Toronto Law Journal

Actions Speak Louder Than Words: The Enforceability of Oral Agreements Collateral to a Franchise Agreement

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In *Meadow Enterprises Inc. v. Quizno's Canada Restaurant Corporation*,[1] the franchisee, Meadow Enterprises Inc., commenced a claim for damages for breach of its franchise agreement with the franchisor, Quizno's Canada Restaurant Corporation.

In 2003, the franchisee acquired the right to operate a Quizno's franchise located in a remote location. The franchise agreement provided: (a) a 15-year term; (b) a 15-year renewal option; (c) that the franchisee pay weekly royalties of 7% of its gross sales; and (d) that the franchisee pay weekly marketing fees of up to 5% of its gross sales. The franchisee alleged that there was an oral collateral agreement entered into at the time of the execution of the franchise agreement, providing that:

a) The franchisor would subsidize the franchisee's purchase of products and supplies (known as the Ocean Freight Subsidy) because the franchise was in a remote location;

b) Part of the consideration for the payment of royalties was the appointment of an area director, who would provide services and assistance to the franchisee; and

c) The franchisor would deal honestly and reasonably with the franchisee and would treat all its franchisees fairly and equally in accordance with its obligations of good faith.

An area director was appointed to liaise between franchisees and the franchisor, and to provide operational and administrative support. In 2008, the area director position was eliminated, and the functions were then performed by the franchisor. The Ocean Freight Subsidy was eliminated in July 2015, at which time the franchisor implemented a new distribution model. In 2016, the franchisor implemented a program reducing royalty and advertising fees for any franchisees who purchased a new type of oven — this program was known as the "New Deal". When the franchise agreement expired in February 2018, the franchisee did not exercise its renewal option.

The franchisee claimed for damages against the franchisor for the following breaches of the franchise agreement: (1) the elimination of the Ocean Freight Subsidy, (2) the elimination of the area director; (3) misuse of the marketing fund; (4) impaired profitability and diminished value of the franchise arising from the misuse of the marketing fund; and (5) failure to reduce royalty and advertising fees.

[1] 2018 BCSC 1967.

1) Elimination of the Ocean Freight Subsidy

The franchisor argued that the Ocean Freight Subsidy was gratuitous and that it had no obligation under the franchise agreement to provide the subsidy to the franchisee. (Note: the authors do not know whether the franchisor argued that the entire agreement clause [assuming the franchise agreement contained such a clause] negated any alleged oral agreement.) The franchisee submitted that the subsidy was part of the business model, and that the franchisor had previously acknowledged the obligation to provide the subsidy. The Court, accepting the franchisee's evidence, found that the subsidy was a fundamental component of the franchise agreement and that therefore the franchisor had breached the agreement by wrongfully eliminating the subsidy.

2) Elimination of the Area Director

The franchisee argued that: (a) the elimination of the area director deprived it of a number of support services; (b) it itself had to assume the area director's functions, post-elimination; and (c) part of the 7% royalty it paid was used to cover the costs of the area director. The franchisee claimed a 2% overpayment from the date of the elimination of the area director, on the basis that franchisees in a competitor business only paid a 5% royalty.

The Court was unconvinced by the franchisee's argument stating that, under the franchise agreement, the franchisor did not have an obligation to retain an area director, but rather the right to do so. The Court was also unable to substantiate franchisee's claim that the 7% royalty was linked to the existence of the area director, as the franchise agreement provided no such breakdown. Thus, this aspect of the franchisee's claim was dismissed.

3) Misuse of the Marketing Fund

Section 12.3 of the franchise agreement provided for the payment of marketing fees to the franchisor to be used for marketing initiatives to the benefit of the franchise system. The franchisee argued that, in respect of the sum of $212,534 paid to the franchisor as a contribution to the marketing fund, it had received little-to-no benefit, and despite numerous requests, and being so entitled, never received financial statements for the marketing fund.

The Court was persuaded by the franchisee's evidence on this point, finding that the value of marketing services supplied by the franchisor was likely even lower than estimated by the franchisee in its breakdown. As a result, the Court awarded the franchisee the full value of its claim regarding the marketing fund, citing the franchisor's failure to provide the benefit for which the franchisee had contracted under the franchise agreement as a serious breach. (Note: there is no analysis in the decision as to how this value was determined.)

4) Impaired Profitability and Diminished Value of the Franchise

The franchisee alleged that its profitability was diminished as a consequence of the franchisor's failure to use the marketing fund to promote the franchise business. The franchisee alleged both loss of revenues and depreciation of the value of the franchise business as well.

For the loss of revenue allegation, the franchisee prepared a calculation, based on marketing investment return figures obtained from the Nielsen Company, which resulted in approximately $347,700 in losses over the franchise agreement's 15-year term. The Court determined that this allegation was not only speculative, but could not be substantiated by expert evidence or factual proof. Therefore, the Court dismissed this aspect of the claim. Turning to the depreciation of the value of the franchised business, the Court held that any such alleged loss in value was never crystallized, since, upon expiration of the franchise agreement, the franchisee did not sell the franchise but merely closed the doors. Consequently, this allegation of breach was dismissed too.

5) Failure to Reduce Royalty and Advertising Fees

The franchisee alleged that despite meeting all the criteria for the "New Deal" program, the franchisor refused to make the fee reduction. The franchisee asserted that the franchisor's refusal was because the franchisee had commenced litigation at the time the program was offered, and that the franchisor required the franchisee to release the franchisor from all claims. The franchisor's position was that the program was only available to franchisees who were in "good standing", being no operational or financial defaults at the time, and that a franchisee engaged in litigation is not considered in "good standing". The Court found that the franchisee's litigation did not put it in operational or financial default. Further, given that the franchisee had no other defaults, it should have been provided the fee reduction, and therefore was entitled to recover its overpayment.

Takeaways

This case demonstrates a court's willingness to recognize the existence of a collateral oral agreement, even as supplementary to an existing written franchise agreement (and perhaps in the face of an entire agreement clause, if any), where the existence of such an oral agreement can be established on the basis of the parties' conduct. In particular, this case represents the principle that actions can speak louder than words, especially where those actions substantiate unwritten elements of a business model and make them enforceable at law. Further, this case also reminds franchisors that, generally speaking, marketing fees collected from franchisees must be used for the purpose for which they were intended, and franchisors must be able to provide evidence of use.