Blaney McMurtry
BARRISTERS & SOLICITORS LLP

EXPECT THE BEST

The Franchisees Tried to Roll Up the Rim and Tim Horton's Won

by H. Todd Greenbloom
Originally published in *Blaneys on Business* (June 2012)

Todd Greenbloom is a partner in Blaney McMurtry's corporate/commercial group. His active general business law practice intersects with a host of competition and restrictive trade practices issues. Todd is a recognized authority on all aspects of franchising and licensing. His clients come from a wide variety of industries, including restaurants, food service, hospitality, recreation, trade shows, retailing, manufacturing, advertising and service.

Todd may be reached directly at 416.593.3931 or tgreenbloom@blaney.com.

Unlike other jurisdictions, there is no general duty of good faith in Ontario contract law – no automatic blanket requirement that one party to a contract perform under the contract in a way that has regard for the legitimate interests of the other party.

A duty of good faith *often* exists, however, where there is an imbalance of power between the contracting parties. Franchises and employment are two examples of situations where such a duty of good faith applies.

A recent case involving Tim Hortons provides a useful summary of the manner in which the duty of good faith applies in Ontario.

The Tim Hortons franchisees complained that changes imposed by Tim Hortons reduced their profitability and, as such, were contrary to the duty of good faith. The changes arose from decisions relating to lunch menu items, and the manner in which donuts should be baked.

Some of the specific allegations made by the franchisees were:

- Tim Hortons decisions had the effect of shifting profits from the franchisees to Tim Horton's
- requiring the franchisees to use partially-baked goods, instead of goods made totally in-house, was an inappropriate change
- Tim Hortons misrepresented the costs of implementing the changes.

Some of the factors that the judge used in coming to his decision were:

- the franchise agreements contemplated the kinds of changes that Tim Hortons required
- nothing in the franchise agreements assured the franchisees of any kind of profit
- nothing in the franchise agreements denied Tim Hortons the right to earn a profit.

Tim Hortons was completely successful.

In delivering his decision, Mr. Justice George R. Strathy of the Ontario Superior Court of Justice gave a useful summary of the factors to be considered in determining whether or not a duty of good faith has been reached. The following is a summary of those factors:

1. Changes can be made to methods of operation, even where the changes may have an adverse effect on the franchisee, where the type of change is contemplated in the franchise agreement and the decisions are not motivated by improper or extraneous considerations.

   In this case, it was determined that the change did represent an improved method of operations and that this improvement should pertain, even if it did not improve profitability. An influencing factor in reaching the conclusion was that the particular change was contemplated by, and permitted by, the express provisions of the franchise agreements.

2. The duty of good faith is imposed in order to secure the performance of the contract that the parties made. The decisions of the franchisor should not eviscerate the objectives of the agreement or substantially nullify the bargained-for objective or benefit.

   Since most franchisees continued to make a reasonable level of profit, it was determined that the decisions made by Tim Hortons could not be said to deprive the franchisees of the benefits of their agreement, or to defeat the purpose of the franchise agreement. In part, it was recognized that a lower profit margin, or absolute loss, on a small group of products, could still have an overall benefit to the franchisees (e.g. the loss encourages customer loyalty and may attract customers who would otherwise patronize a competitor).

3. "The party's conduct must be considered in the context of, and in conjunction with, the contract the party made. It is not a stand-alone duty that trumps all other contractual provisions."

   Given that there was a determination that the changes were permitted by the franchise agreements, there should not be another overarching obligation that would defeat the contract itself.

4. Decisions made by a franchisor must take into account the interests of the franchisees. Discretions cannot be made arbitrarily or capriciously.

   Justice Strathy concluded that, in the end, even though there may have been a diversion of revenue from the franchisees to the franchisor, the end product was better and the actual cost was lower than the alternative. Given the sound business reasons for the decisions, they could not be said to be arbitrary or capricious.

   Justice Strathy determined that the decisions made by Tim Hortons did not eviscerate the objectives of the agreement but were part of a reasonable evolution of the system and had benefits for both parties.It could not be said that Tim Horton's acted in an arbitrary or capricious manner in light of its having consulted with the franchisees throughout the process.

5. A franchisor is not required to prefer the franchisees' interest over the franchise owners. So long as a franchisor takes into account the interests of the franchisees, the franchisor is allowed to act self-interestedly. Essentially, the duty of good faith does not prevent a franchisor from diverting revenue from the franchisee to itself. This presumably is reinforced by the franchise agreement contemplating the franchisor earning profits from different aspects of the operations.

The lessons learned from this case include:

(01) To the extent possible, it is appropriate for a contract to anticipate future needs and incorporate rights that will enable those needs to be addressed.

(02) Furthermore when a change is being implemented, there should be a sound business reason for making the change and the other party should be consulted throughout. ■