generally required from a franchisor – such as adequate protection of trademarks, qualification and initial training of franchisees, efficiency of the supply chain and ongoing operational support – will also be challenged in the future.

As such, and beyond the evolution of the implied duty to act in good faith theory, franchisors will be required to draft franchise agreements that clearly define their duties and obligations to their franchisees in respect of the integrity of the franchise system as a whole. A franchisor should review any performance covenants provided in its franchise agreement with respect to explicit obligations and make sure it can live up to the standards it has imposed upon itself.

Notes

1 *Dunkin' Brands Canada Ltd v Bertico Inc*, 2015 QCCA 624 (CanLII).
2 *Application for leave to appeal on behalf of the applicant Dunkin'Brands Canada Ltd in the Supreme Court of Canada*, 15 June 2015, 2.
3 See n1 above, at para 93.
4 *Provigo Distribution Inc v Supermarché ARG Inc*, 1997 CanLII 10209 (QC CA).
5 *Ibid*, at 31.
6 *Houle v Canadian National Bank*, [1990] 3 SCR 122; *National Bank v Soucisse et al*, [1981] 2 SCR 339.
7 *Bhasin v Hrynew*, [2014] 3 SCR 495.
8 *Ibid*, at para 32.
9 *Ibid*, at para 33.
10 Paul-André Crépeau Center for Private and Comparative law, McGill University, 'Good Faith' [online]: www.mcgill.ca/centre-repeau/fr/terminology/guide/good-faith <viewed on 13 July 2015>.

11 See n7 above, at para 46.
12 Edward Levitt, *Good Faith in Franchising*, Lexpert conference on Implied Obligation of Good Faith, 2 June 2015.
13 Arthur Wishart Act (Franchise Disclosure), 2000, SO 2000, c 3.
14 *Ibid*, at s3 (3).
15 *Fairview Donut Inc v The TDL Group Corp*, 2012 ONSC 1252, at para 500.
16 Manitoba, New-Brunswick, Prince-Edward Island.
17 Dr Mark Abell, Victoria Hobbs, 'The Duty of good faith in franchise agreements – a comparative study of the civil and common law approaches in the EU' (2013) 11 International Journal of Franchising Law 5: www.iflweb.com.
18 Philippe le Tourneau, *Les contrats de franchisage* (2nd edn, Litec 2007) No 89 ; *L'âge d'or Expansion*, Cour d'appel, Reims, Chambre civile, s 1, No 2000-152146.
19 See n17 above, at 9.
20 *Yam Seng Pte Limited v International Trade Corporation Limited* [2013] EWHC 111 (QB).
21 *Emirates Trading Agency LLC v Prime Mineral Exports Private Ltd* [2014] EWHC 2104.
22 *Bristol Groundschool Ltd v Intelligent Data Capture Ltd and others* [2014] EWCH 2145.
23 See n20 above, at para 124.
24 See n17 above, at 15.
25 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, Select Legislative Instrument No 168, 2014.
26 Competition and Consumer Act 2010 (Australia), s 51ACD.
27 See n20 above, at para 125.
28 *Northwest Inc et al v Ginsbert*, 572 US ___ (2014).
29 *Ibid*, n2 above.
30 *Ibid*, at 11.
31 Edward Levitt and Georges J Eydt, 'The Devil is in the Details: How Canadian and U.S. Franchise Legislation Differs' (2013) 32(4) Franchise Law Journal.
32 *Ibid*.
33 Alexander M Meiklejohn, 'Redressing harm caused by misleading franchise disclosure: a role for the Uniform Commercial Code' (2009) 3(2) Entrepreneurial Business Law Journal 495–498.