

# Protecting against bad faith claims when terminating franchisees

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The Alberta case of *Seto v Wendy's* reminds franchisors that the courts may scrutinize the purpose of significant decisions affecting franchisees' interests, such as terminating a franchisee. When considering such decisions, franchisors should accurately articulate and document the underlying business rationale to defend against claims of a breach of the duty of good faith and fair dealing.

In this case, the plaintiffs operated a Wendy's franchise in Camrose, Alberta. Despite accommodations granted by the franchisor, the franchisee was persistently in arrears on rent, royalties and other fees payable to the franchisor. The franchisee also owed significant amounts to its bank and the Canada Revenue Agency. This resulted in a series of default notices and put the franchisor in the position to terminate the franchise agreement.

Against this backdrop of escalating financial difficulties, the franchisee sought to sell the franchise. The franchisee entered into a purchase agreement and requested that the franchisor provide transfer documentation, which it did. However, the franchisee failed to forward the documentation to the purchaser by the purchaser's deadline.

After learning that the Canada Revenue Agency had obtained writs of seizure and sale for the franchisee's assets, the franchisor terminated the franchise agreement, took possession of the premises and reopened it as a corporate location. Around the same time, there was some suggestion that the sale to the third-party purchaser could be revived.

The plaintiffs argued that the franchisor improperly terminated the franchise agreement. Among other arguments, the plaintiffs contended that the franchisor had breached the duty of good faith and fair dealing by terminating the franchise agreement while there was a pending sale. The Alberta court rejected this argument, finding that the offer to purchase the franchise was in its earliest stages and that there was no evidence that the franchisor's true purpose in terminating the agreement was to frustrate the prospective sale. In this case, the history of accommodation by the franchisor, the admitted defaults by the franchisee and the early stage of the proposed sale by the franchisee appear to have assisted the court in concluding the franchisor had no improper purpose in terminating the agreement.

The practical lesson is that courts will consider the franchisor's purpose or motives for exercising a right to terminate, even when the franchisor has such a right. It therefore goes without saying that undertaking franchisee terminations (or other major decisions affecting franchisees) for ulterior purposes exposes franchisors to legal risk, even in cases where the decision is otherwise within the franchisor's contractual rights.

Franchisors who are contemplating terminating a franchisee would be well-advised to articulate and document the rationale for the termination decision, particularly if the franchisor is aware that the franchisee has financial interests, such as a potential sale, that could be negatively affected by the termination. Doing so will augment the franchisor's

factual defences to any claim for breach of the duty of good faith and fair dealing.