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A WORLD OF TROUBLE: HOW TO LIMIT LIABILITY EXPOSURE IN INTERNATIONAL FRANCHISE EXPANSION

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Introduction

Traditional Risks Faced by Franchisors in International Expansion and Traditional Mitigation Strategies

- Liability for Franchisor's Own Actions
  - Disclosure violations
  - False / misleading statements in connection with franchise sales
  - Failure to provide promised support explicitly set forth in the franchise agreement
- Traditional Mitigation Strategies
  - Understanding local requirements and hiring competent counsel
  - Training employees to comply with a thorough sales and disclosure process
  - Implementing a properly designed sales, support and termination process

Introduction

<u>Traditional Risks Faced by Franchisors in International Expansion and Traditional Mitigation Strategies</u>

- Liability for Franchisee’s Actions or Omissions (e.g., Vicarious Liability)
  - Typically arises because either (i) Franchisor possesses too much control (typically over day-to-day operations) (actual agency) or (ii) a reasonable person would conclude that the Franchisee and/or its employees are agents of Franchisor (apparent agency)
  - Sample areas where Franchisor faces potential vicarious liability:
    - Employment-related law;
    - Data privacy;
    - Tort and similar liability; and
    - Statutory claims (FCPA, ADA, etc.)

Introduction

<u>Traditional Risks Faced by Franchisors in International Expansion and Traditional Mitigation Strategies</u>

- Traditional Mitigation Strategies for Vicarious Liability Risks
  - Express language / requirements in the franchise agreement (e.g., compliance with laws);
  - Audit and inspection rights;
  - Indemnification;
  - Insurance; and
  - Guarantees / backstops.

Introduction

Recently Enacted Laws and Judicial Decisions: A Changing Landscape or Much Ado About Nothing?

- Do Franchisors have a responsibility to actively monitor their Franchisees' compliance with applicable laws?
- Must Franchisors assist Franchisees in combating rising competition or other commercial risks?
- What obligation does a Franchisor have to enter into a "workout" or amendment of existing contractual obligations when a Franchisee encounters difficulties?

Let's Consider a Few Case Studies……

Hypothetical #1

Hypothetical #1

Facts

- Country X has a high and expensive standard of living and very high minimum wage rate.
- It has historically been very receptive to franchising in many forms.
- Franchisor A, a convenience store franchisor, with a large market presence in country X has a large number of franchisee owners who are "predominantly of migrant backgrounds, particularly from China, Pakistan and India."

Hypothetical #1

Facts

- It also has a large number of students who are on student visas who do not speak the language in country X and who need to work due to the high cost of living.
- Stories in the press begin to surface in the late 2000s about various violations of Country X's employment law through a variety of forms of underpayment at the franchised locations of Franchisor A.

Hypothetical #1

Questions

- To what extent does a franchisor have a duty to employees of its franchisees to confirm their franchisees compliance with applicable law?

- To what extent does a franchisor have a duty to confirm that its franchisees comply with applicable law?

7-Eleven

History / Facts

Rolling Series of Wage Scandals Reported in Press

- 7-Eleven is the largest convenience store franchisor in Australia.
- In 2008 allegations about a “double hours scam” were received under which a 7-Eleven store would record and pay for half the hours worked by employees.
- In 2009-2010, a 2nd investigation revealed instances of underpayment and weekend extra pay improperly paid.

7-Eleven

History / Facts

Rolling Series of Wage Scandals Reported in Press

- In 2010 legal proceedings were commenced against a former C-store franchisee for a "half pay scam" whereby employees who were international students were underpaid the base hour rates of pay.
- According to the Report, "employees felt that 7-Eleven was either disinterested in their grievances or aware of high levels of non-compliance through the network which it ignored because it was to their benefit that stores appear profitable"

7-Eleven

History / Facts

Fair Work Ombudsman Investigation

- In June 2014 the Fair Work Ombudsman, an independent statutory agency established to investigate alleged labor law violations, commenced an investigation into allegations of significant underpayment of wages and falsification of employment records across much of the franchisee network of Australia's leading C-store retailer 7-Eleven Pty Ltd.
- The investigation disclosed "concerning levels of non-compliance" with Australia's Fair Work Act and Regulations (2009).

7-Eleven

History / Facts

Fair Work Ombudsman Investigation

- The inquiry found that 7-Eleven's corporate "approach to workplace matters, while ostensibly promoting compliance, did not adequately detect or address deliberate non-compliance and . . . compounded it."
- The franchisees have a low awareness of and familiarity with the workplace laws of Country X and were generally unsophisticated as business owners and employers, and would often adopt the workplace practices of other stores rather than legal compliance.

7-Eleven

Issues/Responses

- Franchisors do have some duty under applicable law in Australia to monitor their franchisees workplace compliance

- In Australia Franchisors do have some duty to train their franchisees as to workplace compliance laws.

Hypothetical #2

Hypothetical #2

Facts

- Franchisor B is one of the most recognized quick service restaurant brands in the world
- Franchisor B had expanded to Country Y several decades ago and had established a strong presence, facing minimal competition in its market segment
- However, Competitor B, a local competitor within Country Y, slowly gained ground on Franchisor B and began to overtake Franchisor B's leading position in the market

Hypothetical #2

Facts

- Franchisor B's franchisees began to complain to Franchisor B about the rising competition from Competitor B
- While Competitor B's franchised locations were new and in desirable locations, Franchisor B's franchised stores were beginning to look dated, as franchisees of Franchisor B were not investing in their stores
- Franchisor B devised a strategic plan to respond, which included generous financial incentives for franchisees to remodel as well as new product offerings; however, most franchisees lacked funds to remodel, requesting that Franchisor B fund the remodeling

Hypothetical #2

Questions

- To what extent does a franchisor have a duty to protect and enhance its brand in the face of rising competition?
- To what extent does a franchisor have a duty to assist its franchisees and cooperate with them as they seek to face new competition?
- Does a franchisor have duties only to franchisees or the system as a whole?

Dunkin' Donuts

History

- One of the most recognised QSR brands in the world
- In the early 2000's, over 5,000 restaurants worldwide
- In the 80's and 90's, 250 restaurants in the province of Québec, Canada
- Québec was the first place DD expanded outside the U.S.
- DD had little if no competition until the mid-90's
- The competition was Tim Hortons
- Tim Hortons slowly and strategically gained ground in Québec

Dunkin' Donuts

Issues

- In the late 90's, Franchisees complained about the mounting TH competition
- TH was opening many new stores in great locations
- Meanwhile, DD stores were showing wear and tear and many locations were no longer in good locations
- Franchisees had not invested in their stores nor saved money to do so
- Franchisees were looking to DD to pay for remodels and fight TH

Dunkin' Donuts

Response

- DD devised a detailed Strategic Plan to respond to the competition:
  1. Remodel Program with generous financial incentives
  2. Reorganization of product offering and marketing
  3. Franchise development Plan to open new stores
- Most Franchisees had no money to remodel their stores and were not prepared to reinvest in their business
- Franchisees were looking to DD to pay for it all

Dunkin' Donuts

Legal Proceedings

- Lawsuit filed by a group of 10 franchisees representing over 25 restaurants in May 2003
- Trial held in 2010-2011 and lasted 72 days
- Trial decision handed down in June 2012
- The Court awarded 100% of damages claimed *i.e.* $16.4M
- DD appealed the decision before the Québec Court of Appeal
- Court of Appeal handed down its decision in April, 2015
- The CA upheld DD's liability but reduced the damages to $12.3M
- Leave to appeal to the Supreme Court of Canada was denied in 2015

Dunkin' Donuts

Key Legal Issues Raised by This Case

- Case very fact specific, language of the franchise agreements and Civil Law
- Concept of implied obligations incidental to the nature of franchise agreements
- Obligation of means to "protect and enhance the brand" as a "necessary complement" to the franchise agreement
- Duty to assist in staving off competition in order to promote the on-going prosperity of the system
- Duty to cooperate, Duty to assist, Duty of Good Faith
- Duty not only to the Franchisees individually but to the system as a whole
- Application of the case outside the province of Québec?

Hypothetical #3

Hypothetical #3

Facts

- A Franchisor in Country Z operates pastry shops and looks to expand in its home country by entering into a development agreement ("DA") with a new franchisee to open 20 new pastry shops
- Franchisee opens 25% of the required locations under the DA, but suffers financial difficulties and cannot satisfy the DA obligations
- Franchisor and franchisee attempt to negotiate a settlement agreement in an attempt to continue the relationship and accomplishing the objectives of the DA

Hypothetical #3

Facts

- Franchisor and franchisee are unable to agree on settlement terms
- The franchisor issues a notice of default, demanding performance of the DA obligations, and when franchisee fails to cure the franchisor terminates the DA in accordance with its terms. The franchisor also elects not to renew the existing franchise agreements that had been entered into when they are up for renewal.
- Following the termination and non-renewals, franchisor sues franchisee for noncompliance and the franchisee sues the franchisor for unfair termination and breach of a disclosure duty

Hypothetical #3

Questions

- Should franchisor be permitted to terminate the DA for the franchisee's noncompliance?
  - What if the DA includes an express termination right for failure to comply with the development schedule?
  - Does the right of the franchisor to approve sites or franchised locations affect your answer? Any other facts / questions that could affect your answer?
- What possible duty would the franchisor have to propose settlement terms acceptable to the franchisee? What if the franchisor conditioned approval on the franchisee agreeing to sell the shares of the franchisee it the development schedule was not satisfied?
- Regarding disclosure, if franchisor discovered that the franchisee's projections included incorrect assumptions or omitted items, would franchisor have a duty to correct them?
- What obligation would the franchisor have to provide financial projections based on the target market as opposed to projections based on its experience?

Paul Bakery

History / Facts

- Paul is a French bakery/café concept established in 1889 in France
- Paul has 400+ locations in over 33 countries throughout the world
- In 2004, the franchisor entered into a memorandum of understanding / development agreement ("DA") with the master franchisee to develop 18 franchised locations in exchange for exclusivity in three areas in the south of France
- The master franchisee initially opened 5 franchised locations but by 2005 encountered difficulties and could not meet its development obligations under the DA

Paul Bakery

Issues / Responses

- In 2006, the franchisor and the master franchisee discussed the difficulties encountered in the market
- The master franchisee's auditor conducted an audit to assess the status of the business, with the resulting report noting that the business was not viable unless it could renegotiate its debt borrowings
- Following the audit, the franchisor proposed to enter into a settlement agreement with the master franchisee setting forth modifications to the DA and future obligations of the master franchisee

Paul Bakery

Issues / Responses

- The proposed settlement agreement terms included:
  - Franchisor waiving 2006 franchise fees;
  - Franchisor receiving one share in each of the master franchisee's sub-franchisee entities that had signed individual franchise agreements;
  - Franchisor's entitlement to reporting on the status of the business and approval rights over certain decisions by the sub-franchisee entities;
  - A recovery plan and the blocking of certain bank accounts; and
  - A requirement for the master franchisee to sell the shares of the sub-franchisee entities if the recovery plan objectives were not met.
- The master franchisee rejected the proposed settlement terms

Paul Bakery

Liquidation and Litigation

- After settlement discussions failed, the franchisor terminated the DA and did not renew any of the 5 existing franchise agreements
- The master franchisee was forced into liquidation and the franchisor sued the master franchisee for failing to fulfill the DA obligations
- The master franchisee counterclaimed for (i) unfair termination of the DA and (ii) breach of the pre-contractual duty of disclosure

Paul Bakery

Legal Proceedings

- The Paris Court of Appeal held franchisor liable for:
  - A breach of its "duty of loyalty" to the master franchisee as a result of an unfair termination of the DA, awarding damages of €150,000
  - A breach of its pre-contractual disclosure obligations, including re: financial projections and the state of the market, awarding damages of approximately €2,000,000
- The Court of Cassation:
  - Affirmed that franchisor breached its "duty of loyalty" to franchisee, noting the franchisor should have proposed "acceptable conditions" when renegotiating the DA considering franchisor was entitled to improve all new franchised locations
  - Overturned the award of €2,000,000 for franchisor's breach of its pre-contractual disclosure obligations (case remanded for new damages award)

Paul Bakery

Key Legal Issues Raised by This Case

- When is it permissible for a franchisor to terminate an agreement when a franchisee fails to fulfill its obligations?
  - What if the agreement provides an express termination remedy?
  - What if negotiations between the franchisor and the franchisee fail?
- Because the franchise agreement gave the franchisor an approval right over each franchised location, the court held that the "duty of loyalty" under French law required the franchisor to cooperate and propose solutions to the master franchisee.
- Regarding financial projections and pre-contractual disclosures
  - What obligation does a franchisor have to correct errors in a master franchisee's projections?
  - A franchisor must provide financial projections and disclosures that are comparable to the target market, not just general projections indicative of its prior experience.

Conclusion

What Are the Possible Implications of These Cases?

- Is Australia's new legal framework re: compliance with laws and monitoring of franchisees an outlier? Or is this framework a sign of a coming approach to be taken by other jurisdictions?

- As highlighted in the Dunkin' Donuts case, what duties do franchisors have to "protect and enhance the brand" or help franchisees stave off competition?

- As noted in the Paul Bakery case in France, what type of "duty of loyalty" or similar responsibility do franchisors owe to their franchisees (or, perhaps more accurately, what sort of duty will courts apply to franchisors, especially when interacting with a franchisee that has encountered financial difficulty).

Conclusion

<u>Questions?</u>