

Fairview Donut Inc. and Brule Foods Ltd. v. The TDL Group Corp. and Tim Hortons Inc.: A proposed class action

Arch and Anne Jollymore are the principals of two Tim Hortons franchisees operating stores in Burlington, Ontario: Fairview Donut Inc. and Brule Foods Ltd. Fairview and Brule have brought a class action against The TDL Group Corp. and Tim Hortons Inc. (“Tim Hortons”).

The purpose of this summary is to provide Tim Hortons franchisees, who are potential members of the proposed class action, with information about what the case is about and how they can obtain further information about the case should they wish to do so.

This proposed class action asks the Court to answer two basic questions:

1. Does Tim Hortons have unlimited power under its license and operating agreements to impose system changes upon franchisees?
2. Does Tim Hortons have unlimited power under its license and operating agreements to charge Tim Hortons franchisees any prices it sees fit, recognizing that franchisees must buy their “inputs” for the products they sell in their stores from suppliers and distributors designated by Tim Hortons (including those owned in whole or in part by Tim Hortons)?

The class action poses these questions based on the facts presented by the Always Fresh conversion (which took place from 2002 to 2004), the prices franchisees pay for frozen product from the Maidstone plant (past and future) and the Lunch Menu (an ongoing issue).

In deciding the case on these issues, the Court may set out general principles to guide future dealings between Tim Hortons and its franchisees. The class action is therefore important for franchisees beyond what it may say about the Always Fresh conversion, the price paid for frozen product from the Maidstone plant and the Lunch Menu.

Always Fresh Conversion

With respect to the Always Fresh conversion, the arguments made by Fairview and Brule (the “Plaintiffs” in the lawsuit) include the following:

- Tim Hortons represented to franchisees, both directly (through communications to franchisees) and indirectly (through communications to the Advisory Board), that the Always Fresh conversion would bring frozen donuts to the stores at a cost of 11 to 12 cents per donut.
- In the result, however, the Always Fresh conversion tripled the food cost of an unfinished donut for Tim Hortons franchisees (from about 6 cents to 18 cents). It also imposed significantly increased food costs on franchisees for the other Always Fresh products (Timbits, muffins and cookies).

- Contrary to Tim Hortons “messaging” to franchisees as the conversion rolled out, the increased food costs of these products were never offset by savings in waste, labour or other operational expenses attributable to the Always Fresh conversion.
- The impact of the increased food costs for donuts, Timbits, muffins and cookies on franchisees was therefore to significantly reduce the profitability of this category of products (“Baked Goods”).
- The Plaintiffs compared the revenue earned by the sale of Baked Goods with their associated food, paper, labour and operating costs. This evidence demonstrates that pre-conversion, Baked Goods made a significant contribution to franchisee operating profits costs. Post-conversion, however, these products either lost money as a category or operated at a near break-even level.

Looking at the financial statements of Cyril Garland, a Chartered Accountant and Tim Hortons’ former VP Finance (he worked in-house at Tim Hortons for nine years, from 1989 to 1998) who was also a franchisee for 12 years (from 1998 to his retirement in 2010), for example:

- Pre-Always Fresh (year ending January 19, 2003), the contribution margin for donuts, Timbits, muffins and cookies in Mr. Garland’s standard store (#385 in Brampton, Ontario) was 19.7%;
 - Post-Always Fresh (year ending January 20, 2004), the contribution margin for donuts, Timbits, muffins and cookies fell to -4.5%, a drop of 24.2%; and
 - Five years post-conversion (year ending July 27, 2008), the negative contribution margin for these products persisted at -0.5, a drop of 20.2% from the pre-Always Fresh contribution to operating profits.
- The Plaintiffs also performed similar “category costs” analyses on their own stores and stores operated by four of the franchisees who swore affidavits filed by Tim Hortons (the “Affiant Franchisees”) using available Clearview data. These analyses demonstrate that both the Plaintiffs and the Affiant Franchisees all lost money on the Baked Goods on an aggregate basis in 2005, and either broke even or made an insignificant profit on these items in 2008.
 - In stark contrast to the detrimental impact upon franchisees, the Always Fresh conversion has been spectacularly profitable for Tim Hortons. Expert evidence put forward by the Plaintiffs in the action demonstrates that:
 - The average cost to manufacture a donut at Maidstone Bakeries in Brantford, Ontario from 2003 to 2009 (including direct materials, labour costs, shipping and overhead) was approximately 10 cents per donut.

- Instead of delivering the donuts directly to the franchisees from Maidstone with a commercially reasonable mark-up, however, the contracts signed by Tim Hortons with its former joint venture partner (initially the IAWS Group plc, and later ARYZTA AG) and their various subsidiaries, required Maidstone to sell the donuts to an off-shore company in Ireland jointly owned by Tim Hortons and the IAWS/Aryzta, CillRyan's Bakery Limited. From 2003 to 2009, the average price that Maidstone sold to CillRyan was 12 cents per donut.
- The Plaintiffs rely upon an expert analysis performed in 2001 for Tim Hortons and its joint venture partner as evidence that a sale price of 12 cents per donut was a reasonable, "arm's length" price to provide Tim Hortons and its partner with a fair rate of return on the capital they invested to build and operate the Maidstone plant. (If the proposed class action is certified, further examination of all relevant documents may lead to the conclusion that even 12 cents per donut was a commercially unreasonable price.)
- Although CillRyan never touched the donuts, which were delivered straight from Maidstone to the distributors who would deliver them to the franchisees across Canada, CillRyan marked up the price a further 4 cents per donut before re-selling them to distributors at a price of 16 per unit.
- Once the distributors marked up the donuts (including Tim Hortons, which began to distribute in Ontario in 2006), the cost of the Always Fresh frozen donuts in the hands of franchisees was about 18 cents per donut.
- Having analyzed documents produced by Tim Hortons in the lawsuit, the Plaintiffs' experts concluded that from 2003 to 2009 the "CillRyan Mark-up" of the donuts (from 12 to 16 cents per donut) provided no value to the franchisees but generated unreasonably high revenues for Tim Hortons and its joint venture partner, earning them returns well in excess of what would provide a reasonable return on their capital investment:
 - The Return on Capital Expended ("ROCE") generated by the joint venture partners' consolidated group of companies from 2003 to 2009 was 33% per year, well in excess of the 10% ROCE that experts retained by Tim Hortons and its joint venture partner characterized as reasonable for the Maidstone plant producing the donuts.
 - Tim Hortons received dividends, inducements and royalties of approximately \$190 million on its investment of \$75 million in the Maidstone plant, resulting in an internal rate of return for Tim Hortons of 21% per year from 2001 to 2010.
 - Factoring in the sale proceeds of \$475 from the Maidstone plant (sold by Tim Hortons to ARYZTA in 2010), Tim Hortons' internal rate of return on its \$75 million investment increases to 39% per year from 2001 to 2010.

- These rates of return were greater than the joint venture parties' expectations for the project and also:
 - greater than Tim Hortons' Inc.'s average rate of return on equity since becoming a public company in 2006 (which was 8.2%); and
 - greater than Aрызta's average return on equity since becoming a public company in 2008 of 9.4%.

It is important to understand that Tim Hortons and its joint venture partners were not the only ones to invest capital in the Always Fresh conversion. The Tim Hortons franchisees, themselves, collectively contributed almost exactly the same amount as Tim Hortons through their purchase and installation of the equipment required to make the change (approximately \$75 million, not taking into account the lost value of the scratch-bake equipment that had to be discarded by franchisees).

The Defendants' expert economist, Roger Ware, testified that franchisees are entitled to expect a competitive rate of return on funds invested into their businesses including, in particular, competitive rates of return on those products that were the subject of the franchisor's innovation (i.e., donuts, Timbits, muffins and cookies), both before the Always Fresh conversion and afterwards. The Plaintiffs contend that this has never happened for Tim Hortons franchisees.

The Plaintiffs accept that Tim Hortons' license and operating agreements give the franchisor the power to impose system changes on franchisees. In these circumstances, however, they argue that the Defendants have gone beyond what they are entitled to do. They argue that the franchisor has, for example:

- breached the terms of the license and operating agreements with franchisees;
- breached the franchisor's obligation to act in good faith and in accordance with reasonable commercial standards in the performance or execution of franchisee license and operating agreements; and
- breached relevant provisions of the *Competition Act*.

The Plaintiffs do not argue for a return to scratch-bake, but rather argue that the franchisees are entitled to a fair return on their considerable investment in the Always Fresh conversion and a commercially reasonable price from Tim Hortons for frozen donuts and Timbits. The loss of franchisee profitability on the Baked Goods and the spectacular profits of Tim Hortons referable to the Maidstone plant provide evidence relied upon by the Plaintiffs to make the case that franchisees have paid Tim Hortons too much for the par-baked product.

The Plaintiffs have also expanded their proposed definition of the franchisees who may participate in the class action, to include all franchisees who have purchased par-baked product (i.e., regardless whether a franchisee was part of the conversion from scratch-bake to Always Fresh).

Lunch Menu

With respect to the Lunch Menu, Fairview and Brule acknowledge that the Lunch Menu has formed a part of the TIM HORTONS SYSTEM for some time. They do not now, and never have, taken the position in the proposed class action that the Lunch Menu should be eliminated.

However, Tim Hortons controls:

- which products the franchisees must sell as part of the Lunch Menu;
- the ingredients, packaging and equipment franchisees must use to produce and sell the Lunch Menu;
- the suppliers and distributors from whom franchisees must purchase the ingredients, packaging and equipment used to produce and sell the Lunch Menu, including the prices they will pay;
- the standards for the in-store delivery of the Lunch Menu including, for example, the times during the day the Lunch Menu must be made available to customers and how quickly it must be served;
- the retail prices franchisees must charge for the Lunch Menu, including discounts that must be made available to customers through lunch “combos” and otherwise; and
- the advertising materials that must be used by franchisees to promote Lunch Menu sales.

In these circumstances, the Plaintiffs argue that it is unreasonable for Tim Hortons to require the franchisees to produce and sell a category of products, the Lunch Menu, that produces revenue for Tim Hortons (through RRA payments and mark-ups on the related products and equipment franchisees must buy) while the franchisees lose money because the costs of selling Lunch Menu items exceeds the revenue they generate at the store level.

There is evidence before the Court that examines and assesses the profitability of the Lunch Menu for franchisees that reveals that the franchisees have suffered an economic loss as a result of the Lunch Menu because these products are sold at negative incremental operating margins. For example:

- On March 6, 2003, Mr. Garland prepared an analysis of the profitability of the Lunch Menu (as for Always Fresh, comparing the revenue earned by these products with their associated food, paper, labour and operating costs) that he shared with members of Tim Hortons Senior Management. This analysis showed that the Lunch Menu operated at a loss of -11.9%.

- Again, the Plaintiffs performed similar “category costs” analyses on their own stores and those of four Affiant Franchisees using available Clearview data. These demonstrate that both the Plaintiffs and the Affiant Franchisees all lost money on the Lunch Menu on an aggregate basis in 2005 and 2008, with contributions to the operating profits for individual stores as low as -49.5% in 2005 and -42.5% in 2008.

While Tim Hortons contends that the Lunch Menu “drives” sales of other, more profitable menu items, they have offered no concrete evidence, analysis or expert opinion in the court case to prove that this is so.

The Plaintiffs therefore argue (among other things) that the franchisor has:

- breached the terms of the franchisees’ license and operating agreements; and
- breached its obligation to act in good faith and in accordance with reasonable commercial standards in the performance or execution of franchisee license and operating agreements.

Further Information

From August 15th to 18th, 2011, and resuming again on October 5th and 6th, 2011, the Court will hear the Plaintiffs’ motion for certification. This part of the hearing will determine whether the Plaintiffs have the Court’s permission to proceed as a class action, representing not just themselves but other franchisees in the chain.

If the Plaintiffs succeed in getting the action class action certified on some or all of the issues they have proposed, the Court will decide how Tim Hortons franchisees are to be formally notified of their entitlement to participate in the class action (should they wish to do so). Understanding that many franchisees may be reluctant to participate in the class action out of fear of retribution by Tim Hortons, the Plaintiffs have asked the Court to adopt an “opt-out” procedure that would keep the identities of those franchisees who do not opt out of the certified class proceeding (and therefore maintain their right to be compensated if the action succeeds) confidential from Tim Hortons.

From August 29th to September 2nd, 2011, the Court heard Tim Hortons’ motion to have the action dismissed without proceeding through all of the usual stages of a court proceeding. The Plaintiffs anticipate that the Court will release its reasons deciding this motion at the same time as the motion for certification.