MACDONALD SAGER MANIS LLP

Lawyers, Patent & Trade-mark Agents

150 York Street, Suite 800
Toronto ON M5H 3S5
Tel: 416.364.1553
Fax: 416.364.1453

Common Disputes in the Franchise Relationship

David Kornhauser
dkornhauser@msmlaw.ca
Direct Phone: 416.862.6280
Direct Fax: 416.862.6287

A. Introduction

No matter how carefully a franchisor or franchisee tries to anticipate the difficulties that could arise in their relationship, the fluid nature of commerce today and the simple passage of time conspire to invent new challenges and potential sources of conflict. Unforeseen market changes and other business realities tend to intrude upon what both parties might view as a well-ordered and highly sophisticated business relationship. Regardless of the depth and quality of the information that the parties have at their disposal, both prior to and at the time the franchise agreement is entered into, each might find that its hopes and expectations are not reflected in the business or in the relationship as the two develop over time.

The perspective that each party has at the time they embark upon their relationship determines in large part what those interests and expectations will be.[1] Franchisors quite reasonably believe that they have created a solid blueprint for success that any individual franchisee can replicate with the right amount of hard work and dedication. A franchisee, who often has little or no experience in the industry, might assume that the franchisor will do whatever it takes to ensure the franchisee's success. There may be little appreciation of the fact that the interests of a franchisee and those of the franchisor are not necessarily one and the same.

Many disputes that arise within the context of the franchisee-franchisor relationship have their genesis in these interests and expectations. Both parties clearly expect to be successful. Otherwise, there would be no point to entering into the relationship. However, it must be kept in mind that the franchisor usually has a deep knowledge of the industry and years of experience in delivering the goods or services associated with the franchised business, which underpins these interests and expectations. More often than not, franchisees do not possess a similar wealth of knowledge or experience upon which their interests and expectations are based.

As a result, franchisees can be somewhat over-reliant on the franchisor's predictions regarding the potential success of the franchised business. Franchisees must carefully review the disclosure materials, the franchise agreement and any other agreement that they will be required to enter into. In most instances, the relevant franchise documentation will contain statements that the franchisor's representations regarding the suitability of a selected or approved location or the sales projections for the franchised business are not guarantees; or that there are no representations or warranties other than those expressly set forth in the agreement(s) or the disclosure document. Franchisees must be acutely aware that these provisions trump whatever

[1] See Chapter 2, Business Aspects of the Franchise Relationship: Interests and Expectations

representations the franchisor might have provided during the course of discussions with the franchisee.

Prospective franchisees in those provinces that have franchise legislation have, however, a distinct advantage over prospective franchisees in those provinces that do not. Franchise legislation imposes significant disclosure obligations on the franchisor and provides franchisees with remedies that can be enforced against the franchisor in the event that it fails to meet them, or there is a misrepresentation contained in, that disclosure.[2]

Franchisees should satisfy themselves that the disclosure document meets the requirements of their provincial franchise legislation. They should also clearly determine what, if any, representations are being made by the franchisor. A careful perusal of the disclosure document will also give the franchisee an appreciation of what each party is entitled to expect from the other regarding operational issues and other matters that are essential to the proper functioning of the franchised business. A fulsome understanding by a franchisee of both its and the franchisor's respective legal obligations will provide better context to understanding whether each party's interests and expectations are likely to be realized.

Notwithstanding the importance of having franchisees conduct due diligence on both the franchisor and the franchised business, franchisors must also bear some responsibility for a franchisee's unrealistic interests and expectations. Firstly, franchisors are generally in a better position to assess the suitability of prospective franchisees. In assessing this suitability they must takes steps to ensure to the extent possible that the prospective franchisee has the necessary abilities, which includes the basic skills, education and personal qualities, together with the needed financial resources, to successfully operate the franchised business. Secondly, franchisors must ensure that the prospective franchisee can actually operate the franchised business given the training they have received from the franchisor.

B. Flawed or Underdeveloped Franchise Schemes

The rise of franchising as a preferred business format, particularly in countries like Canada which are increasingly shifting to services-based economies, has led to an unfortunate proliferation of franchising concepts that have not been sufficiently developed or refined before making their debut in the marketplace. In these situations, franchisees often have little idea of how the franchised business will perform. To a certain extent, they enter the relationship blind, trusting that the franchisor has done everything in its power to ensure the success of the operation. In the rush to attain the holy grail of becoming a franchisor, or to realize franchise fees and royalties, some franchisors prematurely market their businesses as a franchise, and fail to take the time to sufficiently adapt their businesses to the franchise model or develop an adequate strategic plan for expansion.

Clearly, such situations are ripe for conflict and dispute. Although in those provinces with franchise legislation franchisees may have recourse against a franchisor, in some cases there

[2] These obligations, and the consequences as a result of a franchisor's failure to meet them, were discussed in Chapter 4, Canadian Franchise Legislation — An Overview.

might be no way out for a franchisee other than to accept the losses and move on. While less of a concern in mature franchise systems, this reality only serves to underscore the need for prospective franchisees to perform as much due diligence as it can on the status of the franchisor and the franchised business before becoming legally bound by a franchise agreement and the related franchise documentation.

C. Encroachment

Inherent in the grant of a franchise is the right on the part of the franchisee to earn a profit from the operation of the franchised business, provided it is properly run. Although there are some franchisors that do not grant any type of territorial exclusivity, each franchisee will generally be granted an exclusive territory within which the franchisee will be able to operate the franchised business free from encroachment by either the franchisor or another franchisee. The value to the franchisee is in having the only franchised business in the territory that consumers who prefer the goods or services associated with the brand can patronize.

A franchisor must balance a number of factors in firstly determining whether or not to grant an exclusive territory at all and secondly, having made the decision to grant an exclusive territory, in determining its size. The grant of territorial exclusivity to individual franchisees, while necessary for the majority of franchise systems, does limit a franchisor's ability to grow the system. The goal of a franchisor is to saturate the market for its products or services and in so doing increase the odds that the public will purchase its products or services instead of those offered by its competitors. Increasing market share increases the value of the brand. For most franchisors, it is strategically more important to the franchisor that consumers have access to the goods or services associated with its trademarks, and less important that those goods and services are purchased from a particular franchisee. Within the context of this overall strategy to increase market penetration, it might be acceptable to the franchisor that some of its franchisees merely break even or operate at a loss.

In this regard at least, it is clear that the business interests of the franchisee and franchisor are not the same. In those rare cases where the franchisor for some reason permits a new franchisee to operate within the exclusive territory of an existing franchisee, the existing franchisee normally has a remedy against the franchisor based on breach of the franchise agreement, and if applicable, under the relevant provincial franchise legislation. However, a franchisee is often left without an adequate remedy where the encroachment does not result in a breach of the franchise agreement. Encroachment can take many forms.

In Franchise Agreements, the granting clause sets out which rights are being granted by the franchisor to the franchisee. To the extent that rights are specifically not granted, a franchisor is free to pursue the distribution of the goods or services in a manner other than as specifically set out in the franchise agreement. Often, these rights are contained in a section titled "reservation of rights." [3]

[3] Discussed in more detail in the article – Franchise Agreements.

Generally speaking, and regardless of whether or not a franchisor has reserved rights for itself under the franchise agreement, franchisors should ensure that in developing their brand beyond those rights granted to the franchisee, they in good faith select methods that are more likely to maintain the economic viability of the franchisee's business. To the extent that a franchisor fails to take into account the economic impact that developing the franchisor's brand will have on franchisees, franchisees may have a claim against the franchisor for a breach of the statutory duty of fair dealing in those provinces with franchise legislation. Further, since the courts[4] also recognize a common law duty of good faith, franchisees in those provinces which do not have franchise legislation might also have a claim against a franchisor who fails to take into account the economic impact that developing the franchisor's brand has on its franchisees.

In addition to potential encroachments by a franchisor, whether arising from a franchisor's reservation of rights or otherwise, franchisees are also subject to encroachment from other franchisees. These encroachments can range from the innocent, in that they could occur as a result of one franchisee advertising in a medium which includes another franchisee's exclusive territory, to more nefarious encroachments. Examples of the latter include a franchisee locating its premises so as to attract customers within another franchisee's exclusive territory or the deliberate solicitation of customers within another franchisee's exclusive territory.

It is incumbent on a franchisor to develop agreements and implement policies which limit and prevent these franchisee encroachments. To the extent that a franchisor fails to effectively prevent one franchisee from continuing to encroach into the exclusive territory of another franchisee, the franchisor may find itself facing a claim for a breach of contract as well as a breach of either the statutory duty of fair dealing, for those franchisees in provinces with franchise legislation, or a breach of the common law duty of good faith.

Encroachments, regardless of the cause, negatively affect the income of an existing franchised business. If the diversion of customer traffic is significant, the viability of the business itself could be jeopardized.

D. Advertising and Marketing Campaigns

Another common area of dispute is the advertising contributions that franchisees are normally obligated to pay to fund the franchisor's marketing campaigns. The theory behind advertising contributions is that the franchisor is better positioned, financially and otherwise, to mount campaigns to increase market awareness of the systems' products or services. The expectation is that advertising on the system level will translate into increased sales for individual franchisees. It is a widely accepted, if somewhat fuzzy, concept.

In a perfect world, franchisors would treat the advertising and marketing contributions as trust funds. That is, the money received through advertising contributions would be used solely for that purpose. Unfortunately, that is not always the case. Several other problematic issues can

---

[4] For example, see *Shelanu Inc. v. Print Three Franchising Corp.*, 2003 Carswell-Ont 2038, 64 O.R. (3d) 533, 172 O.A.C. 78 (Ont. C.A.). See also - statutory duty of fair dealing.

arise. Firstly, there is often insufficient accounting to individual franchisees as to how their contributions are actually spent.[5] In addition, franchisees frequently do not see a direct correlation between the advertising fees they pay and increased customer traffic. A lack of clear accounting sometimes leads to distrust and a suspicion that the contributions are not being used for the purpose for which they were intended. Even if there are no grounds to believe that the franchisor is misapplying advertising contributions, the inherently imprecise nature of advertising itself can create an impression that a franchisee's money is not being well spent. To properly account for advertising contributions, franchisors should as a general rule maintain a separate bank account, provide an accounting for the monies received and spent on at least an annual basis and set out in the franchise agreement what percentage of advertising contributions the franchisor can charge for administration of the advertising contributions or use of its own staff.

Each party would also benefit from a clearly worded advertising policy. Franchisees should know how their advertising contributions will be applied. Franchisors should provide as much detail as possible regarding the allocation of funds to different marketing strategies. Given the fluid nature of advertising and the constant adaptation it requires, it would not be practical for large national or multi-national franchisors to keep their franchisees current on every tweak to those strategies. However, franchisors should inform their franchisees of any major changes to the marketing program, including how the funds will be applied in the future. This is a very gray area.

Franchisors should understand that the sentiments of its franchisees might be influenced more by perceptions than by marketing realities. As always, building trust is essential.

E. System Changes

Businesses, whether franchised or not, must adapt to changing market conditions if they are to thrive into the future. Consumer tastes change over time. New and competing businesses eat into market share. Advances in technology are being made every day. It is now truer than ever that business, be they franchises or otherwise, must adapt to survive.

The very nature of franchising can be an impediment to effecting changes to the system that are needed to keep pace with a rapidly evolving marketplace. While franchisees and franchisors are bound together in a sophisticated contractual relationship, they operate as independent businesses.

---

[5] Pursuant to the Regulations under the Act, if a franchisee is required to contribute to an advertising fund, the franchisor's disclosure document must contain statements describing for the previous 2 fiscal years preceding the date of the disclosure document: A) the percentage that has been spent on national campaigns and local advertising; and B) the percentage of the fund that has been retained by the franchisor; and must contain a statement describing: A) the projected amount of the contribution; B) projections of the percentage to be spent on national vs. local advertising for the coming year and of the amount to be retained by the franchisor; and C) an indication of whether reports on advertising activities financed by the fund will be made available to the franchisee.

Franchisors rely on franchisee capital to not only establish the franchise, but to implement whatever system changes the franchisor deems necessary. The franchisor's priority is to see those changes adopted over the entire system as quickly as possible. Although a generalization, franchisors are sometimes less concerned with the financial capacity of individual franchisees to accommodate those changes.

A related issue, and one that is more common in today's frenetic business environment, is the issue of changes to the system that have not been fully developed or tested by the franchisor. Not all system changes will be thoroughly vetted before implementation. If the capital investment of its franchisees is not rewarded by increased sales, recrimination and conflict will likely follow. The problem will be compounded if additional, extensive changes are necessitated to remedy the impact of ill-conceived system adaptations.

F. Purchasing and Suppliers

Another common area of dispute is related to the sourcing of supplies and inventory. Most franchisees are required to purchase franchisor approved equipment and other resources from suppliers selected by the franchisor. Franchisees are sometimes obligated to purchase these products from entities that are not operating at arm's length with the franchisor. Even in those cases where the franchisor is dealing with suppliers in which it has no stake, franchisees do not always benefit from the savings realized by the franchisor on account of bulk purchases at wholesale prices. Franchisees represent a captive market and franchisors are often tempted to regard the supply chain as another potential profit centre. Franchise agreements often require the franchisee to acknowledge and agree that the franchisor is entitled to the benefit of any discounts, volume rebates or other concessions that the franchisor may obtain as a result of it supplying goods and products to the franchisee.

Inventory and supply costs have a significant impact on a franchisee's bottom line. Many, if not most, are aware of the existence of local alternate sources that might charge less for particular goods or services required by the franchised business. Franchisees often cannot see any justification in purchasing from franchisor's approved or selected vendors where there are more economical local alternatives just because the franchise agreement requires them to do so. Resentment over onerous continuing purchasing obligations can manifest itself in system-wide discontent.

G. Ongoing Support Obligations

Most franchise agreements require franchisors to provide some level of ongoing support to its franchisees. The degree and quality of support that is needed is generally viewed by franchisees and franchisors from opposing standpoints. A franchisor, having developed the business concept and prepared a detailed operating manual for the benefit of its franchisees, might believe that each franchise is fully equipped to meet whatever challenges it might face. Conversely, franchisees often perceive the role of the franchisor as that of an omnipotent protector capable of fixing whatever problems arise.

Clearly, the potential exists for franchisees to harbour unrealistic expectations regarding franchisor support. However, it is not unknown for franchisors to fall short of the level of support that they are contractually bound to provide, whether it be with respect to the fundamental business of providing goods or services, or with respect to systems and protocols, needed by the franchisee for the operation of the franchised business.

H. Transfer and Assignment Costs

Franchise relationships tend to be of long duration. Initial terms, together with renewal rights, commonly extend from five to twenty years. If renewed on successive occasions, the relationship could outlive the individuals who were responsible for forging it in the first place. However, not all franchisees will be able to make it through the entire term of the agreement or renewal, as the case may be.

There can be any number of reasons for this. Changes in the personal lives of a franchisee's principals due to health or other issues could interfere with the desire to continue to, or the franchisee might simply not be able to successfully, operate the franchised business. Most franchise agreements allow a franchisee to assign or transfer its interest in the franchised business to a third party under prescribed circumstances.

However, the fees demanded by a franchisor to effect such a transfer do not always bear much relation to the amounts that the franchisee might expect to pay to compensate the franchisor for its time and effort in approving the transfer or assignment. Where the reason for the assignment or transfer is financial, the potential for conflict is even greater. Franchisees usually do whatever they can to make the franchised business work, often assuming a significant debt load for their efforts. By the time they come to realize that they might not ever be able to profitably operate the franchised business, the debt can be overwhelming. In such circumstances, a demand for more money to be released from its obligations might be incomprehensible, particularly if the franchisee has found a potential candidate to assume the franchised business. It can seem pointless to seek more money where there is none.

I. An Illustrative Example from the Case Law

Many of these issues were considered by an Ontario court in a 2008 decision involving a well known Canadian fast-food franchise.[6] The franchisor installed a new franchisee just outside the existing franchisee's exclusive territory. The existing franchisee experienced difficulties and could not keep up with the required royalties, advertising and other fees. The franchisee sought financial assistance from the franchisor. The franchisor offered an accommodation that would reduce the outstanding amount but nothing more. The adjusted amount was not paid and the franchisee remained in default. The franchisor terminated the agreement.

The court first observed that the Ontario franchise legislation applied in this case.[7] Thus, each party owed the other a duty of fair dealing, which included the duty to act in good faith and in

[6] *1117304 Ontario Inc. v. Cara Operations Ltd.*, 2008 CarswellOnt 6444, 54B.L.R. (4th) 244 (Ont. S.C.J.)
[7] *Arthur Wishart Act (Franchise Disclosure), 2000*, S.O. 2000, c. 3.

accordance with reasonable commercial standards. The franchisee advanced a number of claims that the franchisor had breached its duty of fair dealing. One of those claims was in respect of the franchisee's assertion that the franchisor had a duty to investigate the location chosen by the franchisee to determine whether or not it was suitable for its intended use.

The court rejected the franchisee's claim that the franchisor breached the duty of good fair dealing by failing to investigate the location in question to determine whether or not it was suitable for its intended use noting that the franchisee had in fact selected the site despite the concerns expressed by the franchisor about its viability. Furthermore, the franchisee had signed a document acknowledging that the franchisor had not made, nor was the franchisee relying on, any representations, warranties or guaranties about the likelihood of success for the restaurant.

The court also rejected the claim that the franchisor's sales projections in a *pro forma* document amounted to a representation or warranty that the franchisee would achieve those sales figures. That document, which was signed by the franchisee, contained a provision stating that the projections were in no way to be considered guarantees of the performance or profitability of the location. The court also found that there was no evidence to support the franchisee's claim that its business losses resulted from inadequate training on the part of the franchisor.

The franchisee argued that the franchisor was under a duty of good faith and fair dealing to respect the exclusive territory it had granted to the franchisee. The court agreed. However, as stated, the new franchisee was located outside of the territory. The franchisor was therefore not in breach of the franchise agreement on that issue. The duty of fair dealing could not be relied upon to extend the area of territorial exclusivity beyond that to which the parties agreed to in the franchise agreement.

The franchisee further argued that the franchisor had provided financial assistance to other franchisees in the past and should have provided it with similar support in this instance because its sales had been below the levels that the franchisor originally had projected. The court found no evidence that the franchisor had an obligation to provide the franchisee with any financial assistance. Although the court did not expressly say so, it appears from the decision that the duty of fair dealing does not require the franchisor to provide financial assistance absent a legal obligation to do so.

Lastly, the court rejected the franchisee's argument that it should be compensated for the value of the equipment and leasehold improvements it made , the benefit of which was gained by the franchisor when it took possession of the location. There was no reason to award compensation because the bank essentially owned the equipment and the franchisee was in arrears of rent and royalties.

J. Conclusions

In light of the foregoing, franchisees are well advised to pay close attention to the terms of the franchise agreement to determine the exact scope of the parties' respective rights and obligations before they agree to assume the obligations to be imposed upon them as a franchisee. A clear understanding of those rights and obligations can minimize the areas of conflict once the

relationship has been formalized. However, businesses and markets are not static. New challenges arise over time, particularly as technologies evolve and competitors multiply. While the economic interests of franchisors and franchisees at times conflict, their mutual success depends in large part on the degree to which they approach difficult issues in a spirit of co-operation. A franchisor's interests are advanced by having as many happy and profitable franchisees as possible. The franchisee's chances of building a successful franchise are greatly improved by a franchisor that is sensitive to the particular realities of a given location and the needs of the people who operate it.

There are a variety of options that franchisees and franchisors can pursue to resolve their differences. Those that are most likely to deliver positive results for both parties require each to harness that spirit of co-operation. It is far better to come to a mutually beneficial resolution than to allow a dispute to descend into open hostility. While resorting to the courts may be necessary in certain circumstances, it is by far the least desirable option.

With this in mind, a more common alternative are dispute resolution mechanisms that can be engaged by the parties to resolve conflicts and, it is hoped, to ensure that their relationship remains mutually prosperous and rewarding.

David Kornhauser | Corporate Counsel | T. 416.862.6280 | F. 416.862.6287 | **dkornhauser@msmlaw.net**