2500, 20 Queen St. West
Toronto, ON
Canada
M5H 3S1
Tel. 416.595.8500
Fax 416.595.8695
www.millerthomson.com

MILLER THOMSON LLP

Barristers & Solicitors, Patent & Trade-Mark Agents

TORONTO VANCOUVER CALGARY EDMONTON WATERLOO-WELLINGTON MARKHAM WHITEHORSE WASHINGTON, D.C.

# Franchise Expansion by System Acquisition: Principal Issues and Concerns

Richard Leblanc and Paul Jones

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## 1. Introduction

The franchise industry was no stranger to the frenetic consolidation activity which characterized the late 90s leading to the dot-com bust in the year 2000. A myriad of franchise companies of all sizes were involved in mergers, acquisitions and divestitures of multiple unit franchises. Some notable examples included the acquisition by John Bitove of master franchisor Scott's Restaurants Inc. to form a 639 unit group with three brands in 1999; the acquisition of the 143 PHARMAPLUS chain by the Katz group in 1997; and the acquisition by the Afton Food Group Ltd. of the 241 PIZZA chain of 160 outlets[1]. While it is true that these transactions each had the obvious effect of significantly growing the acquiror's business, the more subtle strategic rationale for employing the risky and expensive tactic of acquisition differed in each case. An established franchisor may have as its objective straightforward revenue growth or geographic expansion. A franchisor may wish to eliminate a competitor, or it may desire to diversify its core business in a synergistic relationship. An acquisition may be driven by tax reasons, brand positioning concerns, or perhaps, incredibly enough, by sheer hubris.

Where a franchise company undertakes to purchase an existing multiple unit franchise in a similar channel of trade, a wide range of considerations arise. The purpose of this brief discussion is not to attempt to methodically review each of the minute considerations associated with the purchase of another franchise system, nor is it to survey the legal and procedural issues, which are common to all purchase and sale transactions. Instead, this paper seeks to provide some topical insight into due diligence matters relevant to the purchase of a franchise company. Secondly, this discussion considers certain practical difficulties surrounding the acquisition of a

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[1] Some franchisors, such as Cara Operations Limited, have grown entirely by acquisitions. The HARVEY's and SWISS CHALET brands were acquired on the take-over of Foodcorp. More recently it has acquired SECOND CUP and KELSEY'S, among others.

competing franchise, and undertakes a review of Canadian and U.S. caselaw relevant to the issues of territorial and product encroachment, issues which are of growing relevance as franchisees compete for market share in increasingly saturated marketplace.

## 2. Due Diligence

Due diligence is nothing other than the process of accurately assessing the value to be acquired. Value, whether in relation to tangible assets or intangibles such as goodwill, is a concept which is constantly in flux in relationship to time horizons, economic and political environment, cultural perceptions and a host of other subjective and objective variables which ensure that present value can never be a guarantee of future returns. Anyone who owned Nortel stock in 2000 is painfully aware of this reality.

The due diligence process in the context of an evolving franchise system is no different. Apart from the considerations common to any acquisition of a going business concern, such as corporate existence, authority to transact, nature of and title to assets, financial health, labour and employment issues, existence of liabilities, etc., the proposed acquisition of a franchise system involves several additional considerations which pertain exclusively to the nature of the assets being acquired.

### (a) Assessing the Existing System

The potential acquiror will initially want to obtain a picture or “snapshot” of the business to be acquired. This will involve a healthy measure of legal, financial and operational due diligence which will in the case of complex transactions require the effective use of professional advisors. This initial snapshot will provide historical and current data relating to the franchise company and will permit the potential suitor to assess the history and present viability of the target.

#### (i) Business model

In assessing the value of a multiple unit franchise business, a potential suitor will need an appraisal of the financial viability of the enterprise. Once the financial data of the enterprise have been reviewed and subjected to appropriate valuation techniques, a purchaser will have established the cornerstone of any price negotiation. The remaining legal and operational reviews constitute the balance of the elements which must be considered in properly evaluating the franchise business and its ability to provide the purchaser with a suitable rate of return.

The operational assessment, in addition to assessing control procedures, employee relations, managerial talent and a host of other hard and soft factors, must include a review of the franchise's business model. This will involve a comprehensive market analysis, physical inspection of the business premises, interviews with key personnel, study of systems and procedures, review of employee matters, review of marketing, distribution and supply arrangements and an analysis of the target's administration. In addition, and most critically, the prospective purchaser will need to review the forms of franchise operational manuals, training manuals, franchise agreements, disclosure documents, master franchise agreements, development agreements and area rights agreements. This review must contemplate a review of the status of any development plans, pending transactions, rights of first refusal and other franchisor rights.

If significant customer relationship management is part of the franchise system's marketing methods, the purchaser should carefully review the privacy compliance issues that may arise as both a result of the purchase, and as a result of the transfer of personal information from the franchisee to the franchisor. When reviewing supply arrangements, careful attention should be paid to rebates received from suppliers, particularly if these are significant. This has been a sensitive area with franchisees, and some disclosure is required regarding rebates. If such rebates are a significant source of revenue, can they be relied upon in the future?

Each of these surveys should reveal data which provides the purchaser with a thorough understanding of the business procedures and methods which are unique to the franchise system and which give this system its competitive advantage and ultimately, its income earning ability. More critically, where the purchaser is planning on integrating the target's franchisees into its fold, the document review process must by necessity focus on the future ability of the franchisor to implement changes, commit the new franchisees to training, and transfer to individual franchisees at least part of the cost of physical adaptations to existing premises. Where existing documentation does not grant the purchaser such latitude, and significant resistance is expected to a proposed merger from franchisees of the target franchise, the purchaser will need to factor such costs into its assessment of the value of the vendor.

### (ii) Franchise documentation

*Disclosure document:* Prospective purchasers will want to review the form of disclosure document and material change statements for compliance with relevant law. In addition, the purchaser will need to review such documents for concurrency with the balance of the information disclosed to it in connection with the due diligence exercise, to review the franchise company's general attitude relating to disclosure, and to search for signals to existing problems with past and present franchisors. To this end, the due diligence process will by necessity include a review of all pending, actual and settled claims relating to non-disclosure by the franchisor.

The franchise document itself will also need to be carefully reviewed by legal counsel to ensure that the document creates binding obligations, is generally assignable in its standard form and that it will not bind the franchisor to obligations or liabilities which are either impossible for it to fulfill or which may prove to be in conflict with its existing obligations. While this subject will be reviewed in greater detail below, a purchaser will need to confirm that a standard franchise agreement does not grant development rights or exclusivity rights which do not conflict with the rights of the purchaser's existing franchisees in the same or similar channels of trade and geographic proximity.

### (iii) Regulatory compliance

Canadian regulatory requirements, while critical, are not as onerous as those in the United States, where certain state laws require franchisors to register in such states. Nonetheless, any inquiry into the purchase of a franchise system will require the review of the form of business structure employed by the vendor and whether the structure is in accordance with local laws. The purchase of a non-franchised competitor, for example, will initially require an audit of the business structure to determine whether the arrangement does in fact constitute a franchise, in which case the vendor may be in default of disclosure obligations[2]. Additionally, certain franchised businesses may be regulated by other statutes. For example, the *Real Estate and Business Brokers Act*, R.S.O. 1990, c.R-4 imposes limitations on ownership and control of subsidiary entities, presumably to ensure that brokers own and control brokerage corporations and to reduce marketplace conflicts. A franchisor in another jurisdiction wanting to expand into Ontario would need to know this information prior to consummating a sale. Additional regulatory concerns which are common to all transactions involving acquisition of control of a Canadian company include the possible existence of notification requirements under the *Investment Canada Act* in the case of a purchase by a non-Canadian, and the possible requirement for merger notification or review in the case that a merger between two franchisors is expected to substantially lessen competition in the sector in accordance with the provisions of the *Competition Act* and guidelines.

**(iv) Intellectual property**

Once the operating business model and the legal effect of the franchise structure and documentation are assessed and established as being concrete and viable, the remaining critical component in accurately determining the value of a given franchise is a stringent review of the enterprise's intellectual property. A prospective purchaser will need to obtain lists of all registered intellectual properties, such as trade-marks, trade-names, business names, copyrights and patents, if applicable. Equally important are all unregistered intellectual property, as well as all trade secrets, "secret sauce" recipes, or other confidential information which may constitute an important element of the target franchise's

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[2] Such as those set out in Ontario Regulation 581/00 in respect of the *Arthur Wishart Act (Franchise Disclosure), 2000*, S.O. 2000, c.3 (hereinafter, the "Act").

model. Importantly, the purchaser will be interested in understanding the nature of the licensing rights held by franchisees, whether such rights are granted equally to each franchisee and whether or not such rights are capable of being modified and the extent to which trade-marks and symbols may be redesignated in the event of system change.

A prudent purchaser may then wish to conduct searches on key elements, such as the main trade-marks, to determine the degree of distinctiveness possessed by such marks, and whether or not the existing owner has neglected to allocate resources to challenge potentially confusing and infringing marks.

**(v) Material information**

In addition to the foregoing, the suitor should request all other information which is germane to the franchise system, including lists of all past, present and prospective franchisees, franchise agreements outstanding, lists of real property leases, master franchise agreements, unit franchise agreements and area development agreements.

**(b) Assessing Future Viability**

Equally important to assessing the present viability of the franchise company, a potential suitor be concerned with the ability of the franchise to continue to generate a suitable return on investment in light of projected conditions.

**(i) Relationship with franchisees**

Due diligence involving the acquisition of a franchise company requires that special attention be paid to the franchisor's sale of its franchises and to the ongoing relationship between the franchisor and its franchisees.[3] This is considered to be one of the most critical elements of the purchased franchise and requires specific attention at the due diligence stage. In addition to basic

[3] Baer, John R.F., "Due Diligence in the Acquisition of a Franchise Company" in Vines, Leonard D., ed. Mergers and Acquisitions of Franchise Companies, (Chicago: American Bar Association, 1996), p. 32.

statistics, such as names and contact information of past and present franchisees, the purchaser will also require records of all renewals and terminations, as well as a high level of disclosure relating to franchisee disputes, franchise agreement breaches, claims for non-disclosure, litigation and pending litigation. The franchisor will also seek to obtain details of any franchise association, minutes or records of all recent meetings of the association and the contact information of any representative of the association. The relationship between the franchisor and its franchisees will be the bellwether of the health of the franchise system and its importance cannot be underestimated. In addition to the foregoing statistics, the purchaser may wish to obtain additional information by interviewing individual franchisees, although this may not be permitted prior to the execution of conclusive documentation.

A review of the manner of use of any advertising or marketing fund will also be well-advised in order to confirm that the fund has been administered in accordance with its terms and to evaluate any contingent claims which may relate to payments made by franchisees into the fund.

**(ii) Health of individual franchisees**

Some authors suggest that the purchaser should conduct a review of each franchise agreement and collateral agreement (including any premises sublease) to ensure that the rights thereunder are fully assignable and whether or not any consents are needed for transfer. While this is the most conclusive manner of confirming that each individual franchise arrangement is valid and subsisting, this fact and the financial health of each individual franchisee may be more easily confirmed by way of actionable representations and warranties to the purchase agreement, to be discussed below. The purchaser may also request that estoppel certificates be provided by landlords to subleases and that similar estoppel certificates be obtained from each franchisee with respect to the selling franchisor's obligations under its franchise agreement with such franchisees.

### (iii) Use of representations and warranties

Representations and warranties are definitive statements made by the parties declaring their authority to transact, the title to the assets, the health of the purchased business, the condition of the assets themselves, and the status of other circumstances which may materially affect the value of property sold. The breach of a representation or warranty may give rise to a right of damages in favour of the party who relied upon such a representation or warranty to their detriment. The purchaser is interested in securing strong representations and warranties from the vendor in order to crystallize the assumptions upon which the purchase price is based and to quantify the risk of operating the franchise company as a going concern. The vendor will prefer to provide as few representations and warranties as possible. In respect of risks which are not easily verified, such as threatened franchisee claims, market conditions relating to the subject franchise business, and the existence of material liabilities relating to the target. The vendor will often attempt to qualify a related representation by making it "to the best of knowledge." This type of wordsmithing becomes an exercise in risk allocation since the truth of the representation cannot be demonstrated in a cost-effective manner at the date of closing. The purchaser is well-advised to resist such qualification where the purchase price is negotiated in heavy reliance upon the truth of the subject representation or warranty.

## 3. Practical Issues Surrounding Expansion via Acquisition

### (a) Announcing the Transaction

The timing of any announcement relating to a contemplated acquisition can be of significant consequence, particularly if a negative franchisee reaction is contemplated. Franchisees may collectively, through franchise associations or otherwise, wield considerable influence over decisions of the franchisor which affect the franchise system. The degree of influence of franchisees in such matters will depend upon the latitude provided in the franchise agreement to adapt to changes in the system's ownership and direction. Where this latitude is restricted, then the franchisees may be better positioned to resist changes[4].

Generally, there is no duty to disclose a prospective acquisition of a franchise system to existing franchisees. The execution of a definitive agreement between a purchaser and a vendor does however constitute a “material change” and must be disclosed to a prospective franchisee who has received a disclosure document but not yet completed the acquisition of the franchise as soon as practicable after the change has occurred and before the earlier of the signing by the prospect of the franchise agreement and the payment of any consideration by the prospect relating to the franchise[5]. The timing of disclosure to existing franchisees will be governed in large measure by the business objectives of the purchaser and the degree to which the vendor is reasonably certain that the transaction will proceed. In certain cases, early disclosure may materially influence the due diligence process in that franchisees may have incentive to threaten claims in order to assert bargaining power in the wake of negotiations between two franchisors. If the vendor fears that these types of problems may emerge, it may be motivated to forestall disclosure until the last possible moment and trust that its representations have been neither overbroad nor too optimistic. Alternatively, the purchaser may push for early disclosure in order to have access to franchisees for due diligence purposes, in order to formulate and begin implementation of its business plan and to gauge franchisee reaction to an anticipated merger.

The timing issue is the subject of considerable debate amongst franchise lawyers. In a securities law context, disclosure is usually made upon the signing of a letter of intent or its equivalent. In a franchise situation, this would allow the existing franchisees to voice their concern about the transaction before the transaction is closed. In the United States

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[4] Cannon, Charles B., “Practical Problems Associated with Buying or Selling a Franchise Company” in Mergers and Acquisitions of Franchise Companies, note 3, *supra*, p.8.

[5] Section 5(5) of the Act.

there is authority for the proposition that a franchisor does not have a duty to disclose to existing franchisees.[6]

### (b) Integration Issues

A plethora of issues must be contemplated in anticipation of a merger with a competing franchisor. The integration of two systems with different cultures, philosophies, processes, managerial styles and legal documentation is a challenge which will require forethought and preparation. Where a franchisor chooses to integrate a competing chain into its own system, it will effectively need to remanufacture the target franchise company's legal and operational infrastructure. By necessity, and in order to restore what will have been a costly interruption in sales volume during the acquisition process, a newly merged franchisor will want to "hit the ground running" with its marketing materials and franchise documentation. Critically, a disclosure document which reflects the reality of the newly merged entity will need to be prepared contemporaneously with the finalization of the acquisition transaction. In addition, where a competing chain is being swallowed in its entirety, consideration must be given to whether the target's franchisees will be required to sign an amended form of franchise agreement to conform with the franchisor's obligations to its existing franchisees. As noted above, the due diligence process will need to focus on the degree of flexibility which the franchisor will have in effecting such adjustments.

In addition to the marketing materials and franchise obligations, procedures and training manuals will need to be conformed or replaced and franchisees will need to be trained in the purchaser's systems and procedures. In addition to the "culture shock" which a franchisee will experience when faced with the requirement to convert to another brand, the costs of performing such a conversion cannot be understated. The franchise

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[6] In *Vaughn v. General Foods and Burger Chef,* (1986) C.C.H. Bus. F.G. 8630 (7th Circuit) the existing franchisees had been encouraged to invest in their franchises notwithstanding the franchisor's potential plans to sell the business to a competitor.

agreement will be very instructive in assisting a purchaser in determining who will bear the costs of integration as they relate to training, adaptations to trade-marks and logos, marketing support and physical upgrades or retrofitting of premises. If a franchisor is liable to perform such obligations and is unable to do so due to due to unwillingness or a cash shortfall following the acquisition, then it may be subjecting itself to an action for breach of contract[7].

**(c) Encroachment and the Duty of Good Faith and Fair Dealing**

Prospective purchasers should in the context of any acquisition of a competing franchise company undertake an exhaustive review of their and their target's encroachment policies. Specifically, a purchaser will be very careful to consider the scope of territorial rights granted to each franchisee, and will also determine the precise nature of rights of the target franchisor to establish competing locations near existing locations and to exploit other forms of distribution. Typically, encroachment occurs when a franchisee's revenues are impaired or "cannibalized" by the establishment of a competing site in the same geographic area. Similarly, encroachment can occur where other methods of product delivery are used by the franchisor, such as supermarket distribution, internet sales, or other methods which have the effect of reducing a franchisee's sales. Where the franchise documentation is silent on the right of franchisor to establish new locations or competing services in an established location, the courts have sometimes looked to the franchisor's common law and statutory duty of good faith and fair dealing.[8]

In Canada, the courts have recently considered the common law duty of good faith owed by a franchisor to its franchisees. In *Shelanu v. Print Three Franchising Corporation*[9] the complainant was a Print Three franchisee operating in Toronto. The franchisee

[7] Brimer, Jeffrey A., Gawne, Cathryn S., and Vines, Leonard D., "Buying and Selling Franchise Business – Why is this Deal Different from Other Deals?", American Bar Association Forum on Franchising, October 22-24, 1997, Colorado Springs, Colorado, p.2.

[8] See section 3(1) of the Act.

[9] [2000] O.J. No. 4129, Ontario Superior Court of Justice (October 31, 2000); [2003] O.J. C35392, Ontario Court of Appeal, (May 20, 2003).

alleged, among other, that the franchisor had breached its statutory and common law duty of good faith to the franchisee by establishing a downmarket print franchise concept branded “Le Print Express” and by allowing for the operation of three such franchises in close proximity to the franchisee. This alternative franchise concept was allegedly formed to service the printing needs of individuals and small businesses whereas the Print Three stores purportedly targeted a commercial and higher volume clientele.

At trial, Justice Nordheimer found that notwithstanding the retroactive effect of the *Arthur Wishart Act (Franchise Disclosure), 2000* [10] (hereinafter, the “Act”), that he would have nonetheless found a common law duty of good faith. In finding that the duty had been breached, he stated as follows:

> “Even though the Le Print Express franchises were directed at a specific segment of the industry, I am satisfied that they not only would, but did, take work and customers from existing Print Three franchises. As a consequence, in my view, the establishment of such an enterprise by the very person who owned and controlled the defendant was fundamentally at odds with the defendant’s obligations, including the obligation to deal in good faith, to its franchisees.”[11]

The trial judge further stated that the defendant’s duty at the very least required it to obtain the agreement of the existing Print Three franchises to the “crucial change to their contractual relationship.”

Interestingly, this portion of the trial decision was reversed on appeal. After refusing to decide on the issue of the retroactive application of the duty of good faith provisions of the Act, Weiler J.A. agreed with the trial decision on the existence of a common law duty of good faith. However, after overturning the trial judge’s factual finding that Le Print Express contributed to the decline in the number of Print Three franchises, the appeal

[10] See note 2 above.

[11] See note 9 above, at paragraph 38.

judge overturned Nordheimer J.'s conclusion that Print Three breached its duty of good faith to the complainant as having not been proved by the evidence presented.[12]

It is noteworthy that notwithstanding the conclusions of the court of appeal in *Shelanu*, the decision was cited in *Katotikidis v. Mr. Submarine Ltd.*[13] in support of the proposition that a common law duty of good faith exists notwithstanding the statutory duty set out in the Act. In this case, Taliano J. held that "by opening a new restaurant in unreasonably close competitive proximity to the plaintiffs and then awarding the restaurant to someone else, the defendant violated the implied duties of good faith and fair dealing contained in their franchise agreement and promotional materials and thereby betrayed the trust that epitomizes the relationship between a franchisor and franchisee."[14]

Prior to *Shelanu*, a leading Canadian case addressing the duties of the franchisor in the area of encroachment was *Supermarché A.R.G. Inc. et Supermarché Frontenac Inc. c. Provigo Distribution Inc.*[15], confirmed on appeal. In this matter, the complainant sought damages and injunctive relief from Provigo on the basis that the latter was acting in bad faith toward its grocery store franchisees in favouring its corporately owned discount grocers operating under the "Heritage" brand. Provigo had altered its market strategy to focus on retail instead of wholesale and in doing so had shifted its attention on the fast-growing discount segment of the market. At trial, the court found that Provigo had breached its implied duty of good faith[16] by failing to provide its Provigo franchisees with the tools and support necessary to compete effectively in their chosen market segment. Moreover, Provigo had restricted the ability of its franchisees to price their product strategically, forcing them to maintain high prices in the face of stiff competition, both from Heritage and other conventional and discount grocery stores.

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[12] See note 9 above, Ontario Court of Appeal decision at paragraph 107.

[13] [2002] O.J. No. 1959, Ontario Superior Court of Justice (May 9, 2002).

[14] Id., at paragraph 75.

[15] [1995] R.J. Q. 464 (C.S.Q.); [1998] R.J.Q. 47 (C.A.).

[16] As set out in article 1024 of the former Code Civil du Bas Canada and as set out in article 1375 of the new Code Civil du Bas Canada, L.Q. 1991, ch.64.

Notwithstanding its agreement with the lower court, the court of appeal qualified the effect of the trial decision and declared as follows:

> "…, it would appear difficult to state as a general rule that a franchisor could never, in any manner, undertake an activity which have the effect of competing with its franchisees in a market in perpetual evolution where the constant adaptation of commercial techniques to market fluctuations and public preferences are, for it, a matter of economic life or death."
>
> [Translation]

Justices Gendreau, Beaudoin and Fish reasoned that to so constrain a franchisor's activities would be to condemn it to death. Accordingly, the appeal court determined that a franchisor could well restructure its practices and distribution strategies to address competition, provided that these changes were made in good faith, were not directed at undermining the franchisees and did not have the consequence of destroying the benefits of the franchise[17]. The court developed this principle by stating that the franchisor's right to adapt to market change was subject to the franchisor's good faith duty to concomitantly provide its franchisees with technical assistance, cooperation and newfound know-how, or at the very least to assist it to develop other means to insure that its franchisees would not be deprived of the fruit of their contract with the franchisor.[18]

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[17] Note that the Quebec Court of Appeal denied a Provigo franchisee motion for injunctive relief to prevent Provigo from enlarging the floor space of one of its discount grocers. The court relied on the principle set out in *Provigo* above that an enterprise should not be denied the right to react to market realities in order to keep pace with its competitors. See *P.R. St-Germain Inc. c. Provigo Distribution Inc.*, [2001] J.Q. no. 1551, Cour Supérieure du Québec, District de Montréal (le 3 avril, 2001).

[18] See note 11, Quebec Court of Appeal, at page 60. See also Jones, P., "Alternative Channels of Distribution: Encroachment and the Risk of Being "Amazoned"", Canadian Franchise Association Legal Symposium, Toronto, 1998. In his paper, Mr. Jones paraphrases the court of appeal decision to state that "Provigo had a duty in concert with its franchisees to undertake an adequate commercial response which would permit the franchisees to minimize their loss and reposition themselves in an evolving market."

In the U.S., numerous cases have been cited to underline the duty of good faith held by franchisors in dealing with their franchisees. In *Scheck v. Burger King Corp.*[19] the contract between the parties stated that it did not grant the franchisee any exclusivity over a particular site. Nonetheless, when Burger King sought to establish a franchise location near the existing franchisee, the courts reasoned that the franchisee, while not entitled to an exclusive territory "was entitled to expect that Burger King will not act to destroy the right of the franchisee to enjoy the fruits of the contract."[20] since the agreement did not expressly provide that right. In a somewhat similar decision, the Florida courts found in favour of a franchisor who had been sued by a franchisee for allowing the Army and Air Force Exchange Service to open a Burger King franchise in proximity to its three existing outlets. The court, following the *Scheck* case, suggested in its reasoning that the absence of an affirmative grant of rights to the franchisor to establish a location in a competing territory would leave the door open to franchisees to resist such competition.[21]

The implied covenant of good faith and fair dealing was again imputed by the courts in the case of *Vylene Enterprises, Inc. v. Naugles, Inc.*[22] In this case, where the contract language was not sufficient to support the franchisor's establishment of a competing franchise within one and a half miles from an existing location, the court in applying *Scheck* held that the implied covenant applied.

In contrast to the *Burger King* cases, the courts found in *The Domed Stadium Hotel, Inc. v. Holiday Inn*[23] that a franchisee had no right to expect a duty of good faith from a

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[19] 798 F.Supp.692, 693 (S.D. Fla. 1992), Bus. Franchise Guide (CCH) ¶10, 049.

[20] Id. at 693.

[21] See also *Barnes v. Burger King Corp.*, 932 F. Supp. 1420 (S.D. Fla. 1996); *Burger King Corp. v. Agad*, 941 F. Supp. 1217, Bus. Fr. G. (CCH) ¶11,159 (N.D. Ga. 1996); *Clark v. America's Favorite Chicken Co.*, 110 F. 3d 295, Bus. Fr. G. (CCH) ¶11,147 (5th Cir. 1997); *Camp Creek Hospitality Inns v. Sheraton Franchise Corp.*, Bus. Franchise Guide (CCH) ¶10,775 (N.D. Ga. June 22, 1995); *Chang v. McDonald's Corp.* Bus. Franchise Guide (CCH) ¶10,078 (9th Cir. 1996); and *Payne v. McDonald's Corp.*, 957 F. Supp. 749, Bus. Fr. G. (CCH) ¶11,140 (D. Md. 1997).

[22] 90 F.3d 1472 (9th Cir. 1996)

[23] 732 F.2d 480 (5th Cir. 1984).

franchisor who purchased a Holiday Inn hotel near the franchisee's existing hotel. In that case, the governing contract granted the franchisor the right to construct and operate a new site which the courts construed as granting the franchisor the right to purchase an existing site. Due to the express terms of the contract, the courts were not required to supplant a gap in drafting with the duty of good faith[24]. Notably, in *Rosenburg v. The Pillsbury Company*[25] the courts dismissed a claim of breach of the covenant of good faith and fair dealing made by a Haagen-Dazs ice cream franchisee against the franchisor since the agreement between the parties provided for the use and exploitation by the franchisor of alternative forms of distribution. In that case, the franchisee had claimed that its sales were suffering as a result of the recruitment of supermarkets as distribution channels for the sale of its ice cream products.

The case of *Carvel Corp. v. James Baker et al.*[26] is similar to those in *Rosenburg* in that both are concerned with product encroachment as compared with territorial encroachment. Carvel Corporation is in the business of confectioning and selling ice-cream cakes and frozen desserts. Carvel franchised its business to independent operators who manufactured and sold Carvel products from retail outlets. Despite the fact that Carvel had assured its franchisees that they would remain the sole retail distributors of Carvel products, the franchisor nonetheless began to distribute its products in supermarkets to the dismay of many of its franchisees. Carvel had applied to the court for a declaratory judgment to confirm that it had the right to implement supermarket distribution. The court reviewed Carvel's former and current forms of franchise agreements. While the earlier agreement was vague with respect to Carvel's rights to employ alternative channels of distribution, the later agreement clearly granted the franchisor this right. The court decided that, in accordance with the implied covenants of good faith and fair dealing, "the defendants could have reasonably expected, at the time

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[24] See also *Carlock v. Pillsbury Co.,* 719 F. Supp 791 (D. Minn. 1989); *Orlando Plaza Suite Hotel Ltd.-A v. Embassy Suites, Inc.*, Bus. Franchise Guide (CCH) ¶10,456 (N.D. Fla. March 1, 1993), aff'd, 15 F.3D1097 (11th Cir., 1994); *Cohn v. Taco Bell Corp.*, 1994 WL 13769 (N.D. Ill. 1994).

[25] 718 F.Supp. 1146, 1149 (S.D.N.Y. 1989, Bus. Franchise Guide ¶9445.

[26] (1997) Business Franchise Guide ¶11,208.

of contracting, that Carvel would not use such a system to compete directly against them, especially since the distribution to supermarkets and other retail outlets was not a practice that existed prior to the agreement."[27] The court refused to decide by way of summary judgment the issue of whether or not Carvel had acted reasonably in the circumstances.

## 4. Summary and Conclusion

While mergers and acquisitions issues in franchise systems are a significant topic of discussion in the United States such that the American Bar Association Forum on Franchising in 1996 produced a book dedicated to these issues, in Canada not much attention appears to have been given to these issues. This may be in part because until recently only Alberta has had franchise legislation.

This lack of awareness in Canada of the issues has, on occasion, possibly led to franchisors acquiring problems that could have been prevented. This is unfortunate because as Wendy's and Tim Horton's have shown us, expansion through acquisition can lead to positive synergies, such as co-branding.

In general studies have suggested that mergers often do not achieve the efficiencies or improved results that were hoped for. In an era of reduced inflation, more care must be taken in making acquisitions as the business cannot afterwards buy its way out of mistakes with inflated dollars. More attention must be given to issues arising out of the methods of distribution of goods and services, such as encroachment, privacy and customer relationship management, and dealer acceptance, if revenue levels are going to be maintained and stakeholder value increased.

[27] *Carvel*, supra at page 20, 683. For a more detailed analysis and commentary on both the *Provigo* and *Carvel* decisions, see Jones, P., supra, at note 18.