The Quebec Superior Court's Recent Judgment in *Stereo Plus v. 140 Greber Holding*: Shedding Light on Penalty and Legal Expenses Provisions in Franchise Agreements*

*Important Note: FMC (Mr. Stéphane Teasdale and Ms. Mélanie Jacques) represented Distribution Stereo Plus Inc. in this case.

On January 13th, in the case of *Distribution Stereo Plus Inc. c. 140 Greber Holding Inc.* [1], the Quebec Superior Court reaffirmed that penalty provisions and provisions relating to the reimbursement of legal costs both have their place in a franchise agreement.

Facts:

On November 26, 2001, Distribution Stereo Plus Inc. ("Stereo Plus") signed a franchise agreement with 140 Greber Holding Inc. ("Greber") in relation with the operation of a Stereo Plus store in Gatineau. Like all other Stereo Plus franchisees, by signing the franchise agreement, Greber agreed to follow the pre-established operational framework and design in accordance with the Stereo Plus system (the "System").

Early on in their franchisor-franchisee relationship, Stereo and Greber encountered difficulties in agreeing on various aspects of the implementation of the System in Greber's store. Despite Stereo Plus's requests and notices, Greber decided to do things its own way, ignoring the System's standards.

[1] *Distribution Stereo Plus Inc. c. 140 Greber Holding Inc*, Quebec Superior Court, January 13, 2012, File No. 500-17-019472-045, cited as 2012 QCCS 33. An appeal from this judgment has been filed on February 13, 2012.

Following Greber's failure to ensure that its store complied with the Stereo Plus System, particularly with respect to the flooring used in its store, and its refusal to remedy its defaults despite Stereo Plus's requests and notices, the latter had no other choice than to terminate the franchise agreement, which it did in June 2002.

Following such termination, several legal proceedings were undertaken and a Superior Court Judge ultimately declared the notice of termination sent by Stereo Plus valid and enforceable and the franchise agreement thereby terminated. After having appealed the ruling, Greber withdraws its appeal a few weeks after receiving Stereo Plus's attorneys' motion to dismiss the appeal.

The franchise agreement between Stereo Plus and Greber provided that a penalty of $ 25 000 was payable by the franchisee in the event of a default to its obligations thereunder, as well as another provision requiring that the franchisee reimburse the franchisor for all legal costs (judicial and extrajudicial) reasonably incurred by Stereo Plus as a result of the franchisee's failure to fulfill its obligations.

The validity and enforceability of these two provisions were the subjects of the judgment rendered last January 13th by the Quebec Superior Court in this case.

The Court first addressed the question as to whether these provisions were valid and justified in franchise law. Next, the Court considered the reasonableness of the claims arising from these provisions.

Analysis:

The criterion that allows a franchise agreement to be characterized as a contract of adhesion: *the inability to negotiate.*

First, the Court reaffirmed that, in order to characterize a contract as a "*contract of adhesion* ", two conditions have to be met: (a) its essential stipulations were drawn up by one of the parties and imposed on the other party, (b) the other party unable to negotiate said stipulations."

In its attempt to demonstrate that the franchise agreement it had signed with Stereo Plus was a contract of adhesion, Greber failed to meet the second condition of this test. According to the Court, a real attempt to negotiate was necessary to meet this criterion.

In this case, the Court held that, in its eagerness to sign the franchise agreement, Greber did not even try to negotiate the provisions of the Stereo Plus franchise agreement. Under the circumstances, Greber could not prove the second element necessary for a contract to be characterized as a contract of adhesion, namely the inability to negotiate.

Penalty for breach of contract: *the protection of the legitimate interests of the parties to a franchise agreement*

Although the Court did conclude that the franchise agreement in this case was not a contract of adhesion, it nevertheless examined the validity and reasonableness of its penalty and legal costs provisions in the context of a franchisor-franchisee relationship.

According to the Superior Court, a franchisor possesses a legitimate interest in enforcing the obligations of its franchisees under the franchise agreement. It is the image and reputation of the whole franchise network that is in play. Each of the franchisees, and not just the franchisor, could suffer from a misstep committed by delinquent franchisees.

The Court emphasized that such provisions could prevent such situations and that they should not be prohibited in franchising. They however have to be reasonable, and, therefore, can be reduced by a tribunal depending on the circumstances of each case.

In this case, the provision imposing a penalty of $ 25 000 in the event of a franchisee's default to its obligations under the franchise agreement was considered reasonable since it serves both the interests of the franchisor and of its franchisees and encourages franchisees to think twice before departing from their obligations under the franchise agreement.

Reimbursement of legal expenses: *a valid provision*, even *in franchising*

The attorneys representing Greber pleaded that the provision requiring the franchisee to reimburse the legal expenses incurred by the franchisor was both unreasonable and invalid as the franchisee's undertaking thereunder was for an undetermined and indeterminable amount.

In this regard, the Court relied on a recent judgment rendered by the Quebec Court of Appeal in the case of *Van Houtte v. Développements industriels et commerciaux de Montréal* inc.[2] which confirmed the validity of provisions requiring the reimbursement of legal fees of a party in the event that legal proceedings were instituted by reason of a default committed by the other party to the contract. In its judgment, the Quebec Court of Appeal declared that the validity of these provisions was now recognized, at least in the context of a contract by mutual agreement duly negotiated by the parties."[3]

In Stereo Plus, the Superior Court stated that, although the legal fees incurred by the franchisor could not be quantified at the signing of the franchise agreement, the legal expenses provision was not invalid on the ground that such amount was then indeterminable. To the contrary, such provision should be recognized and enforced. In order to prevent abuse, these provisions are, however, subject to the criterion of reasonableness, whether the franchise agreement is characterized as a contract of adhesion or not.

In the context of a franchise agreement, these provisions are justified, among other things, in light of the interest of the franchisor in enforcing the contractual obligations of its franchisees. Legal expenses provisions therefore pursue "*an objective of protecting one party against the discretion of the other party*" which threatens the value of the banner.

Before the judgment in the *Van Houtte*'s case dealt with this question, several courts have held that these provisions were invalid, particularly in franchise agreements[4]. The judgment rendered by the Quebec Superior Court in the case *Stereo Plus* reverses that trend by confirming the validity of legal expenses provisions in a franchise agreement.

Finally, although valid, before such provision could be enforced by a court, it is necessary that the legal expenses claimed under a legal expenses provision be found reasonable. Several factors will be considered to assess the reasonableness of such claim, including the importance and difficulty of the litigation, the time invested and the extent of the proceedings, the usefulness and appropriateness of such proceedings, the inherent reasonableness of the hourly rate and of the invoiced amounts and the proportionality of the fees[5]. In the *Stereo Plus* case, the legal fees claimed have been arbitrated and reduced by the Court according to those criteria.

Conclusions:

This judgment reaffirms the principle, now well established in Quebec law, that a franchise agreement is not necessarily a contract of adhesion. Among other things, there must be a clear inability to negotiate before a court characterizes it as such.

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[2] Groupe Van Houtte inc. (A.L. Van Houtte ltee) v. Développements industriels et commerciaux de Montreal inc., 2010 QCCA 1970.

[3] *Id.*, at para. 104.

[4] Franchises Cora inc. v. 2955-2544 Quebec inc., 2001 IIJCan 25069 (QC C.S.)

[5] *Van Houtte*, supra note 2, at para. 124.

With regards to penalty provisions, a penalty of $ 25 000, representing the minimum damages suffered by a party, was considered reasonable. However, such decision was based on the particular facts of this case and each such provision has to be analyzed in light of the particularities of the facts surrounding the agreement. A conservative, but effective, drafting of such provisions will make all the difference.

Finally, legal expenses provisions should be written in clear and unequivocal language. When they do not state a specific dollar amount or do not set a limit, the wording used must be sufficiently clear so that they still present a character of adequate predictability. When well drafted, judicial review of theses provisions will then be limited to the evaluation of the adequacy and reasonableness of the amounts claimed thereunder.

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