In recent years, there have been a number of important developments in the case law concerning the duty of good faith and fair dealing, not only in franchise disputes but also more generally in commercial litigation. As members of the franchise community know all too well, the duty of good faith permeates the franchisor-franchisee relationship and gives rise to important practical compliance issues for franchised businesses and for franchise lawyers.

The purpose of this paper is to canvass the current state of the law on good faith, particularly as it applies in the franchise context, and to distill the best practices and practical tips that franchisors can adopt to maximize their efforts to comply with this legal duty and mitigate the risk of litigation and adverse judicial and arbitral decisions.

Since the case law and legal principles that govern the duty of good faith and fair dealing arise in different contexts and different types of disputes, it is helpful to group the cases according the issue being litigated. Therefore, this paper has six sections. After addressing in Section One the general principles that apply despite the nature of the dispute, the subsequent sections focus on particular kinds of disputes and the good faith principles and practical tips that apply in that context:

- Section Two addresses the good faith principles that arise in the context of the termination of franchise agreements.
- Second Three focuses on the non-renewal of a franchise agreement by the franchisor.

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* Adam Ship is a litigation partner at McCarthy Tétrault and Co-Chair of the firm’s National Franchise & Distribution Group. Eli Lederman is a partner at Lenczner Slaght.
• Section Four discusses the principles and best practices that apply when a franchisor is asked to provide its consent to a transfer or assignment of the franchise to a third party.

• Section Five deals with system-wide decisions by a franchisor, such as in the context of franchise system change, and the good faith principles that govern in this context.

• Section Six addresses communications issues, including the extent to which the duty of good faith encompasses an ongoing disclosure obligation.

1. General Principles

It is important to begin any assessment of a good faith issue with reference to the underlying franchise agreement between the parties and the specific covenants and obligations that govern the particular topic at issue. The appellate courts in Canada, particularly in Ontario, have made this clear. In *Transamerica Life Canada Inc. v. ING Canada Inc.*, the Ontario Court of Appeal highlighted that the duty of good faith is always based in the terms of the contract:

… The implication of a duty of good faith has not gone so far as to create new, unbargained-for rights and obligations. Nor has it been used to alter the express terms of the contract reached by the parties. Rather, courts have implied a duty of good faith with a view to securing the performance and enforcement of the contract made by the parties, or as it is sometimes put, to ensure that parties do not act in a way that eviscerates or defeats the objectives of the agreement that they have entered into.

As this language confirms, the assessment of good faith issues depends on identifying the “bargained objective or benefit contracted for” and the “original expectation of the parties”. In our view, a careful review of the agreement and the underlying factual matrix of the dispute is critical.

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to such an analysis. The duty of good faith is not freestanding, but is instead measured by examining the parties’ mutual objectives as defined in the agreement.

*Transamerica* was applied in the leading franchise case of *Fairview Donut Inc. v. The TDL Group Corp.*\(^3\) Justice Strathy’s decision in *Fairview Donut* was affirmed by the Ontario Court of Appeal before he was elevated to Chief Justice of Ontario.\(^4\) In *Fairview Donut*, Justice Strathy emphasized the critical role that the words of the contract have in the analysis of the duty of good faith:

> The duty of good faith and fair dealing and the duty to act in accordance with reasonable commercial standards, as expressed in the *Arthur Wishart Act*, relate to the performance and enforcement of the franchise agreement. The duty is imposed in order to secure the performance of the contract the parties have made. It is not intended to replace that contract with another contract or to amend the contract by altering the express terms of the franchise contract. ([Citations omitted](#)).

It follows from this that in assessing whether a party has demonstrated good faith and fair dealing in the performance and enforcement of the agreement, the party’s conduct must be considered in the context of and in conjunction with the contract that the parties have made. It is not a stand-alone duty that trumps all other contractual provisions.\(^5\)

Importantly, the Court held that franchisees’ bad faith allegations were without merit largely because they were attempting to use the duty of good faith to imply contractual terms not found in the agreement:

> … The court’s responsibility is to give effect to [the] contract and to require the parties to discharge their contractual obligations fairly, in good faith and in a commercially reasonable manner. Under the guise of their *Arthur Wishart Act* claims, the plaintiffs are really asking the court to re-write their contracts and to require [the franchisor] to perform those re-written...

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\(^3\) 2012 ONSC 1252 (Ont. S.C.J.).  
\(^4\) *Fairview Donut Inc. v. The TDL Group Corp.*, 2012 ONCA 867.  
\(^5\) *Fairview Donut Inc. v. The TDL Group Corp.*, 2012 ONSC 1252 at paras 500-501.
contracts in a manner that the plaintiffs or their expert would find commercially reasonable. This is not the court’s function.6

Therefore, in our view, the case law requires that the agreement at issue, and in particular the contractual provisions in issue in the dispute, be examined before the issue of good faith is analyzed.

Once the process of interpreting the franchise agreement is complete, there must be a detailed assessment of the factual record before applying the duty of good faith in a particular franchise dispute. This provides significant scope for franchisors and their legal counsel to work to ensure that communications and conduct between the parties prior to and during the litigation are conducted with the duty squarely in mind. In Shelanu Inc. v. Print Three Franchising Corp, the seminal case in Ontario recognizing a common law duty of good faith in franchise relationships, the Ontario Court of Appeal emphasized that “[w]hether or not a party under a duty of good faith has breached that duty will depend on all the circumstances of the case”, including considerations of fairness flowing from those circumstances.7 Although not a franchise case, the Supreme Court of Canada’s decision in Bhasin similarly recognizes that the duty of good faith requires a “context-specific” analysis:

Good faith may be invoked in widely varying contexts and this calls for a highly context-specific understanding of what honesty and reasonableness in performance require so as to give appropriate consideration to the legitimate interests of both contracting parties.8

A clear focus on the facts and circumstances of the parties and their communications featured prominently in the Ontario Court of Appeal’s decision in 3574423 Canada Inc. v. Baton Rouge Restaurants Inc.9 According to the Court, in assessing whether the duty of good faith had

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been breached under the *Arthur Wishart Act*, courts must consider “…the knowledge of the parties and the history of dealings between them”.\(^{10}\) The Court emphasized that “[t]he extensive prior dealings between the parties … inform the standard of fair dealing between them”.\(^{11}\) In *Baton Rouge*, these facts were critical to the court’s decision that the franchisor’s conduct did not breach the duty of good faith.

Another general principle that emerges from *Baton Rouge* is one of causation. The Court considered whether the alleged breach of the duty of good faith in that case actually played any causal role in the damages allegedly suffered by the franchisee. The Court held that no causation was established, since the franchisee would ultimately have been in the same position even had the franchisor acted as the franchisee alleged it ought to have.\(^{12}\) This principle of causation is also apparent in *Shelanu*, where the Court accepted that the franchisee’s damages – which were allegedly caused by the franchisor’s development of a competing franchise system – were actually caused by prevailing economic conditions, not by the franchisor.\(^{13}\) In other words, the alleged breach of good faith did not cause the alleged damages.

The governing standard of good faith has been often quoted by courts, but in our view stating the standard in the abstract provides little guidance for franchisors and legal practitioners without understanding how the standard is actually applied by the courts to the facts of a case. As noted above, the fact patterns at issue in the good faith case law are very diverse, addressing disputes over a myriad of different types of disputes. The legal standard for good faith, however, is often expressed in broad language such as “commercial reasonableness” and the considerations of the “legitimate interests” of the franchisee, which requires a very context-specific

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\(^{12}\) 3574423 *Canada Inc. v. Baton Rouge Restaurants Inc.*, 2013 ONCA 39 at para 24 (where the Court found that the franchisee found itself in its current position because of its own internal decision-making process, not because of the franchisor’s impugned conduct).

application by the courts and depends on the unique facts at issue. This is in part why we have structured this paper by focusing on the different categories of disputes that give rise to good faith problems. Nonetheless, a helpful summary of the principles that are often cited by the courts can be found in *Fairview Donut Inc. v. The TDL Group Corp.* as follows:

The content of the duty of good faith and fair dealing has been expressed to include the following:

• to require the franchisor to exercise its powers under the franchise agreement in good faith and with due regard to the interests of the franchisee;

• to require the franchisor to observe standards of honesty, fairness and reasonableness and to give consideration to the interests of the franchisees;

• to ensure that the parties do not act in such a way that “eviscerates or defeats the objectives of the agreement that they have entered into”; or “destroy the rights of the franchisees to enjoy the fruits of the contract”;

• to ensure that neither party substantially nullifies the bargained objective or benefit contracted for by the other, or causes significant harm to the other, contrary to the original purpose and expectation of the parties; and

• where the franchisor is given a discretion under the franchise agreement, the discretion must be exercised “reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties”.

• The duty of the franchisor to give consideration to the interests of the franchisee does not require the franchisor to prefer the franchisee’s interests to its own … [A] party may act self-interestedly, however in doing so that party must also have regard to the legitimate interests of the other party.14

### 2. TERMINATION OF FRANCHISE AGREEMENTS

14 *Fairview Donut Inc. v. The TDL Group Corp.*, 2012 ONSC 1252 at paras. 502-503 [citations omitted].
Parties are entitled to terminate a franchise agreement in accordance with its terms. Where a franchise agreement provides for termination, the analysis undertaken by the Courts generally focuses on whether the manner of termination was consistent with the terms of the agreement. However, there are some instances where Courts have considered broader good faith and fair dealing requirements in the termination context. For example, a unilateral termination of a franchise agreement, accompanied by an “arbitrary amount for compensation to franchisees”, has been found to be in breach of the duty of fair dealing.\(^\text{15}\)

In *C.M. Takacs Holdings Corp. v. 122164 Canada Ltd.\(^\text{16}\)*, the Court considered the termination of a franchise agreement which permitted termination without notice upon the franchisee committing an act of bankruptcy. In that case, the franchisor terminated four franchise agreements without notice on the basis that the franchisee was in arrears in respect of multiple obligations, including unpaid rent, suppliers and arrears of PST and GST, totaling approximately $500,000.\(^\text{16}\) The Court rejected the submission that the duty of fair dealing required a notice requirement in this circumstance, as the agreement itself precluded it, and the franchisees were sophisticated business entities who proffered no evidence they misunderstood the agreements.\(^\text{17}\)

In another recent decision, *ANC Business Solutions Inc. v. Virtualink Canada Ltd.*\(^\text{18}\), the Court found that the franchisor breached the franchise agreement by failing to give the proper notice of termination, as required under the agreement. The Court ordered the franchisee be immediately reinstated and regain possession of the leased premises.\(^\text{18}\) While the Court directed a trial to determine the franchisor’s alleged breach of fair dealings,\(^\text{19}\) the Court interestingly considered, in *obiter*, the franchisee’s alternative claim for relief from forfeiture. The Court

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\(^\text{16}\) C.M. Takacs Holdings Corp. v. 122164 Canada Ltd., 2015 ONSC 5358 at paras. 4-6.
\(^\text{17}\) C.M. Takacs Holdings Corp. v. 122164 Canada Ltd., 2015 ONSC 5358 at paras. 9-11.
\(^\text{19}\) ANC Business Solutions Inc. v. Virtualink Canada Ltd., 2014 ONSC 1619 at paras. 3, 58.
concluded that, had the franchisor been entitled to terminate the franchise agreement as it did, this was an appropriate case to grant the franchisee relief from forfeiture.\textsuperscript{20} This result is particularly interesting in light of the history of defaults under this franchise agreement, as the franchisee was trying to establish a viable business. However, the Court was ultimately persuaded by the evidence that the franchisee was making genuine efforts to respond to the defaults, and grossly disproportionate nature of the harm to the franchisee as compared to the franchisor, such that the equitable relief sought was warranted.\textsuperscript{21}

Additionally, the duty of good faith in played an interesting role in the termination dispute in \textit{France v. Kumon Canada Inc.}, where the Court held that as a matter of law, at least in Ontario, a Court may imply a provision of unilateral termination on reasonable notice in an indefinite franchise agreement.\textsuperscript{22} In that case, the Court implied such a provision into a long-standing oral franchise agreement.\textsuperscript{23}

The Court noted that the franchisor sought to require the franchisee to enter into a uniform written agreement, as it had changed its business model to require its franchisees to abide by certain common obligations.\textsuperscript{24} The franchisee in this case refused to enter into the written agreement over a number of years, and was ultimately provided 12 months notice prior to the termination of the franchise agreement. The Court considered the franchisor’s duty of good faith in this context, and concluded:

\begin{quote}
Kumon wanted to change the business model. The new business model may well have been less advantageous to Ms. France. A franchisor does not act in bad faith simply because it wants to change the business model. A franchisor does not act in bad faith simply because it insists on a uniform franchise agreement with its franchisees and will not negotiate individual agreements. That said, a franchisor cannot use its unequal bargaining
\end{quote}

\textsuperscript{20} ANC Business Solutions Inc. v. Virtualink Canada Ltd., 2014 ONSC 1619 at para. 68.
\textsuperscript{21} ANC Business Solutions Inc. v. Virtualink Canada Ltd., 2014 ONSC 1619 at para. 69.
\textsuperscript{22} France v. Kumon Canada Inc., 2014 ONSC 5980 at paras. 58, 62.
\textsuperscript{24} France v. Kumon Canada Inc., 2014 ONSC 5980 at para. 40.
power and greater resources to force unfair changes on its franchisees. A franchisor acts in bad faith where it uses its unequal bargaining power to act unconscionably toward the weaker party.\footnote{France v. Kumon Canada Inc., 2014 ONSC 5980 at para. 42.}

The Court concluded that the franchisor did not act unconscionably, as it went to great lengths to accommodate the franchisee, and there was no evidence of bad faith.\footnote{France v. Kumon Canada Inc., 2014 ONSC 5980 at para. 43.} The Court implied an ability to terminate on reasonable notice in the franchise agreement, and sought additional argument on what constituted reasonable notice in these circumstances.

In subsequent reasons, the Court concluded that 18 months notice was reasonable in this case. The Court articulated numerous factors in the determination of a reasonable notice period in the franchise context, including: the length of the relationship between franchisee and franchisor; whether there was a history of oppressive conduct or bad faith on the part of the franchisor; whether there was a history of poor performance by the franchisee; and whether the franchisor or franchisee has acted in good faith throughout the relationship.\footnote{France v. Kumon Canada Inc., 2014 ONSC 7181 at para. 16.}

These cases illustrate the importance of the particular terms of a franchise agreement as well as the facts surrounding its purported termination, including any unfair or bad faith conduct by a party, in disputes arising from contested terminations.

\section*{3. Non-Renewal of Franchise Agreements}

In Ontario, the statutory duty of fair dealing explicitly applies with respect to the renewal or extension of a franchise agreement.\footnote{Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3, s. 2(1) and 3.} Good faith permits a party to act in its own interest, but requires it to take into consideration the interests of the other party.\footnote{Salah v. Timothy’s Coffees of the World, [2009] O.J. No. 4444 (S.C.J.) at para. 116; aff’d 2010 ONCA 673; see also Shelanu Inc. v. Print Three Franchising Corp., [2003] O.J. No. 1919 (C.A.) at para. 96.} Courts have found the
failure of a franchisor to communicate with a franchisee, including deliberately withholding critical
information and failing to respond promptly to inquiries from the franchisee, constituted breaches
of its duty of good faith in this context.30

In addition, the franchisor’s statutory disclosure requirements apply to renewals and
extensions of a franchise agreement, and the failure to provide adequate disclosure has been
found to constitute a breach of the franchisor’s duty of good faith.31 However, the Arthur Wishart
Act provides that a franchisor need not make disclosure at the time of renewal where there has
been no interruption in the operation of the business operated by the franchisee and where there
has been no material change since the franchise agreement or latest renewal or extension of the
franchise agreement.32 A material change is defined as a change in the business or operations
of the franchisor that would reasonable be expected to have a significant adverse effect on the
value or price of the franchise to be granted or on the decision to acquire the franchise.33
“Materiality” in this context is objective.34

The determination of what constitutes a “material change” in the particular circumstance
will accordingly be central to any allegations of bad faith. For example, in 1159607 Ontario Inc.
v. Country Style Food Services Inc., the Court concluded that the altered terms of a lease renewal
constituted a material change that the franchisor was obliged to disclose to the franchisee.35 In
that case, the franchisor and franchisee renewed the franchise agreement pursuant to the five
year renewal option. However, the franchisor failed to advise the franchisee that it had entered

33 Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3 s. 1; 1201059 Ontario Inc. v. Pizza Pizza Ltd.,
2013 ONSC 5200 at para. 89.
34 Trillium Motor World Ltd. v. General Motors of Canada Ltd., 2012 ONSC 463 at para. 17; 1201059 Ontario Inc. v.
Pizza Pizza Ltd., 2013 ONSC 5200 at para. 93.
into a lease renewal for the property for only an additional year, not the entire duration of the renewal term. 36 The Court found that the franchisor’s deliberate concealment of information about the new lease agreement, while actively leading the franchisee to believe that the lease had been renewed, breached its duty of good faith. 37 The Court rejected the franchisor’s submission that its actions were “commercially reasonable” in the circumstances, concluding that it was not in good faith to favour its own business interests at the expense of the franchisee’s ability to make informed financial and business decisions. 38

It is clear that good faith, even in the context of a long-standing commercial relationship, does not in and of itself create a right of renewal for either party. That is, the good faith doctrine and the statutory duty of fair dealing are restrained by the express terms of the franchise agreement entered into by the parties. 39 Where a franchise agreement is for a fixed term, without a right of renewal or options to renew, good faith “surely does not compel one party to renew an expiring relationship where it considers it to be commercially unreasonable.” 40

This scenario was considered by the Court in TDL Group Ltd. v. 1060284 Ontario Ltd. In that case, the franchise license and sublease had a term of 10 years, with no provision for renewal. The franchisor advised the franchisee that it would not be offered a new franchise when the agreements expired, and the franchisee sought to restrain the franchisor terminating the agreement. 41 The franchisee alleged bad faith on the part of the franchisor and submitted that,

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38 1159607 Ontario Inc. v. Country Style Food Services Inc., 2012 ONSC at para. 130; aff’d 2013 ONCA 589.
because of the long-standing good relationship with the franchisor, it had a reasonable expectation that the franchise would be renewed.42

The Court concluded that the failure of the franchisor to renew did not amount to bad faith,43 noting that:

The fact that TDL and the defendants have been in a long-term profitable relationship does not convert into an obligation on TDL to renew the agreements. When a party enters into an agreement which contains no right to renew or an option to renew on ascertainable terms there will be no renewal enforceable by a court. If, however, the evidence discloses that a commitment made to renew on terms certain or ascertainable has been agreed to by the parties, or by the parties’ conduct, then a court can infer that a contract to renew has been formulated.44

This principle is also reflected in the Bhasin decision, where the Supreme Court considered a contract that was subject to non-renewal. Justice Cromwell found that it was “a considerable stretch, as I see it, to turn even a broadly conceived duty of good faith exercise of the non-renewal provision into what is, in effect, a contract of indefinite duration.”45

4. WITHHOLDING OF CONSENT TO A FRANCHISEE TRANSFER46

Commonly, franchise agreements expressly provide the franchisor with the right to elect to provide its consent as a condition to an effective transfer by the franchisee to a third party. This is often seen by the franchisor as an important right because it allows for an independent evaluation of the transaction, in particular the experience and resources of the transferee.47

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46 This section of the Article is based in part on: Adam Ship and Mohammed Sohail, "Franchise Renewals and Transfers in Canada’s Common Law Provinces" 2015 35(2) Franchise Law Journal 237 at 247-249.
47 See, e.g., 1518628 Ontario Inc. v Tutor Time Learning Centres, LLC, 2006 OJ No 3011 (Sup. Ct. J.) , para. 25 (“It would not serve the best interests of [the franchise] or that of its network of franchisees to allow a franchise to be transferred without an assessment of the proposed transferee’s character, experience and credit worthiness”).
Modern franchise agreements commonly contain detailed clauses that require the franchisee to meet very specific requirements as conditions precedent to the transfer. Where an agreement places restrictions on a prospective transferee’s ability to transfer, Canadian courts will generally enforce those restrictions and any noncompliant transfer should be legally ineffective.\(^{48}\) However, many older franchise agreements simply provide that the franchisor will not unreasonably withheld its consent to a transfer by the franchisee.

Where a franchisee transfer is subject to the consent of the franchisor, but the agreement is silent on the standard that applies to that decision, the franchisor will be required to meet the standards of good faith and fair dealing before withholding its consent. In our view, this standard also applies where the franchise agreement simply provides that the franchisor will not be unreasonably withhold its consent to a transfer.

We have not been able to find any reported cases where the courts have considered the standard of good faith that applies in the particular context of a franchisor’s decision to withhold consent to a proposed franchisee transfer. However, in the commercial leasing context, the common law has developed clear principles to determine the reasonableness of withholding consent to a proposed transfer.\(^{49}\) Given the apparent lack of franchise cases in Canada where the courts have had to determine whether a franchisor has unreasonably withheld its consent to a transfer, the principles in the leasing and other commercial contract cases will likely be persuasive to a Canadian court facing this issue in the franchise context.

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\(^{49}\) See *1455202 Ontario Inc. v Welbow Holdings Ltd.*, [2002] O.J. No. 1785, para. 9 (Ont. Sup. Ct.) (which sets out the principles in this area). These principles were held by the Ontario Court of Appeal to constitute “the applicable test” for whether a landlord is withholding consent unreasonably to a lease assignment in *Tradeage Inc. v Tri-Nov Group Inc.*, 2007 ONCA 562, para. 2. These principles were also cited with approval by the B.C. Supreme Court in *Hayes Forest Services Ltd. (Re)*, 2009 BCSC 1169, para. 33. The Alberta Court of Queen's Bench has also applied many of these principles in *IFP Technologies (Canada) Inc. v Encana Midstream and Marketing*, 2014 ABQB 470, paras. 155-161, 183-184.
These cases suggest that—consistent with all good faith issues—the court’s assessment will be highly fact sensitive and will depend on the individual circumstances of the case. As a general matter, however, a franchisor will always be permitted to consider the suitability of the proposed transferee in deciding whether to grant consent, including whether the transferee is able to satisfy the financial and other covenants in the agreement.

A principle that is consistently applied in the commercial leasing context is that consent to a proposed transfer cannot be denied for reasons that are wholly unconnected to the contract. In our view, this principle would apply in the franchising context as being subsumed within the duty of good faith. Under this principle, it is unreasonable for a landlord to withhold consent to an assignment solely because it is no longer satisfied with the financial or other terms provided for in the original lease and simply wants to extract better terms from the transferee. In such circumstances, unless the lease expressly provides the landlord with the right to impose different terms on the transferee, the landlord has been found to have withheld its consent for a collateral purpose unconnected to the terms of the lease. In our view, this applies in the franchise context where the franchise agreement does not expressly require the transferor to sign “then-current” form of franchise agreement and ancillary documents. In this situation, where a franchisor refuses to consent to the transfer primarily because the transferee declines to sign these updated agreements, there is a that the franchisor’s refusal to consent will be found to breach the duty of good faith. While the franchisor can still attempt to negotiate such an outcome, the duty of good faith

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51 For analogous findings in the non-franchise context, see Welbow Holdings Ltd., supra, at para. 9; Exxonmobil Canada Energy v Novagas Canada Ltd, 2002 ABQB 455, paras. 54, 58-60.

52 Tri-Novo Group Inc., supra, at paras. 38-39, aff’d 2009 ONCA 855. See also Harvey Haber, Tenant’s Rights and Remedies in a Commercial Lease 38-39 (2nd ed. 1998) (citing cases where courts have found the refusal of consent to be unreasonable where the landlord was demanding a (a) higher rent than contemplated by the original lease, (b) a more robust restrictive covenant from the transferor and (c) further and different security than it was entitled to under the original lease); Welbow Holdings Ltd., supra, at para. 9 (“The Landlord is not entitled to require amendments to the terms of lease that will provide it with more advantageous terms” unless such is expressly provided for in the lease).
faith may prohibit the franchisor from refusing to consent solely on the basis that the transferee will not agree to voluntarily sign different documents.

As a practical matter, this provides an additional imperative for the franchise agreement to clearly provide the franchisor with the right to require a transferee to sign the “then current” franchise agreement and ancillary documents. Where a franchisor wishes to attempt to negotiate better terms in the agreement with the transferee, care should be taken to ensure that the transaction doesn’t fall apart for this reason, as the franchisee may assert a bad faith claim against the franchisor.

Similarly, courts have occasionally held that a landlord is acting unreasonably when it refuses to consent to a transfer for the purpose of obtaining the leased premises for itself, either to use on its own or to grant a lease to one of its larger tenants. In this context, landlords have been held by courts to have withheld their consent for a collateral purpose unconnected to the terms of the contract. In our view, this may be analogous to the franchising context where a franchisor refuses to consent to a transfer simply because it prefers to retain the transferring franchisee’s territory for its own corporate location or for another larger franchisee. In such a context, there is a risk that the franchisor’s refusal may be found to be commercially unreasonable and contrary to the duty of good faith.

In this context, a franchisor should ensure that it carefully evaluates the suitability of the proposed transferee and that any decision to withhold consent is reasonable having regard to the criteria set out in the franchise agreement, the suitability of the proposed transferee and/or any other factors relating to the proposed transaction and the standing of the transferor. Franchisors

53 See Loblaws Inc. v The General Store, 2007 NLTD 160, para. 25 citing Bromley Park Garden Estates Limited v Moss, [1982] 2 All E.R. 890 (C.A.) (“the landlord [in refusing to consent] was attempting to regain possession of the premises in order to gain a further advantage by letting the entire premise to one tenant”). See also Haber, supra note 63, at 38 (citing two decisions where the courts found against the landlord on the basis that he “refused to consent because he wanted to obtain possession of the premises for himself”).

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considering transfer requests by franchisees can mitigate their risk by clearly documenting their decision-making process and ensuring that ultimate decisions are based on the circumstances of the franchisee, the proposed transaction and the proposed transferee.

5. SYSTEM CHANGES THAT ECONOMICALLY AFFECT FRANCHISEES

In our view, courts approach their assessment of system-wide decisions by franchisors differently than they approach bilateral disputes between a single franchisee and its franchisor. The system-wide context generally entails greater deference shown by the courts to the decisions that franchisors make, with the context and circumstances facing the franchisor often playing a leading role in the courts’ analysis. In the recent decision of *Trillium Motor World Ltd. v. General Motors of Canada Limited*, the court emphasized this point at the outset of its good faith analysis:

> The specific context of [the franchisor’s] conduct was that it was making crucial business decisions very quickly during a time of instability and flux for both [it] and its dealers. When considering each of the [specific alleged breaches of the duty of good faith] below I will review the statutory duty of fair dealing through the lens of commercial reality – that is, [the franchisor’s] conduct in that context.

The leading system change decision in *Fairview Donut* illustrates the different level of scrutiny that courts bring to bear when analyzing good faith claims in system-wide cases as contrasted to bilateral disputes. The language used in the critical passages of the decisions in *Fairview Donut*, in particular the short endorsement of the Ontario Court of Appeal, suggests a more deferential standard applies than a mere assessment of “commercial reasonableness”. The court emphasized that one of the challenged system changes was a “rational business decision” made by the franchisor “for valid economic and strategic reasons, having regard to both its own interests and the interests of its franchisees.” In our view, two practical implications flow from the

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54 This section of the Article is based in part on Adam Ship et al., “Legal Risk Management in Franchise System Change”, *Focus on Franchising* (OBA, 2014).
55 *Trillium Motor World Ltd. v General Motors of Canada Limited*, 2015 ONSC 3824 at para. 163.
court's analysis of good faith in *Fairview Donut* which are particularly apposite in the context of franchise system change.

First, in our view, the legal standard requires the franchisor to consider the legitimate interests of its entire network of franchisees, rather than each individual franchisee in the network. When making system-wide decisions, a franchisor should consider the impact on the franchise system as a whole and perhaps on defined classes of franchisees within that network. *Fairview Donut* suggests that the key to good faith compliance in the system change context is for the franchisor to illustrate both a rational business purpose and meaningful consideration of the interests of the entire system. In our view, it will be rare for a court to find a business decision made for purposes of growing market share or profitability for the system as a whole to lack a rational basis. Moreover, the courts will normally assess the impact of a system change decision on the entire class of franchisees affected, rather than on individual franchisees. With these elements made out, *Fairview Donut* suggests that system changes that turn out in hindsight to be ‘incorrect’ or unprofitable should be protected from liability under the duty of good faith.\(^56\)

Second, *Fairview Donut* provides the best example of a procedural risk management tool for franchisors when making system change decisions: engage franchisees in a meaningful consultation process. In addition to allowing the franchisor to properly educate franchisees about the issues and to receive non-binding feedback and guidance, consultation can build an evidentiary record that can be deployed by franchisors in defence of allegations of bad faith in subsequent litigation. *Fairview Donut* provides a road map for the gold standard of consultation, which will not always be feasible or practical, but worth considering whenever a significant system change is contemplated. A key element to the franchisor’s successful defence in *Fairview Donut*

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\(^56\) See also Horkins and Ronde, “Change Before you Have To”: Franchise Lessons from Canada’s Donut Wars.” May 21, 2013 Mondaq.com (“Franchisors that make calculated decisions to promote the profitability of the system as a whole … are unlikely to attract liability for sweeping, system-wide changes”).
was a large evidentiary record that proved ongoing and transparent consultation with franchisees throughout the development and implementation of the system changes.

In *Fairview Donut*, the franchisor had a formal system in place for non-binding consultation with its franchisees, which included a franchisee-elected advisory board that was actively engaged and consulted on the proposed changes and encouraged to ask questions. In addition, the franchisor also engaged in numerous one-on-one consultations with individual franchisees. The Court of Appeal noted positively in its discussion of good faith the franchisor’s “process for considering [the] franchisees’ position”.

As noted, this level of consultation may not always be feasible for a franchisor, particularly in situations where the system change occurs not from within the system but in the wider market or industry and/or arises in situations of exigency or financial distress. The Ontario Superior Court recognized this in *Trillium Motors*, where it emphasized the “frenetic pace of events” and “challenges” facing the franchisor in upholding its decision not to consult more closely with its dealers prior to taking steps to significantly reduce the size of its dealer network. The context will always be critical to the courts’ analysis. That being said, where feasible, a meaningful consultation process can greatly mitigate the risk of adverse litigation.

Despite the deferential legal standard and endorsement of consultation in *Fairview Donut*, and the sensitivity to the context facing the franchisor in *Trillium Motors*, we suggest two words of caution in the context of franchise system change.

First, as always in good faith cases, the analysis must begin with the franchise agreement and the system change at issue should be as firmly anchored in the franchise agreement as possible. The courts are generally careful to ensure that franchisors do not attempt to circumvent

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58 *Trillium Motors*, *supra* at para. 181.
specific contractual rights of franchisees by relying on general or catch all reservation of rights clauses in the system-change context. This was not a concern in Fairview Donut, as there were no clear and specific contractual rights being defeated by the system modifications. However, in Fleet Mobile Tyres Ltd. v. Stone,59 the English Court of Appeal found that the franchisor had not acted fairly (by “derogating from the grant”) by attempting to use general reservation of rights clauses to defeat the franchisees’ specific rights. The franchisor, relying on a number of general clauses, instructed its franchisees to modify their service vehicles, stationary, and advertising to emphasize a different trade name from the one that had historically dominated the franchise system. The court interpreted the franchisor’s right to provide these instructions as being subject to a limitation “that it would not be exercised so as to impede substantially the exercise of the franchisee’s right”, which the court held to include the right to “operate and promote the Business under the [original] Trade Name and the Trade Marks.”60 This is similar to the Ontario Court of Appeal’s comment in Transamerica that the duty of good faith is designed to ensure that parties “do not act in a way that eviscerates or defeats the objectives of the agreement that they have entered into”.

Similarly, in 887574 Ontario Inc. v. Pizza Pizza Ltd.61 a dispute arose over the franchisor’s significant increase of franchisee contribution rates to rent and advertising pools.62 The franchisor attempted to rely on general provisions that allowed it to charge franchises for any deficits in those financial pools, despite more specific provisions which expressly capped franchisee contributions to these funds. The Ontario Superior Court, per MacPherson J. (now MacPherson J.A.), held that the franchisor’s general right to pass rental and advertising pool deficits to franchises was subject

60 Ibid. at paras. 55-57.
to an important limitation. According to the court, the issue of rental and advertising contributions by franchisees was “fundamental” in the context of the franchise relationship as a whole, and therefore could not be “increase[d] by massive amounts” by the franchisor “acting unilaterally and through the side door of the rental [and advertising] pool deficit provision” Again, this appears similar to the Transamerica decision about avoiding actions which eviscerate the bargained-for objective as determined by a careful analysis of the agreement as a whole.

Second, Fairview Donut may potentially be distinguished by a future court on the basis that the franchisor had obtained broad franchisee support for proposed system changes prior to moving forward. Both the Superior Court and the Court of Appeal may have been influenced by the fact that a majority of franchisees apparently supported the impugned system changes. When assessing the business rationale of the system changes, the Superior Court referred to evidence of a number of franchisees that testified in support of the impugned system changes as well as to supportive comments made by certain franchisees during the consultation process. Wide franchisee support for impugned system changes has also been influential in some of the U.S. system change case law. This raises the question of whether the same outcome in Fairview Donut would have occurred if a more sizeable number of franchisees (or, indeed, a majority) had refused to support the system changes. One possible practice to mitigate risk is for the franchisor to attempt to franchisee concerns that arise during the consultation process by making certain modifications to the proposed changes in order to bring more franchisees onboard.

63 Ibid at para. 36.
64 Ibid. at paras. 33-34 and 42.
65 See, e.g., Fairview Donut (S.C.J.), supra, at para. 675.
66 Ibid. at para. 676.
68 Ibid. at p. 239.

A number of recent cases have discussed the extent to which the duty of good faith includes an obligation on the franchisor to disclose material facts after the franchise agreement is signed. Notable recent examples in this regard include 1250264 Ontario Inc. v. Pet Valu Canada Inc. and Trillium Motors. In our view, it is helpful to put this issue into the larger context of the case law that deals with communications issues more generally in order to distill the current state of the law and some suggested best practices.

Prior to the advent of franchise legislation in Canada, the courts were prepared to hold franchisors liable where, at the pre-contractual phase of a franchise relationship, they misrepresented key aspects of their franchise systems to prospective franchisees. In these cases, the misrepresentation was sometimes held to flow from an omission to clarify a state of affairs that had been inaccurately described in promotional materials or other information or materials provided to the prospective franchisee. These cases focused on situations where the promotional materials or other information provided to prospective franchisees were materially misleading, thereby inducing the franchisee to execute the franchise agreement. A notable example in this regard was Camrad Inc. v. Café Supreme F&P Ltd/Ltee, where the franchisor failed to warn the franchisee of a design error for the restaurant which caused reduced seating. The error was brought to the franchisor’s attention by a restaurant developer who also informed the franchisor that the design plans would not likely be approved by the city in which the restaurant was to be built. According to the court:

70 (1995), 25 BLR (2d) 64 (Ont Ct Gen Div).
For [the franchisor] to go forward and represent that their restaurant plan was for 68 seats when they had reputable information that refusal of a building permit would be most likely, constituted a negligent act …

Similarly, in *Perfect Portion Holdings Co. v. New Futures Ltd.*,72 the court found that the franchisor recklessly misrepresented the anticipated revenue that the prospective franchises would earn under the agreement and that this induced them to sign the franchise agreement.73

The recent finding in *Pet Valu* can be read as being conceptually similar to these earlier cases. In *Pet Valu*, the court held that the franchisor acted in bad faith because, “contrary to its representations in [its] disclosure document and [in the] franchise agreement, [it] was never able to generate a meaningful amount [of volume discounts] as was promised and expected and never told its franchisees the truth”.74 The court held that “there can indeed be situations where fair dealing requires that the franchisor tell the franchisee the truth about an important and material fact – particularly if the opposite was stated in the disclosure document and franchise agreement.”75 While the decision is currently under appeal and has been the subject of spirited debate in the franchise bar, the limited duty of disclosure that the decision recognized can be confined to the facts of *Pet Valu*, which on its face dealt with a situation where the disclosure document and the franchise agreement misrepresented the true state of affairs. Indeed, in *Spina v. Shoppers Drug Mart Inc.*, the Ontario Superior Court previously clarified that the duty of good faith does not require a franchisor to make ongoing disclosure to a franchisee for purposes of allowing the franchisee to evaluate the franchisor’s ongoing compliance with the franchise agreement.76

73 Perfect Portion Holdings Co v New Futures Ltd, [1995] OJ No 2113 (Ont Ct Gen Div) at para 17 (“I am satisfied that this agreement was based on representations recklessly made”).
74 Pet Valu, supra, at para. 47.
75 Pet Valu, supra, at para. 58.
As a practical matter, *Pet Valu* should provide a further incentive to franchisors to ensure that disclosure documents, franchise agreements and any other information provided to franchisees is at all times accurate with respect to material matters. Where an inaccuracy is later discovered by the franchisor, consideration should be given to clarifying the inaccuracy in order to avoid litigation or a bad faith finding.

Communication issues were also at issue in the seminal case of *Shelanu*, where the Ontario Court of Appeal made the following finding:

The fact that the royalty rebates were ultimately paid does not mean that [the franchisor] did not breach its obligations towards [the franchisee]. The duty of good faith comprises a time component. That time component requires the party under a duty of good faith to respond promptly to a request from the other party and to make a decision within a reasonable time of receiving that request.77

This obligation of promptness raises practical challenges for franchisors who may be inundated with written or other requests for assistance or information from its network of franchisees. In our view, consistent with the general principles that apply in good faith cases, this particular duty must be applied with sensitivity to the context and circumstances facing the franchisor and the nature and volume of the requests. Nonetheless, to the extent possible, franchisors should structure their operations to mitigate the risk of being found to be offside this particular obligation. While a franchisee will rarely suffer any meaningful compensable damages as a result of a franchisor’s delay in responding to routine correspondence, a pattern of delay and unresponsiveness can colour a court’s assessment of a franchisor in the context of franchise litigation, even where the core issue is unrelated to the communications. In other words, communications issues can become a sideshow in litigation and may work to undermine an otherwise meritorious defence. A practice of courteous communications, even a simple response to note that a request was

77 *Shelanu*, *supra*, at para. 78.
received but will not be addressed for a few weeks given other pressing deadlines, can go a long way to avoiding contentious issues and can mitigate the extent to which routine communications become exhibits in litigation.

Perhaps the best examples of poor communication leading to liability can be found in the well-known cases, *Salah v Timothy's Coffees of the World Inc.* and *1159607 Ontario Inc. v Country Style Food Services Inc.* In *Salah*, the franchisor was found to have acted in bad faith by taking deliberate steps to ensure that the franchisee did not find out that it had selected a new franchisee to take over its location and was in secret negotiations with the landlord on a new space in the mall. The franchisor refused to answer phone calls from the franchisee and instructed the landlord not to discuss this issue with franchisee. The Ontario Court of Appeal held that the franchisor breached the duty of good faith by actively withholding critical information from the franchisee and awarded $50,000 over and above compensatory damages.78

*Country Style* similarly addressed a franchisor that withheld critical information from the franchisee concerning its discussions with the landlord regarding the head-lease. After the franchisor and the landlord agreed to an early termination of the head-lease, the franchisor took active steps to keep this information confidential from the franchisee. In later meetings with the franchisee, the franchisor made no mention of the head-lease termination and instead implied to the franchisee that negotiations with the landlord were in their final stages.79 This active intention to deceive led the court to award $25,000 in non-compensatory damages against the franchisor.80

Taken together, *Shelanu*, *Salah* and *Country Style* speak to the benefit of franchisors investing in systems that allow for documented, courteous communications with franchisees on material issues. While the right balance must be struck to ensure that communications issues

78 *Salah*, supra, at para. 22.
79 *Country Style Food Services Inc.*, supra, at paras. 54-55, 63.
80 Ibid. at para. 129.
are managed in a cost effective and efficient manner, these cases nonetheless provide clear examples of the courts making adverse findings in the face of poor communications and a lack of candor and openness with franchisees.

7. Conclusion

The case law dealing with the duty of good faith has continued to evolve in recent years, especially in the context of franchise relationships. We have attempted to group the cases according to their subject matter in order to stay true to the general principle that the circumstances and context of a good faith dispute will drive the outcome. We have also attempted to identify practical tips and best practices for franchisors and their counsel to comply with the duty.