

## Good Faith, Early Termination and Vendor Rebates All At Issue in the Target Canada CCAA Proceeding

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October 17, 2017

### Background

In the recent decision of *Target Canada Co. (Re)*, 2017 ONSC 2595,<sup>1</sup> the Ontario Superior Court of Justice – Commercial List affirmed a series of rulings by a Claims Officer in the *Companies' Creditors Arrangement Act* (CCAA)<sup>2</sup> proceedings of the Target Canada Co. group of companies.<sup>3</sup> The decision provides interesting insight into the interplay between the rights and obligations of franchise parties in an insolvency context.

The decision involved franchisees who operated in-store Target-branded pharmacies under franchise agreements with Target Canada Pharmacy Franchising LP (the Franchisor).

In January 2015, the Target Canada Co. group of companies obtained court protection for wind down proceedings under the CCAA. The Franchisor subsequently disclaimed all of the franchise agreements,<sup>4</sup> which constituted a breach of those agreements.

A key issue in the decision was the proper method for calculating the period of time for which any franchisee should be entitled to claim losses. In turn, that issue involved a fact-specific consideration of the relationship between the duty of good faith, at common law and under s.3 of the *Wishart Act*,<sup>5</sup> and the exercise of an early termination provision in a franchise agreement.

Each franchise agreement had an initial term of five years, but contained an early termination provision that permitted the Franchisor to terminate after three years, without cause. The Franchisor relied upon the early termination provision to argue that the maximum period of time for which any franchisee should be entitled to claim losses arising from the breach of a franchise agreement is three years.

The franchisees argued that the Franchisor would not have been able to avail itself of the early termination provision in good faith, based upon certain surrounding circumstances. In particular, after the execution of the franchise agreements, the Franchisor introduced an "EBIT Support Program," which was intended to provide financial support and benefits to franchisees throughout the full, initial five-year term of the franchise agreements.

The franchisees characterized the EBIT Support Program as comprising "clear and unequivocal commitments" by the Franchisor to provide EBIT payments throughout the initial term, such that "it would

have been a breach of the duty of good faith for the Franchisor to exercise its right of early termination.”<sup>6</sup>

## **Calculation of the Loss Period: Early Termination and the Duty of Good Faith**

In the decisions below, the Claims Officer appointed to assess and determine each creditor claim applied the principle for calculating breach of contract damages formulated by the Supreme Court of Canada in *Hamilton v. Open Window Bakery*.<sup>7</sup> That principle provides that, where an agreement has multiple modes of performance (such as an early termination provision), damages are to be based on the mode of performance that is least burdensome to the defendant.

Therefore, the Claims Officer framed the issue as follows: In order for a franchisee to succeed on its good faith argument, it would be necessary to show that, as a result of the parties’ interactions relating to the EBIT Support Program, the Franchisor could not possibly have exercised its right of early termination in good faith. Otherwise, it must be assumed that the Franchisor would have terminated the franchise agreements after three years.

The Claims Officer concluded that the parties’ dealings with respect to the EBIT Support Program did not prevent the Franchisor from terminating early in good faith.<sup>8</sup> Although the program demonstrated a clear intention on the part of the Franchisor to continue the program during the initial five-year term, it did not supersede the Franchisor’s right to early termination. Properly interpreted, the Franchisor undertook to provide EBIT payments during the initial five-year term, under those franchise agreements that *remained in effect* during that period.

The Claims Officer based that conclusion on a number of findings, including the following:

1. The EBIT Support Program was a gratuitous program. There was no evidence to indicate that the Franchisor intended to limit its rights under the franchise agreements.
2. There was no evidence of dishonest conduct on the part of the Franchisor, such as lying or misleading the franchisees into believing that the EBIT Support Program amended the terms of the franchise agreements.
3. There was no evidence of any representation by the Franchisor that it would not invoke its right of early termination, or of any reliance on such a representation by any franchisee.
4. After introducing the EBIT Support Program, the Franchisor issued disclosure documents that summarized the early termination provision, which “undermines an argument that the Franchisor necessarily would have been acting in bad faith in relying upon that right.”<sup>9</sup>
5. There was no evidence that the Franchisor would have exercised its right of early termination in an arbitrary or capricious manner.

Therefore, the Claims Officer limited the period for which the franchisees could claim losses for breach of their franchise agreements to three years. On appeal, the Superior Court of Justice – Commercial List

affirmed the decision of the Claims Officer.

## Disclosure of Vendor Rebates

The decision also involved a request by franchisees for greater information from the Franchisor about the amount of rebates it received from a vendor as a result of the vendor's sales to franchisees.

The franchisees asserted that they required the information to assess whether the Franchisor had complied with the duty of good faith and fair dealing in the manner in which it had shared such rebates with the franchisees.

The Claims Officer dismissed the franchisees' request for greater information about the rebates received by the Franchisor, on the following two grounds:

- Each franchise agreement entitled the Franchisor to retain all vendor rebates for its own use, without accounting to or sharing with the franchisee – subject to the one exception discussed below. Therefore, the Claims Officer held that the franchisees had no right to receive information about the amount of those rebates received by the Franchisor.
- The franchise agreements contemplated that the Franchisor would share rebates for certain types of products (generic prescription drug products) with the franchisees, but did not specify the percentage to be shared. As a result, the Claims Officer observed that “viewed objectively, the language provides for a scheme where there is no contractual obligation on the part of the Franchisor to share or to account for rebates.”<sup>10</sup>

Notably, the Franchisor's disclosure documents did specify a percentage of those rebates to be shared with franchisees. However, the Claims Officer noted that the franchisees were able to calculate whether the Franchisor shared that level of rebates, because the percentage is based on their own purchases. Therefore, the franchisees did not require any further information.

The Claims Officer also ruled out any argument that the Franchisor may have breached the duty of good faith in exercising its discretion as to how to share the rebates for generic prescription drug products as follows: “... the discretion, if there was one, was exercised before the Franchisees entered into the Franchise Agreement and was fully disclosed to the Franchisee at that time.”<sup>11</sup>

On appeal, the Court affirmed the conclusion of the Claims Officer.

## Conclusion

Although *Target Canada Co. (Re)* is a fact-specific decision issued in the context of a CCAA proceeding, it offers guidance to franchisors, franchisees, and counsel regarding: (1) the method for calculating damages

for breach of a franchise agreement containing an early termination provision; (2) whether the exercise of an early termination provision by a party to a franchise agreement could give rise to a claim for breach of the duty of good faith and fair dealing; and (3) issues to consider relating to the sharing of vendor rebates and the circumstances in which a court may order a franchisor to disclose information about such rebates to franchisees.

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<sup>1</sup> Available on Westlaw: 2017 CarswellOnt 9021 (the "Commercial List Decision").

<sup>2</sup> *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended.

<sup>3</sup> Decisions of the Claims Officer dated June 28, 2016, August 19, 2016, and October 25, 2016. The decisions may be found on the website of the Monitor.

<sup>4</sup> The Franchisor delivered Notices of Disclaimer pursuant to s.32(1) of the CCAA. The Superior Court of Justice – Commercial List subsequently denied a request by the franchisees to set aside the Notices.

<sup>5</sup> *Arthur Wishart Act (Franchise Disclosure)*, 2000, SO 2000, c 3.

<sup>6</sup> Decision of the Claims Officer October 25, 2016, para. 40.

<sup>7</sup> 2004 SCC 9.

<sup>8</sup> Decision of the Claims Officer dated October 25, 2017 at par. 41.

<sup>9</sup> Decision of the Claims Officer dated October 25, 2017 at par. 42(e).

<sup>10</sup> Commercial List Decision, para. 78.

<sup>11</sup> Decision of the Claims Officer dated June 28, 2016.