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

Methods of Resolving Disputes[1]

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

A. Introduction

Termination is the ultimate form of dispute resolution. It is also a drastic remedy. It is the franchising equivalent of divorce and is an emotionally laden and costly experience for both parties. From the franchisee's perspective, termination can mean the loss of tens, perhaps hundreds, of thousands of dollars that were invested in the business. Coupled with the loss of what is typically the franchisee's sole source of income, the sense of failure from both a financial and a personal point of view is palpable.

Nonetheless, most franchise agreements provide for automatic termination on the occurrence of specific enumerated events. For example, agreements usually state that the legal relationship between the franchisee and the franchisor will be terminated where the franchisee ceases operations or goes into bankruptcy. The appointment of a receiver to wind up the affairs of the franchisee's business is another common ground for automatic termination.

In addition to automatic termination, franchise agreements normally give franchisors the right to terminate the agreement in specific circumstances. There are many reasons why a franchisor might elect to terminate if and when the right to do so arises. Typically, franchisors choose this route where there is a failure to make royalty or other payments or to comply with mandatory operating procedures. Whatever the particular grounds, most franchise disputes leading to the termination of the franchised business generally have their genesis in the fact that the franchisee is not operating its business profitably.

From the franchisor's perspective, time and effort spent on termination diverts management and administrative resources from other, more productive applications. Not only will the franchisor have to devote its time and energy to winding up the relationship—it must, if it wants to maintain continuity of presence in that particular market, take steps to find another franchisee to operate the franchised business or take it over itself. Although the process of establishing a new franchisee is itself costly and time-consuming, franchisors will find some comfort in the fact that a defaulting franchisee has been removed from the system. Notwithstanding that franchisors have a contractual right to look to the franchisee to recover the costs and expenses associated with termination, as well as any damages that they may suffer as a result, a franchisor could find collecting those amounts a difficult proposition, particularly if the reasons for termination are

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financial.

Prior to terminating a franchisee, a franchisor should therefore ensure that all reasonable steps have been taken to find an alternative solution. This is more so in those provinces that have franchise legislation. The duty of fair dealing has been interpreted to require a franchisor to take into account the commercial impact that a decision will have on a franchisee prior to implementing that decision. That duty can be heightened depending on the general economic environment.

What constitutes reasonable steps will depend on the circumstances surrounding the reasons for termination. Some defaults are more serious than others. In the fast-food industry, for example, a failure to ensure the freshness and quality of food product is generally viewed as a serious breach of the franchisee's obligations. A failure to submit reports on time, on the other hand, might be considered to be a relatively minor issue. Looking honestly at the breach goes a long way in shaping the approach that the franchisor should take to exercising its rights under the franchise agreement.

Although statistically franchised businesses have a better chance at being profitable than the average business, they are not immune to market forces. Competition, changing consumer preferences or depressed market conditions can all have negative effects on business. Such circumstances clearly are not the fault of either party. This does not excuse repeated defaults since a franchise system will not survive indefinitely without the regular payment of royalties. However, difficult economic conditions should encourage the parties to recognize the importance of reaching a mutually acceptable resolution to whatever problems exist.

Franchisors presiding over healthy systems need to accept the fact that at certain times the desire to maintain uniformity and consistency may have to be sacrificed to accommodate a franchisee's unique issues and circumstances. However, care must be exercised with respect to the nature of the breaches that are "accommodated," and their frequency. Other franchisees in the system are almost guaranteed to be aware of any special treatment given to a franchisee. They will quite naturally expect to be accorded the same consideration. This can be a prickly issue for franchisors.

Termination is not the only option. The ideal solution is for the parties to work out their differences on their own. However, this is not always possible and the involvement of an independent and unbiased individual might be required to facilitate the resolution of a dispute. There are several well recognized alternative dispute resolution mechanisms including mediation and arbitration, commonly referred to as ADR, that employ this technique and can be utilized by the franchisees and franchisors to avoid the undesirable consequences of termination. Each of these mechanisms has its own advantages and disadvantages. However, there are benefits that are common to all. Most importantly, they offer the parties a chance to salvage their relationship. They also avoid, or at least defer, the necessity of resorting to litigation. This is a very significant advantage. Litigation is an incredibly expensive and time-consuming process. It can be months, if not years, before the court reaches a decision that itself may not be satisfactory to either of the parties. In the interim, the relationship usually goes from bad to worse.

ADR might not always be possible or desirable. However, each of the available options merits serious consideration. The business interests of a franchisee are obviously better served if the relationship is not terminated. A franchisor that refrains from adopting a shotgun approach to dispute resolution will also reap rewards, particularly in trying economic times when defaults by multiple franchisees are not uncommon.

B. Communication and Persuasion

The most common types of franchisee-franchisor disputes, besides the nonpayment of royalties and advertising contributions, arise out of the failure on the part of a franchisee to follow the mandatory procedures outlined in the operating manual. A franchisee who fails to abide by those operational procedures often does so as a result of some perceived unfairness or mistreatment or simply because it does not believe in the value of the particular procedure. The franchisee may have already complained about this perceived unfairness or mistreatment, or lack of value, on a number of occasions. In such circumstances, it is not unusual for the franchisee to feel that its lack of success is someone else's fault, rather than the franchisee's failure to follow the system.

The first step that should be taken by the franchisor is to arrange a face-to- face meeting between a senior-level executive or other franchisor representative and the franchisee for a frank discussion of the issues. The franchisor's representative should have full authority to resolve the issues raised by the franchisee. The meeting should be conducted on a "without prejudice basis." The fact that the franchisee is allowed to air its grievances to a representative of the franchisor who is actually listening may be sufficient to provide the franchisee with the motivation to improve its operation. However, the franchisor's representative must be forthright in the discussions with the franchisee. The franchisee should be made to understand clearly that the franchisor might have no choice but to terminate the agreement if the franchisee does not take steps to cure the default.

C. Mentorship

Mentorship can be a useful tool in cases where a franchisee is not meeting the required standards of performance. Typically, a relationship is established between a franchisee that is experiencing difficulty and one that is, or has been, successful at its own franchise. The goal of the mentor is to assist the troubled franchisee to better understand what in particular needs to be done to improve the quality of its operation. In the best case scenario, the mentor will help the struggling franchisee turn its business around. To facilitate a mentoring program, franchisors should consider providing some form of compensation to mentoring franchisees. It is a relatively low-cost option that can produce very positive results, particularly if the mentor becomes involved early on when problems first become apparent. However, it is not well-suited to address significant issues that no amount of coaching will resolve. There is also no guarantee that a mentor will be successful

D. Ombudsmen

Not-for-profit franchise associations, not to be confused with franchisee associations, regularly offer the services of ombudsmen to assist franchisees and franchisors to resolve disputes on their

own terms. In fact, one of the benefits of membership in the Canadian Franchise Association (the "CFA") is the services of an ombudsman free of charge. As an independent third party, an ombudsman is in a position to offer the parties an objective view of the issues in question. Ideally, an ombudsman will be able facilitate a mutually acceptable solution to whatever problem exists. In those cases where no agreement can be reached, the ombudsman can refer the parties to another form of ADR such as mediation or arbitration.

Engaging the services of an ombudsman is an economical means of resolving conflict. However, it is most effective in the early stages of a dispute. An ombudsman will have little to add to the mix if the parties have become entrenched in their positions and are no longer communicating.

E. Mediation

Mediation is a form of ADR that is regularly utilized in a variety of commercial and other contexts. It has a considerable pedigree in Canadian legal circles and in the franchising community itself. Although some franchisors include mediation provisions in their franchise agreements, the failure to include these provisions does not necessarily prevent the parties from choosing this route. Even if the franchise agreement does not provide for
mediation, the parties if amenable can agree at any time during the relationship to mediate their disputes.

The process is simple and straightforward: when a dispute arises, the parties refer it to an independent third-party mediator whose task is to facilitate an agreement between the parties as to how the issues are to be resolved. Mediators, who are often lawyers and industry executives trained in the art, essentially function as facilitators. However, they do not have the authority to determine how a dispute is to be resolved. Rather, mediation offers the parties a non-confrontational setting where they can work out their differences with the assistance of an disinterested third party.

Typically, a mediator will meet with the parties both individually and collectively. The party who is in the weaker position, usually the franchisee, thus has an opportunity to express its concerns openly to the mediator, in confidence and without fear of reprisal. Once the parties have had the chance to meet with the mediator separately, they are brought together in a discussion moderated by the mediator aimed at resolving the core issues in the dispute.

There are several advantages to mediation. First, it is an established form of ADR with a proven track record. There are numerous regional and national mediation associations, many of which maintain rosters of experienced mediators. Mediators are often well versed in the financial and legal contexts within which the franchised business operates. As knowledgeable individuals, they can help the parties sift through extraneous and irrelevant issues and provide them with an unbiased and impartial view of what lies at the heart of the matter. In addition, mediation is cost effective. The parties generally split the fees and there is no requirement that they be represented by legal counsel. When successful, issues are resolved before they grow to terminal proportions.

There are, however, several disadvantages to mediation. As noted, a mediator is a facilitator, not a decision maker. Further, there are no government mandated or generally accepted training

programs or accreditation standards. A mediator cannot advocate a particular outcome or force the parties to come to an agreement. It is a voluntary process and does not guarantee resolution.

If unsuccessful, the parties could eventually find themselves right back where they started from. Even if a mutually acceptable agreement is reached, it is only as strong as the will of the parties to honour it. If one or the other refuses to abide by the agreement, the parties might have no option but to take the more drastic measures they had hoped to avoid. Although the parties can agree to treat the process and the resulting agreement as confidential, it is entirely possible that news of an unsuccessful mediation will quickly spread across the entire system. The failure of the process could deter the franchisor and any of its other franchisees from availing themselves of mediation in the future.

F. Arbitration

A more formal and binding mode of ADR is arbitration. Some franchisors include arbitration provisions in their franchise agreements. If the franchise agreement does not already provide for arbitration, the parties must then agree to submit their dispute to arbitration. Like mediation, that part of the process is consensual. Similarly, the parties can agree on who will act as the arbitrator or upon a mechanism for appointing an appropriate individual. The main difference between mediation and arbitration is the fact that an arbitrator has the authority to make decisions regardless of whether or not either of the parties agrees with those decisions. However, that authority is not unlimited. In Ontario, arbitrations are governed by the *Arbitration Act, 1991*,[2] which sets out the parameters for the conduct of the proceedings. In addition, if the franchisee agreement contains arbitration provisions, those provisions will usually limit the particular issues that can be settled through arbitration, the criteria for referring a dispute to arbitration as well as a variety of procedural matters. Theoretically, this should allow the parties to negotiate a wide range of options with respect to how the arbitration will be conducted. However, the fact that the arbitration agreement is usually part and parcel of a comprehensive franchise agreement usually means that a franchisee is left with no option but to accept the franchisor's terms regarding arbitration if it wants to acquire a franchise.

Although the decision of an arbitrator is binding and enforceable, an unsatisfied party potentially has a remedy. The Ontario arbitration statute allows a party to apply to the court to have an arbitrator's award set aside on certain grounds. However, the parties can agree that an award can only be set aside on specific, enumerated grounds, or not at all. The legislation also provides a limited right of appeal. However, a party who wishes to appeal an arbitrator's decision must first apply to the court for permission to commence the appeal. The court hearing that application will only allow an appeal to proceed if it is satisfied that the importance of the matters at stake in the arbitration justifies an appeal and the determination of the question of law at issue will significantly affect the parties' rights. That is, an appeal from an arbitrator's decision is a two-step process.

Arbitration also resembles traditional litigation in that there are procedural safeguards in place to protect the interests of the parties and the integrity of the arbitrator's decision. For example, each

[2] *Arbitration Act*, S.O. 1991, c. 17.

party has the right to be treated fairly and must be given a chance to present its case and to respond to the other's case. An arbitrator's award must be in writing and must state the reasons for the award unless the award was made on consent. Arbitrators also have the authority to grant remedies and impose sanctions and can seek the assistance of the court, if necessary, for the purposes of enforcement.

Arbitration offers several other benefits. The parties can select an individual who has experience in franchising or is familiar with the types of issues that are in dispute. The parties can also define the procedural parameters for arbitration. The freedom to determine how the arbitration will be conducted is an advantage over the more technically complex procedural requirements of litigation. This can make the dispute resolution process faster and simpler. Matters referred to arbitration are kept confidential. That is, the particulars of the dispute and the material put before the arbitrator are not disclosed to the public. The existence of an arbitration agreement can be raised by one party to halt any litigation commenced by the other regarding the issues they agreed to refer to arbitration. Although similar to litigation in certain respects, it is far less expensive and time consuming than full blown court proceedings.

Mediation and arbitration should not be viewed as alternatives. Extensive use is now being made of hybrid mediation-arbitration agreements in all manner of commercial and other relationships, including franchising. Again, such agreements are usually set out in the franchise agreement. Under this form of ADR, an independent third party agrees to act first as a mediator. The principles discussed above in relation to mediation apply to this stage of the process. If the parties are unable to reach a mutually acceptable solution, the mediator assumes the role of arbitrator. Again, the principles of arbitration outlined above apply. The process encourages the parties to resolve their issues on their own but does not leave them hanging if no agreement can be reached. In the role of arbitrator, the person appointed to the task has the authority to decide the very issues that were raised in the mediation stage. That is, there is no need to start all over again.

Clearly, mediation-arbitration can be an efficient form of alternate dispute resolution, in terms of both time and money

G. Group Action in the Context of ADR

While franchise agreements commonly require franchisees to mediate or arbitrate their disputes in lieu of the commencement of formal legal proceedings, increasingly both of these tools are being utilized to resolve disputes among franchisors and groups of franchisees. The principles discussed above with respect to both forms of ADR apply equally to the resolution of group disputes.

H. Class Actions

A comprehensive discussion of class actions is beyond the scope of this book However, franchisees are increasingly availing themselves of the advantages offered by provincial class proceedings statutes by commencing class actions against franchisors. The courts view class actions as being consistent with the overarching judicial concern of providing

individual litigants access to justice while at the same time providing a mechanism for cost sharing among the members of the class involved in the litigation.

I. The Franchise Review Committee

Certain sophisticated franchisors have established what are known as Franchise Review Committees to facilitate the resolution of a wide variety of issues affecting the system. Such a committee is usually comprised of a senior representative of the franchisor, an outside professional such as an ombudsman, an independent third party familiar with franchising issues but not with the particular dispute, and a number of franchisees. Ideally, at least from a franchisee's point of view, the committee would function independently from the franchisor. In reality, this is not often the case.

The affairs of the committee are normally governed by written procedural rules. Those rules determine what kinds of disputes the committee has the authority to review. The rules also set out protocols to be followed with respect to the material that is to be submitted by the parties, as well as a variety of other matters. The rules also determine whether or not the committee's decisions are binding. This is a sensitive issue. Franchisors are normally reticent about relinquishing control over a dispute to a body comprised, in part, with franchisees. However, provided that its members are respected, the decision of the committee will carry an aura of legitimacy beyond that which would attach to any unilateral action that a franchisor might take. Such a decision might also serve as a reality check for the franchisor regarding the circumstances that do or do not justify the franchisor's actions or responses to particular issues.

What is significant to note here is that franchisees play an important role in the decision making process of the Franchise Review Committee. This fact has significant implications. The franchisees on the committee, and by extension the others in the system, have a voice in how franchisee-franchisor disputes will be resolved. The resulting sense of empowerment can foster a deeper appreciation on the part of franchisees of their role in the success of the brand, which can in turn motivate individual franchisees to bring their operations in line with the required performance standards. For their part, franchisors reap a benefit from the sense of partnership that franchisee involvement at the system level engenders. The loss of control that some franchisors might feel must be weighed against the advantages to be gained through franchisee participation in the process.

The reluctance to cede control over any matter related to the system has often resulted in very negative reactions to franchisee initiatives. A franchisor's sentiments in this regard are not necessarily insidious. That is, franchisors naturally believe that they know far more about the ins and outs of the business than a franchisee will ever likely come to appreciate. Even if that position is somewhat overstated, at least in certain instances, it is understandable that some franchisors feel that the flow of knowledge about the business is, and should be, one way—top to bottom.

However, many franchisees are not satisfied with a role that is limited to facilitating the resolution of disputes. Especially in larger or more sophisticated franchise systems, franchisees are making greater demands to be involved in a wider range of issues that affect their interests.

Progressive franchisors have seen the value of giving franchisees a greater say in system affairs, while others have reluctantly accepted franchisee involvement. In either case, the particular challenge for franchisors is to determine the appropriate means of harnessing franchisee initiative while at the same time retaining ultimate control over the core business and the standards that must be met by the system's members. They are, after all, the faces behind the brand.