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Canadian Franchise Legislation: An Overview[1]

A. Introduction

To date, five provinces (Alberta, Manitoba[2], New Brunswick, Ontario and Prince Edward Island) have enacted specific legislation in relation to franchises operating within their respective jurisdictions. While there are differences among them, these statutes share certain similarities in the manner in which they affect the franchise relationship. This chapter will review several important aspects of the Ontario statute, the *Arthur Wishart Act (Franchise Disclosure), 2000* (the "Act").[3] Although the focus will be on the Act, many of the principles discussed below are relevant to franchise legislation elsewhere in Canada.

The Act, much like the other provincial franchise statutes and similar legislation in other countries (most notably the United States), has three basic elements:

- an obligation on the part of the franchisor to make detailed disclosure about itself and the franchise opportunity to the prospective franchisee, coupled with a right on the part of the franchisee to rescind, or walk away from, the franchise agreement if proper disclosure is not made;
- the imposition of a duty of fair dealing on all parties to the franchise agreement; and
- a right on the part of franchisees to associate with one another without interference from the franchisor.

The main policy goals of the Act are to provide franchisees with the information they need to make an informed decision about purchasing a franchise, as well as to create a commercial framework which governs the relationship of the parties. The Act is remedial legislation, enacted to redress a perceived imbalance of power favouring the franchisor, and the courts have generally given it a liberal interpretation.

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[1] Adapted from a paper co-authored and co-presented at the OBA 8th Annual Franchise Law Conference, by Peter Viitre, of Blake Cassels & Graydon, LLP and David Kornhauser of Macdonald Sager Manis, LLP, "Franchising 101 — Understanding the Fundamental Aspects of the Franchise Relationship."

[2] Manitoba has passed franchise legislation but it is not yet in force. *The Franchises Act*, received royal assent on June 17, 2010, and will come into force on a date fixed by proclamation. To date, no associated regulations have been published.

[3] S.O. 2000, c.3

B. Application of the *Wishart Act*

The breadth of the Act's scope is nowhere more apparent than in its definition of "franchise," which is defined in subsection 1(1) of the Act, as a right to engage in a business where the franchisee is required, by contract or otherwise, to make a payment or continuing payments, whether direct or indirect, or a commitment to make such payments, to the franchisor, in the course of operating the business or as a condition of acquiring the franchise or commencing operations; and

in which:

- the franchisor grants the franchisee the right to sell, offer for sale or distribute goods or services substantially associated with the franchisor's trademark, service mark, trade name, logo or advertising or other commercial symbol; and

- the franchisor exercises significant control over, or offers significant assistance in, the franchisee's method of operation, including building design and furnishings, locations, business organization, marketing techniques or training; or

in which:

- the franchisor, or the franchisor's associate, grants the franchisee the representational or distribution rights, whether or not a trademark, service mark, trade name, logo or advertising or other commercial symbol is involved, to sell, offer for sale or distribute goods or services supplied by the franchisor or a supplier designated by the franchisor, and

- the franchisor, or the franchisor's associate, or a third person designated by the franchisor, provides location assistance, including securing retail outlets or accounts for the goods or services to be sold, offered for sale, or distributed or securing locations or sites for vending machines, display racks or other product sales displays used by the franchisee.

The definitions outlined above are meant to capture two distinct business Relationships **-** one being the traditional concept of the business format franchise; the second being what is generally known as the product distribution franchise. However, the second part of the definition means that "business opportunities," which were traditionally not thought of as being "franchises," are now defined as such and are therefore also covered by the Act.

Both definitions require the payment of money, whether at the outset or on a continuing basis. Since the Act does not define "franchise fee" but instead refers to a requirement to make a "payment or continuing payments," any payment made to the franchisor or the franchisor's associate, directly or indirectly, and whether made at the time of the acquisition of the business or during its operation, may fall within the ambit of the definition. Unlike the Alberta *Franchises Act*[4] and most U.S. legislation, there is no express exemption for purchases of reasonable

[4] RSA 2000, c. F-23.

amounts of inventory at bona fide wholesale prices, and as such these payments might be deemed under the Act to meet the "payment" requirement.

In addition to the requirement to pay money, the elements required to meet the first part of the definition of "franchise" are twofold, being: (a) that the business be operated in substantial association with the franchisor's trademarks; and (b) that the franchisor exercise significant control over, or offer significant assistance in, the operation of the business. It is unclear how much control or assistance will be considered "significant" for the purposes of the definition.[5]

The second part of the definition is also twofold (again in addition to the payment of money), namely: (a) the grant by the franchisor or the franchisor's associate of representational or distribution rights for goods or services, regardless of whether or not trademark and other intellectual property rights are also granted; and (b) the provision of location assistance by the franchisor, the franchisor's associate or some third party. This definition of "franchise" expressly brings product distribution schemes, such as sales from vending machines and display racks, under the purview of the Act. In this part of the definition, there is no need for there to be an association with the franchisor's trademarks or other intellectual property nor is there any requirement for significant control on the part of, or assistance from, the franchisor.

Importantly, it does not matter that the parties to a given commercial arrangement did not intend to be involved in a franchise relationship. They may regard their relationship as a mere license or distributorship. As stated previously, the characterization of the relationship as that of franchisee and franchisor is a matter of substance rather than form—what they choose to call their arrangement is irrelevant. As Shakespeare so famously said, "What's in a name? That which we call a rose would by any other name smell as sweet." Unless the parties ensure that their

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[5] The recent decision in *Di Stefano v. Energy Automated Systems Inc.*, 2010 ONSC 493, 2010 CarswellOnt 550, 68 B.L.R. (4th) 209 (Ont. S.C.J.) may provide some guidance. In *De Stefano*, the Court considered whether the defendant's five day training program constituted "significant assistance" in the operation of the plaintiff's business (the Court having found that the plaintiff's had paid some money and had the right to sell the defendant's products). At paragraph 27 of its decision, the Court stated that "This slender thread is not 'a reasonable basis' on which to assert that EASI's contracts with the Plaintiffs are 'franchise agreements' for a number of reasons. First, the five day training program is a condition precedent to obtaining an EASI dealership. It is not ongoing assistance during the pendency of the agreement. The statute uses the verbs 'exercises' and 'offers,' in the present tense, in relation to the elements of 'control' and 'assistance.' It does not refer to a one time training program undertaken and completed in the past. Second, the offer of assistance must relate to the business' 'method of operation.' The five day training program, in substance, relates to learning about the products rather than learning about any particular 'method of operation.' Third, the statute sets out six examples of what it means by 'method of operation'— building design, furnishings, locations, business organization, marketing techniques and training. The first five are clearly inapplicable and the 'training' offered does not, in its real substance, relate to 'method of operation.' Finally, the result of the Plaintiffs' submission, if correct, would be that any company selling a sophisticated product, and offering advance training about that product to its nascent distributors, would in law be a 'franchisor.' It is unlikely the Legislature intended this result."

commercial relationship is not a "franchise" as defined, they may be bound to the respective rights and obligations provided by the Act.

C. Disclosure

Under the Act a franchisor is required to deliver to each prospective franchisee a disclosure document that complies with the Act and which meets the detailed requirements set out in regulations made under the Act (the "Regulations).

The disclosure document must be provided to prospective franchisees no later than 14 days prior to the earlier of the franchisee:

- signing the franchise agreement or any other agreement relating to the franchise; or
- paying any consideration relating to the franchise.

In addition, the regulations made under the Act require the disclosure document to be certified as true and complete by two officers or directors of the franchisor. The Ontario Court of Appeal has stated that if this is not done, disclosure as required by the Act will not have been made. In such circumstances, the franchisee will have the right to rescind—that is to walk away from—the agreement.[6]

There is a long list of other information listed in the regulations that must be contained in the disclosure document, including the business background of the franchisor, its finances, its bankruptcy and insolvency history, the expected costs to the franchisee associated with establishing the franchise, copies of all agreements relating to the franchise, and contact particulars for both current and former franchisees. The overarching requirement is that the document must contain all "material facts," which are defined to *include* any information about the business, operations, capital or control of the franchisor, or about the franchise system, that would reasonably be expected to have a significant effect on the value or price of the franchise or the decision to acquire it. Accordingly, the list set out in the regulations should not be viewed as exhaustive.

There are also certain formal requirements that must be met. Subsection 5(3) of the Act provides that a disclosure document must be one document, delivered "as one document at one time," a requirement that has been expressly upheld by the courts.[7] Subsection 5(6) further provides that the information in a disclosure document must be "accurately, clearly and concisely set out."

Finally, there are certain statements and other information that must be presented together, in some cases in specific locations, within the disclosure document. One result of these requirements, taken together, is that it is generally not recommended that a franchisor use in Ontario a disclosure document that was created for use in outside of Canada. Also, unlike the

[6] *6792341 Canada Inc. v. Dollar It Ltd.*, 2009 ONCA 385, 2009 CarswellOnt 2514, 95 O.R. (3d) 291 (Ont. C.A.) at para. 32.
[7] *Ibid.*, at ¶16.

franchise legislation of Alberta, PEI and New Brunswick, "wraparound" documents (i.e., supplements to an extra-jurisdictional disclosure document) are not *per se* acceptable under the Act.

Finally, it should be noted that a franchisor is also required, in subsection 5(5) of the Act, to provide the prospective franchisee with a written statement of any material change that occurs after the disclosure document is delivered but before the franchise agreement or any agreement relating to the franchise is signed, or any consideration is paid by the franchisee.

Under section 1(1) of the Act, "material change" is defined to mean:

> a change in the business, operations, capital or control of the franchisor [. . .], a change in the franchise system or a prescribed change, that would reasonably be expected to have a significant adverse effect on the value or price of the franchise to be granted or on the decision to acquire the franchise and includes a decision to implement such a change made by the board of directors of the franchisor [. . .] or by senior management of the franchisor [. . .] who believe that confirmation of the decision by the board of directors is probable;

It is important to note that while "material facts" include any information about the business, operations, capital or control of the franchisor, or about the franchise system that would reasonably be expected to have a significant effect on the value or price of the franchise or on the decision to acquire it, only *adverse* changes amount to "material changes." Careful consideration must therefore be given to the definition of "material change" in determining whether updated disclosure is required as a result of changes that occur prior to the date that the franchisee signs the franchise agreement, as well as in determining whether an exemption to the obligation to provide disclosure is available in the case of a renewal or extension of an existing franchise agreement.

D. Fair Dealing[8]

Section 3 of the Act imposes a duty of fair dealing on all parties to a franchise agreement. Subsection 3(3) of the Act defines the duty of fair dealing to include a duty to act in good faith and in accordance with reasonable commercial standards.

Canadian courts have held that the Act merely codifies the duties owed by parties to act in good faith one to the other and that this duty would not normally be characterized as "fiduciary" in nature. While the manner in which courts have applied the duty of fair dealing is for the most part beyond the scope of this work, the courts have generally held that it at least requires one party to consider the commercial interests of the other in making decisions and exercising any discretion that it has. The courts have also held franchisors in breach of this duty where the franchisor has established a competing system and used scarce resources to favour one group of

[8] The duty of fair dealing will be discussed in greater detail in Chapter 9, Legal Protection of the Right to Associate. The authors believe that the duty of fair dealing will, to a certain extent, inform the judicial interpretation of the right to associate.

franchisees at the expense of another,[9] where the franchisor has professed its support for the franchisee one moment, and then "turned its back on the franchisee when the latter needed it most"[10] and where the franchisor deliberately kept the franchisee "in the dark about its intentions, . . . actively sought to keep the franchisee from finding out what was going on, . . . deliberately withheld critical information and did not return phone calls."[11]

E. The Right to Associate

Section 4 of the Act guarantees franchisees the right to associate with one another without interference or fear of reprisal by the franchisor. This right will be considered in greater detail in subsequent chapters.

F. Remedies and Enforcement

Unlike other jurisdictions, most notably those in the United States, Canada's provinces have to date opted not to require franchisors to be registered, or for their disclosure materials to be filed with any government agency. In fact, there is currently no regulatory authority in any Canadian province that has responsibility for enforcing applicable franchise statutes or regulations. Franchisors should however, note that franchisees do have two significant statutory remedies upon which they can rely.

First, Canadian provincial franchise legislation typically provides that a breach by a franchisor of its statutory obligations will give the franchisee a right of action for damages against it and any other person who may be liable for the breach. That is the case under subsection 3(2) of the Act, in respect of breaches of the duty of fair dealing, and subsection 4(5), in respect of interference, prohibition or restriction of the franchisee's right to associate.

Similarly, section 7 of the Act contains a right of action for damages in favour of the franchisee where it suffers a loss because of a misrepresentation contained in the franchisor's disclosure document or any statement of material change, or as a result of the franchisor's failure to comply in any way with its disclosure obligations under the Act. It should be noted that that right of action lies not just against the franchisor, but also against its agents, brokers and every person who signed the disclosure document, thereby potentially visiting personal liability on the directors or officers who certified the document and expanding liability beyond the persons who would otherwise be liable without regard to the Act or the regulations.

The Act does, however, allow franchisors and others certain express defenses to actions for misrepresentation brought by franchisees. Subsection 7(4) provides that a person, including the

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[9] See *Shelanu Inc. v. Print Three Franchising Corp.*, 2000 CarswellOnt 4040, 11 B.L.R. (3d) 69, [2000] O.T.C. 768 (Ont. S.C.J.); reversed 2003 CarswellOnt 2038, 64 O.R. (3d) 533, 172 O.A.C. 78 (Ont. C.A.).

[10] See *Country Style Food Services Inc. v. 1304271 Ontario Ltd.*, 2005 Carswell-Ont 2744, 33 R.P.R. (4th) 1, 7 B.L.R. (4th) 171, ¶98 (Ont. C.A.).

[11] See Abdulhamid Salah and *Salah v. Timothy's Coffees of the World Inc.*, 2010 ONCA 673, 2010 CarswellOnt 7643, 74 B.L.R. (4th) 161, ¶22 (Ont. C.A.).

franchisor, will not be liable for misrepresentation if that person proves that the franchisee acquired the franchise with knowledge of the misrepresentation or of the material change, as the case may be. In addition, with respect to a person other than the franchisor, subsection 7(5) provides such a person is not liable for misrepresentation if:

(a) he or she proves that the disclosure document was given to the franchisee without their knowledge or consent;

(b) after the disclosure document or statement of material change was provided to the franchisee, he or she withdrew consent, and gave notice of the withdrawal to the franchisor, after becoming aware of the misrepresentation; or

(c) with respect to any part of the disclosure document or statement of material change purporting to be made on the authority of, or that is extracted from a report, opinion or statement of, an expert, they had no reasonable grounds to believe, and did not believe, that there had been a misrepresentation or that the relevant part of the disclosure document did not fairly represent the expert's report, opinion or statement or was not a fair copy of the relevant extract thereof.

More importantly, if a franchisor fails to deliver a disclosure document to a prospective franchisee (or if its contents do not meet the requirements of section 5 of the Act) within the time specified under the Act, the franchisee will have the right, in accordance with subsection 6(1) of the Act, to rescind the franchise agreement at any time in the 60 days following the franchisor's delivery of the document. Furthermore, in accordance with subsection 6(2) of the Act, if the franchisor does not deliver the disclosure document at all, or delivers a seriously deficient disclosure document, the franchisee's right to rescind runs for two years from the date it signed the franchise agreement.[12]

In the event of rescission, subsection 6(6) of the Act requires the franchisor, within 60 days of the effective date of the rescission, to:

(a) refund to the franchisee any money received from or on behalf of the franchisee, other than money for inventory, supplies or equipment;

(b) purchase from the franchisee any inventory that the franchisee had purchased pursuant to the franchise agreement and remaining at the effective date of rescission, at a price equal to the purchase price paid by the franchisee;

(c) purchase from the franchisee any supplies and equipment that the franchisee had purchased pursuant to the franchise agreement, at a price equal to the purchase price paid by the franchisee; and

[12] See for example: *2189205 Ontario Inc. v. Springdale Pizza Depot Ltd.*, 2010 ONSC 3695, 2010 CarswellOnt 5257 (Ont. S.C.J.); *6792341 Canada Inc. v. Dollar It Ltd.*, 2009 ONCA 385, 2009 CarswellOnt 2514, 95 O.R. (3d) 291 (Ont. C.A.); *Melnychuk v. Blitz Ltd.*, 2010 ONSC 566, 2010 CarswellOnt 373, 67 B.L.R. (4th) 191 (Ont. S.C.J.).

(d) compensate the franchisee for any losses that the franchisee incurred in acquiring, setting up and operating the franchise, less the amounts set out in (a) to (c).

Thus, late or non-delivery of a franchise disclosure document can prove to be a very costly error on the part of the franchisor, not to mention a significant concern for anyone considering an acquisition of a franchise.

The consequences of failing to comply with the disclosure obligation imposed by the Act highlight the importance of considering the applicability of franchise legislation to a given commercial arrangement, even when the parties do not intend to engage in franchising.

G. Exemptions

The Act specifically excludes certain relationships from its application, including employer-employee relationships, partnerships, membership in a prescribed co-operative association and certain types of commercial or leasing arrangements; namely arrangements for the evaluation, testing or certification of goods or services, concessions, oral agreements and arrangements with the Crown.

In addition, there are a number of exemptions from the disclosure obligations under the Act. For example:

- grants of additional franchises to existing franchisees, provided that the additional franchises are substantially the same as the existing franchise and there has been no "material change" since the existing franchise agreement was entered into;
- grants to directors or officers of the franchisor;
- grants of a franchise where the total sales relating to the franchise do not exceed a certain percentage of the total sales of the business, which is currently prescribed by regulation to be 20%, (sometimes known as "fractional franchises");
- renewals or extensions of a franchise agreement where there has been no interruption in the operation of the business and there has been no "material change" since the franchise agreement or latest renewal or extension of the agreement was entered into;
- grants by a franchisee, for the franchisee's own account, where the grant is not effected by or through the franchisor;
- grants where:
    - the franchisee's total annual investment to acquire and operate the franchise is less than $5,000;

- the franchise agreement is not valid for more than one year, and does not involve the payment of a non-refundable franchise fee; or

- the franchisee will invest more than $5,000,000 in one year for the acquisition and operation of the franchise.

Interestingly, master franchises are expressly included within the scope of the Act. However, there is no express disclosure exemption for the grant of a franchise to an entity related to the franchisor. Accordingly, foreign franchisors seeking to expand to Ontario by incorporating a subsidiary to act as master franchisee are technically required to make disclosure to their subsidiary. While many do not take this step, failing to do so can raise issues if, for example, the subsidiary is sold, in whole or in part - or becomes subject to bankruptcy or insolvency proceedings - within two years following the grant.

Furthermore, the Act contains an effective prohibition on the parties agreeing not to be bound by Act by providing specifically that any purported waiver or release by a franchisee of a right given under the Act, or of an obligation or requirement imposed on a franchisor under the Act, is void. It should be noted that there is no size-based or other exception from this provision.

Accordingly, even the largest and most sophisticated of parties may not have an enforceable means of mitigating any unwanted implications of the legislation on their bargain. Thus, parties to commercial arrangements should be aware of the potential implications of the Act before striking their deal, or at least in time to make any required disclosure before closing.

H. Governing Law and Venue Restrictions

Finally, issues of the franchise agreement's governing law and the venue for resolving disputes often arise where the franchisor is from outside a province with franchise legislation, and understandably would prefer to have the agreement interpreted and adjudicated under its own law and on its own turf. Although there is nothing in the Act, *per se*, which prevents a franchisor from stating that the courts and laws of its own jurisdiction are to govern, section 10 of the Act provides that "[a]ny provision in a franchise agreement purporting to restrict the application of the law of Ontario or to restrict jurisdiction or venue to a forum outside Ontario is void with respect to a claim otherwise enforceable under this Act in Ontario."

As well, franchisors in Ontario historically would often designate Ontario law as governing the franchise agreement even for franchisees operating outside of Ontario, not expecting that Ontario law would apply since the wording under section 2 of the Act states that the Act applies to those franchises being operated wholly or partially in Ontario. This concept has now been turned on its head as a result of the decision of the Ontario Court of Appeal in. *405341 Ontario Limited v. Midas Canada Inc.*13 which held that where the franchise agreement specifies that Ontario law is to govern, the Act applies to franchisees operating outside of Ontario. Presumably courts in those provinces with franchise legislation would follow *Midas* and find that their own provincial franchise legislation applied to franchises operating outside of their province if the franchisor designated the laws of their province to govern.

As a result of the foregoing issues, lawyers in Ontario, as well as the other provinces that have franchise legislation, are now redrafting their franchise agreements to provide that the laws of the jurisdiction in which the franchisee operates its business will govern.

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