The validity of non-refundable franchise fees

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In *Mancilla* c. *Franchises Coq & Rico inc.*, the Québec Superior Court discussed the obligations of the parties to a franchise agreement. In its decision, the Court confirmed that a franchisee has the obligation to inform itself prior to undertaking the operation of a franchise, and that a clause requiring a non-refundable franchise fee is entirely valid. Moreover, the Court stated that according to the facts in this case, franchisees speaking to a journalist about their bad experience with the franchisor did not constitute defamation.

Context

Anoldo Mancilla (Mancilla) and Lenix Gonzalez (Gonzalez) (collectively, the Franchisees) went into business as operators of a Coq & Rico franchise. Mancilla contacted the franchisor of the Salvatore and Coq & Rico brands (the Franchisor). After submitting a draft franchise agreement, the Franchisees paid the initial franchise fee, which, according to the agreement, was non-refundable, save in the case where the Franchisor rejects the Franchisees' application. The Franchisees then signed the agreement.

Unable to secure the necessary financing, the Franchisees asked the Franchisor for a refund of the franchise fee. The Franchisor refused, invoking the franchise agreement with regard to the non-refundable nature of the fee. Instead, he suggested that they acquire a Salvatore franchise, which is better known in the food service sector, and for which the Franchisees should be able to obtain financing. The Franchisees agreed to proceed with the acquisition of an existing restaurant with vendor financing.

Once the transaction was complete, Mancilla seemed to lose interest in the franchise. He neglected to fully participate in the training offered by the Franchisor before fleeing to Colombia, leaving Gonzalez with the burden of managing the business by herself, without giving her access to the business' bank account. Gonzalez therefore became incapable of paying the money owed to the Franchisor and its suppliers. The Franchisees later completely ceased operation of the franchise.

The Franchisor terminated the franchise agreement on the basis of the Franchisees' failure to fully invest themselves in the business and the failure to pursue the operation of the franchise. In addition, the Franchisees failed to pay a portion of the 8% royalties to the Franchisor.

Following the termination, an article was published in the *Journal de Québec*, citing the former Franchisees who claimed they were scammed by the Franchisor.

The Franchisees brought an action against the Franchisor, among other defendants. They pled that they were the victims of the behaviour of the Franchisor who should have, from the beginning, taken note of their inability to operate the franchise. According to the

Franchisees, the clause providing for the non-refundable franchise fee is abusive, given that it is included in a contract of adhesion. They alleged that they were entrapped by the Franchisor's refusal to refund the franchise fee, thereby forcing them to undertake the operation of the alternative franchise as offered by the Franchisor.

The Franchisees sought the annulment of the franchise agreements, the refund of the money paid to the Franchisor as well as damages. By way of a cross-demand, the Franchisor claimed damages for defamation in addition to the money owed by the Franchisees under the franchise agreement.

Reasons and conclusions

The non-refundable franchise fees and the liability for the franchise's failure

To qualify as a contract of adhesion, two requirements must be met: the agreement must have been drafted by the party that imposed its terms upon the other party, and the other party must have truly been unable to freely negotiate the terms. Failure to negotiate is not sufficient to fulfill this second condition.

In this particular case, the Franchisees never attempted to negotiate the terms of the franchise agreement and, in fact, they never consulted any professional for advice. Therefore, the second requirement mentioned above was not met. Being a contract by mutual agreement, the clause under attack by the Franchisees cannot be qualified as being abusive. Furthermore, the Court specified that the non-refundable nature of the franchise fee is a current and legitimate business practice in the franchise context, given that it assures the franchisor that the franchisee is serious.

The Court also reiterated the obligations that govern a franchise agreement. The franchisor must act in good faith with regard to the franchisee, for example, by disclosing all relevant information in connection with the franchise. For its part, the franchisee must inform itself adequately prior to venturing into the operation of a franchise.

In this case, the Court was of the opinion that the Franchisees did not fulfill their obligations. On one hand, they made no effort to obtain the information regarding the future operation of their business. On the other hand, it is the Franchisees themselves who later on stopped investing in the franchise, and thus its financial sustainability.

The Court concluded that the Franchisor did not deceive the Franchisees in any way, and was, therefore, not liable. In fact, the Court deemed the Franchisor's claim to be justified, up to $67,000, due to the losses and amounts owed under the terms of the franchise agreement.

The defamation

What about the Franchisor's claim for defamation following the publication of the article in the *Journal de Québec*?

According to the Court, this request must be dismissed. The meeting between the Franchisees and the journalist was not malicious. The Franchisees' freedom of expression afforded them the right to share their experience with a journalist based on their genuine belief that they were victims.

Comments

This decision by the Superior Court of Québec reminds franchisees that they have an important obligation to inform themselves, especially when they have little or no business experience. While a franchisor must act in good faith during the marketing and sale of a franchise, this does not mean that it must compensate for a franchisee who neglects to inform itself.

As for the question of defamation, we note that the Franchisor's claim was based on the general regime of civil liability. There is nothing in this case to indicate that the franchise agreement included the customary clause forbidding the Franchisees from harming the reputation of the Franchisor. The existence of such a clause may have changed the Court's analysis.