ONTARIO BAR ASSOCIATION
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L'ASSOCIATION DU BARREAU DE L'ONTARIO
Une division de l'Association du Barreau canadien

Institute 2012 of Continuing Professional Development

Franchise Law
Dealing With and Litigating Disputes Involving Franchises

Hot Spots in Franchising

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With thanks to KRISTINA DAVIES of Teplitsky, Colson LLP for her assistance

February 9-11, 2012

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DEALING WITH AND LITIGATING DISPUTES INVOLVING FRANCHISES - HOTSPOTS IN FRANCHISING

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A. INTRODUCTION

The relationship between a franchisor and franchisee is one of independent contractors and is established contractually through a number of documents, principally a franchise agreement. There may be ancillary agreements, depending upon the nature of the franchise, between the franchisor and the franchisee, including a lease and/or a sublease, a guarantee by the principals of the franchisee if the franchisee is a corporation, a security agreement in favour of the franchisor securing payments and other obligations under the franchise agreement, a software licence agreement, separate non-competition agreements executed by officers, directors and/or shareholders of the franchisee corporation, and specialized documents depending upon the nature of the franchise including a reservations systems agreements, loan documents, promissory notes, internet usage and participation agreements, pre-authorized deposit agreements and assignment agreements. While disputes between franchisors and franchisees typically arise under the franchise agreement, ancillary or additional disputes may also arise under any of the other documents executed by the parties in connection with the franchise.

In addition to contractual disputes, with the enactment of the *Arthur Wishart Act (Franchise Disclosure)*[1] (the "*Act*"), certain statutory obligations between the parties also exist. These obligations include the obligation of the franchisor to deliver a disclosure document (subject to applicable exemptions), the obligation on each party to deal fairly in respect of the performance and enforcement under the franchise agreement, a prohibition of the franchisor against interfering with a franchisee from forming or joining an organization of franchisees or from associating with other franchisees, the right of a franchisee to rescind the franchise agreement for late disclosure or no disclosure, and a prohibition against a waiver or release by a franchisee of a right given under the legislation or an obligation or a requirement imposed on a franchisor by or under the legislation.

Since enactment of the *Act*, there has been a continually increasing number of franchise disputes heard by the courts with respect to the statutory obligations imposed under the *Act*. These claims may also include contractual claims. The claims may be brought by an individual franchisee, a group of franchisees, or a class proceeding.

This paper will canvas the following "hotspots" in franchising involving disputes between franchisors and franchisees:

1. Problems with the content of franchise disclosure documents.

2. Problems with the franchise disclosure process.

3. Misrepresentation in franchising.

4. Disputes relating to the duty of good faith and the right to associate.

5. Common contractual troubles spots, including claims relating to advertising funds, the supply chain, renewals and re-sales.

[1] *Arthur Wishart Act (Franchise Disclosure) 2000*, S.O 2000, c. 3 (the "*Act*").

The paper will also canvas a lawyer's duties related to the content of and process relating to franchise disclosure documents.

B. PROBLEMS WITH THE CONTENT OF FRANCHISE DISCLOSURE DOCUMENTS

1. Definitions

The *Act* requires a franchisor to deliver a disclosure document to a prospective franchisee The Regulations to the *Act* (the "Ontario Regulations")[2] contain details of the disclosure requirements. The starting point for determining whether a disclosure document is required is to determine whether the arrangement between the parties constitutes a "franchise" as defined in section 1(1) of the *Act*. The definition is complicated and difficult to interpret. In effect, it is a two part definition covering traditional business format franchises, and business opportunities. However, due to the all encompassing definition, many relationships commonly known as distributorships or dealerships can be caught by the definition. The essential elements of a franchise include the following:

- Franchisee required to make a payment or continuing payments.
- Payments to be made to the franchisor.
- Payments made in the course of operating the franchise or as a condition of acquiring the franchise.
- Franchisor grants the franchisee the right to sell or distribute goods or services substantially associated with the franchisor's trade-marks.
- Franchisor exercises significant control over, or offers significant assistance in, franchisee's method of operation.

Along with analysing whether the arrangement constitutes a "franchise", it is equally necessary to determine who is the "franchisor" and who may be the "franchisor's associate". Both terms are defined in the *Act* and are relevant in establishing who is required to deliver the disclosure document.

In *1706228 Ontario Ltd. v. Grill It Up Holdings Inc.*[3], the plaintiff brought an action seeking a return of its deposit and damages for an aborted transaction to purchase a restaurant from the Defendants. The plaintiff sought damages on the basis that it had agreed to purchase a franchise but never received a disclosure document. The Defendants argued that the parties intended to enter into a franchise agreement but never did so and that instead, they executed an asset purchase agreement, a sub-lease and a licence agreement. A draft franchise agreement had been prepared by the Defendants and rejected by the plaintiffs and both parties proceeded towards closing without a document formally described as a "franchise agreement". The Court determined that the definition of "Franchise" under the *Act* addressed the substance of the relationship and not whether the parties executed a document titled a "franchise agreement." The Court further found that the parties' dealings constituted a franchise transaction because the characteristics of the relationship met the definition of "franchise" under s. 1(a) and (b) of the *Act*. Such characteristics included, among others, the following:

a. The parties understood they were entering into a franchise relationship;

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[2] O. Reg. 581/00
[3] *1706228 Ontario Ltd. v Grill It Up Holdings Inc.* 2011 ONSC 2735

b. The transaction was structured in a manner typical of franchise transactions;

c. The Defendant granted the plaintiff the right to sell and offer for sale food that was associated with their name and trademarks; and

e. The Defendants, although they had not exercised control over the plaintiff, did offer significant assistance respecting the store, construction, design, equipment, location, menu, training and branding.

In *MBCO Summerhill Inc. v. MBCO Associates Ontario Inc.*[4], on a motion for summary judgment brought by the franchisee seeking rescission and return of monies payable under the *Act*, the motions judge held that a principal of the Defendant, Elian, was a franchisor's associate on the basis that a. he was directly involved in the grant, b. he met with the principal of the plaintiff on several occasions and c. he ran the day to day business of the Defendant franchisor.

The motions judge also found that the Defendant, MBCO Rosedale, which entered into a sublease with the plaintiff for the premises in which the franchise would be operated, was also a franchisor's associate. This finding was made on the basis that Elian was the president and sole shareholder of MBCO Rosedale and that he signed various agreements with the plaintiffs on behalf of MBCO Rosedale. Moreover, the plaintiff franchisee had an ongoing obligation pursuant to the sublease to pay rent to MBCO Rosedale for the duration of the agreement and thus, MBCO Rosedale exercised "significant operational control" over the plaintiff franchisee.

On appeal, the finding of the motions judge that Elian was a franchisor's associate was upheld. However, the Court set aside the order finding that MBCO Rosedale was a franchisor's associate on the basis that the motions judge had not cited evidence to support the finding that MBCO Rosedale "exercised significant operational control" over the franchisee. Accordingly, that issue was ordered to proceed to trial.

2. Form and Content

With respect to the actual content of franchise disclosure documents, as set out in the Ontario Regulations, there are a number of specific items that must be contained in the disclosure document. Pursuant to section 5(4) of the *Act*, a disclosure document must contain[5]:

- all material facts (a defined term);
- material facts prescribed in the Ontario Regulations;
- financial statements as prescribed in the Ontario Regulations;
- copies of all proposed franchise agreements and other agreements relating to the franchise to be executed by the prospective franchisee;
- statements prescribed in the Ontario Regulations for the purposes of assisting the prospective franchisee in making informed investment decisions; and
- other information and copies of documents as prescribed (none prescribed to date).

[4] *MBCO Summerhill Inc. v MBCO Associates Ontario Inc.* 2011 ONSC 5432; 2011 ONCA 236

[5] *Act*, *supra* note 1 at s. 5(4)

Section 5(6) of the *Act* requires that all information in a disclosure document should be accurately, clearly and concisely set out.[6] On occasion this requirement may conflict with the obligation to provide details with respect to material facts, including the prescribed material facts. However, it is generally the view of most franchise practitioners that over-disclosure is preferred to under-disclosure in terms of the risk analysis pertaining to the right of rescission for incomplete disclosure.

3. Franchisor Information

The Ontario Regulations require disclosure of business background information concerning the franchisor, including the name and address of the franchisor as well as the name and business form under which the franchisor does or will do business. If incorporated, the jurisdiction of incorporation of the franchisor must be included and if the franchisor is a subsidiary, the name and principal business address of its parent corporation must be included. The names of affiliates and predecessors are not expressly required under the Ontario Regulations, but are recommended to be included if they would be considered to be material facts as defined in the *Act*.[7]

The principal business address of the franchisor is required and, if the principal business address is outside Ontario, the name and address of a person authorized to accept service in Ontario on the franchisor's behalf must be disclosed. The principal business addresses of affiliates who have dealings with the prospective franchisee may well be considered to be material, but the principal business address of a predecessor in many cases will not be considered to be material.

The disclosure document must include a description of the franchisor's business and the franchises to be offered. In addition, the franchisor must disclose how long it has been selling the franchises, the length of time it has operated a similar business, whether the franchisor sells franchises in other lines of business (including a description of each), the number of franchises sold in the previous five years in each other line of business, the length of the time the franchisor has offered franchises in the other lines of business. Similar disclosures are recommended for affiliates or a predecessor if the information would constitute a material fact.[8]

The names of the directors, general partners and officers of the franchisor and their current positions are required to be disclosed. Unlike in other provinces, disclosure in Ontario is not limited to those persons who will have day-to-day management responsibilities relating to the franchise. The disclosure document must also contain a description of each person's principal occupation and employers during the five years preceding the date of the disclosure document, and a brief description of the relevant prior business experience of such persons and the length of time each has engaged in the line of business of the franchise.[9]

4. Litigation History

A franchisor is required to provide details relating to the franchisor and its affiliates of any of the directors, general partners, and officers of the franchisor on currently pending criminal charges involving a violation of a law that regulates franchises or other businesses or offences involving fraud, embezzlement, unfair or deceptive acts or practices, and other comparable offences. Details relating to such parties are also required in respect of any currently pending civil actions including violation of a law that regulates franchises or other businesses and actions involving misrepresentation, unfair or deceptive

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[6] *Act, supra* note 1 at s. 5(6).
[7] *O. Reg. 581/00, supra* note 2 at s. 2(1).
[8] *Ibid* at s. 2(1).
[9] *O. Reg. 581/00, supra* note 2 at s. 2(2).

acts of practices, and other comparable actions regardless of the merits or status of such actions. For past or concluded criminal matters, the requirement is to provide details on convictions relating to the franchisor and its affiliates and any of the directors, general partners and officers of the franchisor for the commission of such criminal offences. For past or concluded civil matters, the requirement is to provide details relating to all such persons on any finding of liability in a civil action involving any such civil matters. It is uncertain as to whether the disclosure requirements for civil matters includes matters subject to arbitration, and arbitration decisions.[10]

The franchisor is also required to provide details relating to such persons of any prior administrative order or penalty, including any currently effective injunctive or restrictive orders imposed by, or any pending administrative actions to be heard before, any public agency, involving a law that regulates franchises or other businesses.[11]

Details on criminal convictions are required for the previous ten years, but there is no time limit regarding the disclosure of the details of civil or administrative matters.

If a franchisor is involved in a civil action against one or more franchisees involving matters other than the prescribed civil matters, such an action may be required to be disclosed if it is considered to be a material fact.

The Ontario Regulations do not expressly require that arbitration awards or proceedings be disclosed, but they must be disclosed if they are considered to constitute material facts.

Finally, there are no express requirements to disclose a settlement of a civil proceeding unless such a settlement would be considered to be a material fact.

5. Bankruptcy

The Ontario Regulations require disclosure of the details of any bankruptcy or insolvency proceedings, voluntary or otherwise, any part of which took place during the previous six years against the franchisor and its associates, a corporation any of whose directors or officers either currently are or were, at a time when the proceeding was taking place, directors, general partners, or officers or the franchisor, a partnership any of whose general partners either currently are or were, when the time the bankruptcy or insolvency proceeding was taking place, directors, general partners or officers of the franchisor, and a director, general partner or officer of the franchisor in his or her personal capacity.[12]

6. Costs and Fees

With respect to fees, the Ontario Regulations require disclosure of all of the franchisees costs associated with the establishment of the franchise. They further require disclosure of certain items including the amount of deposits or initial franchise fees, estimates of the costs for leases, rentals, pre-paid expenses and all other tangible and intangible property necessary to establish the franchise, and an explanation of any assumptions underlying the estimates; and any other costs associated with the establishment of the franchise not otherwise listed, including any payments to the franchisor, whether direct or indirect, required by the franchise agreement, an estimate of the nature and amount of the payment, and when the payment is due.[13] Franchisors must be careful to ensure that all required costs are disclosed. However,

[10] *O. Reg. 581/00, supra* note 2 at s. 2(3)
[11] *O. Reg. 581/00, supra* note 2 at s. 2(4)
[12] *O. Reg. 581/00, supra* note 2 at s. 2(6)
[13] *O. Reg. 581/00, supra* note 2 at s. 6(1)

unless they are amounts to be paid by the franchisee directly, there is no specific obligation to disclose fee sharing arrangements or commissions payable by the franchisor to consultants, agents, brokers or area representatives.

While the Ontario Regulations do not specifically require that ongoing or recurring fees to the franchisor or its associate be detailed, under the assumption that these might nevertheless constitute material facts, most disclosure documents will contain a list of these items, including royalty fees, advertising fund payments, training fees, renewal fees, transfer fees and any other typical payments.

7. Operating Costs

In addition to the requirement described above relating to a list of the franchisee's costs associated with the establishment of the franchise, if an estimate of annual or other regular periodic operating costs is to be provided by the franchisor, directly or indirectly, the Ontario Regulations require a statement specifying the assumption and basis underlying the estimate, and that the same are reasonable, and in location where information substantiates the estimate is available for inspection.[14] Franchisors need to be very complete when describing the assumptions. The obligation to disclose the costs of establishing a franchise pertains to the particular province or provinces in which the franchise is to be operated. Franchisors without experience in establishing franchises in Ontario need to use care in the preparation of the description of such costs as it should not be assumed that conditions in Ontario are like or similar to those in the franchisor's domestic market. Further, there are no special provisions or guidance in the Ontario Regulations for franchisors having no previous operational or franchise experience in the province and, accordingly, franchisors need to undertake a fair amount of research in order no estimate the required initial investment amounts for Ontario.

8. Advertising Contributions

The Ontario Regulations require disclosure in respect of advertising fund contributions including the percentage of the fund that has been spent on national campaigns and local advertising in the past two fiscal years, the percentage of the fund other than such disclosed percentages that has been retained by the franchisor or the franchisor's parent or associate during the two fiscal year period. The franchisor is also required to disclose the same percentages projected for the current fiscal year and the amount of the franchisee's contribution to the fund that is projected for the current fiscal year.[15]

Finally, the disclosure document must indicate whether reports on advertising activities financed by the fund will be made available to the franchisees, but does not require disclosure of such advertising activities.

9. Products and Services

A regular source of dispute between franchisors and franchisees pertains to the supply chain or sources of products and services. The Ontario Regulations require disclosure of any obligations on the part of the franchisee to purchase or lease from the franchisor or its associates or from suppliers approved by the franchisor or its associates or under the franchisor or its associates' specifications. The franchisor is also required to disclose restrictions or conditions imposed on the goods or services that the franchisee may

[14] *O. Reg. 581/00, supra* note 2 at s. 6(2).

[15] *O. Reg. 581/00, supra* note 2 at s. 6(6).

sell, or that limit the customers to whom or the means by which the franchisee may sell goods or services.[16]

10. Rebates

The franchisor is required to disclose its policies and practices, if any, regarding volume rebates, commissions, payments or other benefits. There is considerable uncertainty associated with the meaning of the terms "policies" and "practices", but franchisors should be diligent and thorough in making such disclosure. The franchisor must state whether or not there are any rebates or other benefits that the franchisor or its associates may receive or are receiving as a result of the purchase of goods or services by franchisees and to indicate if any of these rebates or other benefits are shared with franchisees, either directly or indirectly.[17]

The Ontario Regulations do not mandate that the amounts of such rebates or other such benefits, or the names of the sources, need to be disclosed. There is considerable uncertainty as to the types of items which might be required to be disclosed under this item. However, the general "other benefits" language would indicate that disclosure should be broad, as opposed to narrow, in respect of the types of rebates or other benefits. For example, landlord inducements or allowances payable to the franchisor or its associates in respect of the leasing of or construction of franchisee premises to be occupied by the franchisee arguably are either subject to disclosure under this item or constitute a material fact which should be otherwise disclosed.

11. Obligations of Franchisor

There is no specific requirement to the Ontario Regulations for a chart or list of any obligations of the franchisor, but arguably a summary of the franchisee's obligations may be required under the general requirement to disclose all material facts. While there are specific requirements in the Ontario Regulations for disclosure of particular obligations, the list is not exhaustive due to the general requirement to disclose all material facts.

12. Licenses

A regular item of controversy under the Ontario Regulations pertains to the requirement to disclose every licence, registration, authorization or permission the franchisee is required to obtain under any applicable law, to operate the franchise in Ontario or to sell or distribute the particular goods or services sold or distributed by the franchisee.[18] While this item was included in the Ontario Regulations likely for the purpose of ensuring that any licence or permit unique to the business will be disclosed, its general practice has developed to disclose all usual licences and registrations including, for example, registrations with municipal and taxing authorities, liquor licence requirements, facility licences and the like. While a specific statement is not required under the Ontario Regulations, the practice has also developed, due to the difficulty of determining specific municipal licence requirements for every possible location where a franchise may be offered, that the franchisee should make its own inquiries to determine whether it will be required to obtain further licences, registrations, authorizations or other permissions to operate the franchise under other laws or local by-laws not specifically disclosed by the franchisor.

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[16] *O. Reg. 581/00, supra* note 2 at s. 6(7).

[17] *O. Reg. 581/00, supra* note 2 at s. 6(8)

[18] *O. Reg. 581/00, supra* note 2 at s. 6(10)

13. Financing

The Ontario Regulations required disclosure of the terms and conditions of any financing arrangement that the franchisor or its associate directly or indirectly offers to the franchisee.[19] This may relate to such common items as financing for the establishment of franchise, ongoing trade terms for inventory or supplies, equipment lease terms, and arrangements negotiated with third parties (including suppliers and financial institutions) to provide financing or trade terms.

14. Franchisor Obligations

The Ontario Regulations do not expressly require any description of the franchisor's obligations, either before or after the franchisee opens the franchise business. However, there are specific references in the Ontario Regulations to disclose descriptions of a number of particular items. Interestingly, the Ontario Regulations do not specifically reference disclosure of operations manuals or the table of contents of such manuals. It is arguable that the contents of operations manual constitute material facts, particularly if the franchisee is required to operate the franchise business in accordance with the manuals. It is further arguable that if the contents of the manual constitute terms and conditions of the franchise agreement, and the franchisor has the right to unilaterally amend the manual, that such facts should be disclosed as a material fact.

15. Territory

The Ontario Regulations require disclosure of a description of any exclusive territory granted to the franchisee.[20] The franchisor must also disclose its policies and practices, if any, as to how proximate to an existing franchise outlet the franchisor may establish another franchise, a franchisor outlet may be established, the franchisor may establish another distributor or licensee or other methods of distribution using the franchisor's trade-marks, the franchisor may establish other franchises that distribute similar products or services under a different trade-mark, and the franchisor may establish an outlet that distributes similar products or services under a different trade-mark.[21] These disclosure obligations are particularly relevant to multi-system franchisors. The Ontario Regulations do not specifically require description of any restrictions on the franchisee's territorial promotion via the internet or otherwise, subject to the requirement for disclosure under the general requirement to disclose material facts.

In *1230995 Ontario Inc. v. Badger Daylighting Inc.*[22], the plaintiff franchisee brought an action against the franchisor for breach of contract. The court found that the franchisee was entitled to damages for prior and future income loss resulting from the loss of territory taken from his assigned work zones. The franchisor had failed to comply with the disclosure requirements because the disclosure document referred to a work zone agreement that was not attached to the disclosure document and the only description of the franchisee's territory was in the Marketing Agreement, which was also not attached to the disclosure document. Moreover, the disclosure document did not include the performance levels required to continue the franchisee's exclusive territory. This decision was affirmed by the Court of Appeal.

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[19] *O. Reg. 581/00, supra* note 2 at s. 6(4)
[20] *O. Reg. 581/00, supra* note 2 at s. 6 (12)
[21] *O. Reg. 581/00, supra* note 2 at s. 6(14)
[22] *1230995 Ontario Inc. v Badger Daylighting Inc.* 2010 ONSC 1587; aff'd 2011 ONCA 442

16. Intellectual Property

Disclosure with respect to intellectual property is quite limited under the Ontario Regulations. The regulations require a description of the rights the franchisor or its associate has to trade-marks associated with the franchise.[23] There is no requirement that the trade-marks be applied for or registered when offering franchises, but if they are not so protected, this should likely be disclosed as a material fact. There is no specific reference in the Ontario Regulations to domain names, but these will likely fall under the general reference to "other commercial symbols". Accordingly, if domain names are important to the business, their registration and duration should be disclosed. Disclosure of information regarding pending or threatened legal or administrative action relating to their marks or their use, and any restrictions on the franchisee's right to use the marks, would likely constitute material facts although not specifically required to be disclosed.

The Ontario Regulations do not deal with disclosure of patents or copyrights specifically, subject to the general requirement to disclose material facts.

17. Personal Participation

The regulations require the franchisor to disclose whether it requires the franchisee to participate personally and directly in the operation of the franchised business, and if the franchisee is a corporation, the requirement is extended to the principals of the corporation.[24]

18. Restrictions on Sales

The Ontario Regulations require disclosure of restrictions or conditions imposed on the sale of goods or services by the franchisee, or that limit the customers to whom the franchisee may sell goods or services.[25] Disclosure is also required of any exclusive territory grant to the franchisee which may have the effect of being a restriction or condition imposed on the franchisee's sales activities. The Ontario Regulations do not specifically require disclosure of restrictions on the franchisee as to channels in which the franchisee may sell, or where the franchisee may sell, unless this information otherwise constitutes a material fact.

19. Termination, Renewal and Transfer

The Ontario Regulations require disclosure of any provisions of the franchise agreement relating to termination, renewal and transfer.[26] The general practice is to list in the disclosure document the paragraphs in the franchise agreement and other documents that contain provisions dealing with termination, renewal and transfer of the franchise, with at least a brief description or summary of such provisions. It is also common practice for the franchisor to disclose and describe the governing law, jurisdiction and venue provisions in the franchise agreement, and that these provisions cannot be waiver or released by the franchisee. Post-termination obligations of the franchisee arguably relate to termination, and as such should be disclosed.

[23] *O. Reg. 581/00, supra* note 2 at s. 6(9)
[24] *O. Reg. 581/00, supra* note 2 at s. 6(11)
[25] *O. Reg. 581/00, supra* note 2 at s. 6(7)
[26] *O. Reg. 581/00, supra* note 2 at s. 6(18)

20. Dispute Resolution

With respect to dispute resolution, the Ontario Regulations require the inclusion of a mandatory warning statement that mediation is a voluntary process to resolve disputes with the assistance of an independent third party, and that any party may propose mediation or another dispute resolution process, and that the process may be used to resolve disputes if agreed to by all parties. In addition, if an internal or external mediator or other alternative dispute resolution process is used by the franchisor in disputes with the franchisee, the Ontario Regulations require disclosure of a description of a mediation or other alternative dispute resolution process and the circumstances under which the process may be invoked.[27]

21. Earnings Projections

One of the most controversial and frequently contested disclosure items under the Ontario Regulations pertains to disclosure of certain information if the franchisor provides earnings projections or financial performance information. If an earnings projection is made by the franchisor, the disclosure document must include a statement specifying the reasonable basis for the projection, the assumptions underlying the projection, and the place where substantiating information is available for inspection by the franchisee.[28] Earnings projections made on the internet or in the media, or in some other means of communication, are not regulated differently in Ontario from other financial representation. There is no definition of what is meant by or what is included in the term "earnings projection". It is generally assumed that earnings projections include both historical earnings information and future oriented projections, and may be made directly or indirectly, in all cases requiring disclosure.

In *Sovereignty Investment Holdings Inc. v. 9127-6907 Quebec Inc.*[29], the applicant franchisee was granted rescission of a franchise agreement on the basis that the disclosure document did not comply with s. 5 of the *Act*. In addition to the fact that the purported disclosure document did not include a certificate of the franchisor and that all the documentation was not collected in a single document, the franchisor failed to provide any financial statements. Moreover, although the disclosure document did contain earnings projections with the required principal assumptions underlying the projections, no location was identified where substantiating information could be reviewed by the then prospective franchisee, as required by the Regulations. Accordingly, Justice Wilton-Siegel found that the franchisee was unable to make an informed assessment of the credibility of this financial information even though such information was highly relevant to a prospective franchisee's investment decision. He further concluded that the franchisor had failed to deliver a disclosure document because of the four fundamental deficiencies set out above, but noted that each of them, on its own, was sufficient to the franchisor's assertion that it had delivered a "disclosure document.

22. Franchisee Information

The Ontario Regulations require the disclosure of the names, mailing addresses, and phone numbers of all franchisees operating in Ontario, but do not require specific disclosure of outlets owned or operated by the franchisor or its associates.[30] However, such information may constitute a material fact, thereby requiring disclosure. If there are fewer than 20 franchises in Ontario, disclosure is required on additional outlets geographically closest to Ontario until information on 20 franchises is provided.[31]

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[27] *O. Reg. 581/00, supra* note 2 at s. 5
[28] *O. Reg. 581/00, supra* note 2 at s. 6(3)
[29] *Sovereignty Investment Holdings Inc. v. 9127-6907 Quebec Inc*. [2008] 303 D.L.R. (4th) 515 (Ont SCJ).

[30] *O. Reg. 581/00, supra* note 2 at s. 6(17)
[31] *Ibid* at s. 6(17)

Disclosure is required with respect to any franchisee or outlet of the name, address and telephone number of every former franchisee, whose franchise has been terminated, cancelled, not renewed, re-acquired by the franchisor, or otherwise left the system within the franchisor's previous fiscal year. This information has to include all former franchisees in Ontario.

For each closure of a franchise or the type being offered within the previous three fiscal years, the franchisor must disclose the reasons for closure, including whether the franchise was terminated or cancelled by the franchisor, not renewed by the franchisor, not renewed by the franchisee, or otherwise left the system. The information is not limited to franchises located only in Ontario.[32]

23. Financial Statements

As stated earlier, a disclosure document must contain financial statements, reports, and other documents in accordance with the requirements of the *Act* and the Ontario Regulations. The financial statements of the franchisor must be included in the disclosure document and be prepared in accordance with generally accepted accounting principles. The statements must be for the most recently completed fiscal year or, if 180 days have not yet passed since the end of the most recently completed fiscal year and financial statements have not been prepared and reported on for that fiscal year, the financial statements for the previous fiscal year must be included. If the franchisor has not completed one fiscal year of operation or 180 days have not passed since the end of the first fiscal year of operation, and financial statements have not been prepared and reported on for that fiscal year, the disclosure document must include the franchisor's opening balance sheet.[33]

The financial statements must be either audited in accordance with generally accepted auditing standards set out in the Canadian Institute of Chartered Accountants Handbook, or reviewed in accordance with the review standards and reporting standards applicable to review engagements set out in the Canadian Institute of Chartered Accountants Handbook. The auditing, review, and reporting standards of other jurisdictions that are least equivalent to those described are acceptable. However, it is uncertain what supporting material may be required to confirm that the reporting standards of another jurisdiction are equivalent to those in Ontario. There have been a number of cases in which franchisors have not prepared or included financial statements which meet the required standards, or where financial statements have been delivered but not as part of the disclosure document.

There are specific exemptions from the requirement to include financial statements based on net worth, number of franchises, engagement in the line of business, and absence of any judgement, order or award relating to fraud, unfair or deceptive practices, or a law regulating franchises.[34] One of the difficulties pertaining to exemption from financial disclosure is the fact that the net worth of the franchisor must be determined on the basis of the most recent financial statements, even though the determination may result in the conclusion that these statements need not be disclosed. As a result, franchisors who have determined on an internal net worth valuation that they will be exempt from disclosure but without independent financial statements will not meet the exemption requirements because such statements were not been prepared to support the make the net worth conclusion.

In *6792341 Canada Inc. v. Dollar It Ltd*.[35], the court determined that the franchisor's complete failure to provide any financial statements or a balance sheet precluded any finding of substantial compliance and accordingly, the deficiencies in the disclosure document were so materials that it could not be considered

[32] *O. Reg. 581/00, supra* note 2 at s. 6(16)
[33] *O. Reg. 581/00, supra* note 2 at s. 3
[34] *O. Reg. 581/00, supra* note 2 at s. 11
[35] *6792341 Canada Inc. v Dollar It Ltd* 2009 ONCA 385.

to be a disclosure document under s. 6(2) of the *Act.* The Franchisee was accordingly entitled to a two year period for rescission.

In *Melnychuk v. Blitz Ltd.*[36] the plaintiff/franchisee sought to rescind its franchise agreement on the ground that the disclosure of material fact required under the *Act* did not take place and what was provided to him, amounted, in law, to no disclosure. The court found that the financial statements were stale and did not meet the required accounting standard and that this was a material deficiency. The disclosure provided was so deficient as to constitute no disclosure pursuant to Section 6 (2) of the *Act*.

24. Receipts; Certificate of Disclosure

No receipt page is required to be signed and dated by the prospective franchisee, although a receipt page is permissible and is most frequently used in practice in order to provide evidence of receipt of the disclosure document.

The Ontario Regulations require that every disclosure document shall include a certificate certifying that the disclosure document contains no untrue information, representations or statements, and include every material fact, financial statement, statement or other information required by the *Act* in the regulations. This certificate must be signed and dated by the franchisor (if not incorporated), by the director or officer of a franchisor that is incorporated and has only one officer or director, or by at least two persons who are officers or directors for corporate franchisors that have more than one officer or director.[37]

In *6792341 Canada Inc. v. Dollar It Ltd.*[38], the franchisor's failure to include a certificate of disclosure that was executed and dated was in itself a basis for finding that no disclosure was provided as required by the *Act* and the franchisee was entitled to rescind within 2 years pursuant to s. 6(2) of the *Act*.

25. Miscellaneous

The *Act* does not expressly permit the use of a disclosure document from another jurisdiction. Therefore, the standard practice in Ontario is to prepare the disclosure document that follows the Ontario Regulations in respect of mandated order, format and content, and not to use a disclosure document from another jurisdiction that has been amended or supplemented.

In *1518628 Ontario Inc. v. Tutor Time Learning Centres LLC*[39], a U.S. franchisor provided its U.S. equivalent to a "disclosure document" called a Uniform Franchise Offering Circular ("UFOC") to an Ontario franchisee. The franchisee subsequently sought to rescind the Franchise agreement. One of the issues to be determined was whether the American UFOC constituted proper disclosure under the *Act* and accordingly whether disclosure was simply incomplete or whether the UFOC did not constitute disclosure at all. The court determined that the UFOC was not provided by the franchisor for disclosure purposes and was provided only for information purposes a few days before the transaction was completed. Further, the UFOC did not provide all of the information required under the *Act*. Moreover, it failed to provide the material facts pertinent to the franchise. Accordingly, the non-disclosure of material facts in itself meant that there was no compliance with the disclosure required by the *Act*. Rescission was granted.

If a material change (as defined) has occurred since delivery of the disclosure document prior to execution of a franchise agreement or the payment of consideration by the franchisee, a franchisor must provide a

[36] *Melnychuk v Blitz Ltd* 2010 ONSC 566.

[37] *O. Reg. 581/00, supra* note 2 at s. 7

[38] *Dollar It, supra* note 9 at para 32.

[39] *1518628 Ontario Inc. v Tutor Time Learning Centres LLC* (2006), 150 ACWS (3d) 93 (Ont SCJ).

franchisee with a form of material change statement confirming the nature of the material change. Failure to provide the material change statement as soon as practicable after the change has occurred will constitute non-disclosure under the *Act*.

The *Act* requires that the contents of the disclosure document be clear and concise, that all required enclosures be contained within one document, and that the disclosure document be delivered as a whole at one time.

In *1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd.*[40], the Court of Appeal affirmed the decision of the applications judge, permitting the franchisee to rescind the Franchise agreement pursuant to s. 6(2) of the *Act* where the required disclosure was provided in several documents. The franchisor had argued that they provided proper disclosure, albeit in a piecemeal fashion, over the course of several meetings and in several different documents. They argued that this method of disclosure substantively met the requirements of the *Act* and that rescission was inappropriate. In upholding the order for rescission, Justice MacFarland stated the following:

> There is no issue of "substantive" versus "procedural" compliance. The requirement that disclosure occur in the form of a single document is not an empty formal requirement. The legislature clearly envisioned that the purpose of the legislation – i.e., ensuring that decision to enter into a franchise agreement is an informed one – would be best fulfilled by giving prospective franchisees the opportunity to review a single document or documents, so that all information is before them at the same time...
>
> Section 6(1) presupposes the existence of a single disclosure document. None was provided on the facts of this case. Accordingly, s. 6(1) is inapplicable...Section 6(2) is the provision applicable to this case.[41]

The disclosure document must be current at the time of delivery, and updating is dependent on the accuracy of the information as at the time of disclosure. This requirement in practice mandates an updating of a disclosure document at least annually, and more frequently in the event of material changes. Annual updating is triggered by the requirement in the Ontario Regulations that the disclosure document contain financial statements for the most recently completed fiscal year, and other specific items must be disclosed based on completed fiscal years.

In addition, disclosure must be particular to the specific franchise being offered. Accordingly, it has become the practice to prepare separate disclosure documents, or that contain separate sections pertaining to specific disclosure items, in the case of a new franchise, the transfer or resale of an existing franchise, the renewal or extension of an existing franchise, or the sale of a corporate unit, subject to any exemptions contained in the *Act*.

C. PROBLEMS WITH THE FRANCHISE DISCLOSURE PROCESS

In addition to the onerous requirements with respect to the content of disclosure documents and the ambiguities and uncertainties in the Ontario Regulations pertaining to the scope and detail of disclosure, a franchisor must cope with a number of additional challenges and uncertainties in connection with the actual franchise disclosure process.

1. Who is the Franchisor

[40] *1490664 Ontario Ltd. v Dig This Garden Retailers Ltd.* (2005), 256 DLR (4th) 1 (Ont CA) [*Dig This Garden*] aff'g (2004), O.J. No. 3008 (Ont SCJ)

[41] *Dig This Garden*, *supra* note 13 at paras 18 and 22.

The question as to who must give disclosure is dealt with in a circular manner in the *Act*. Section 5 of the *Act* requires a franchisor to provide a prospective franchisee with a disclosure document. However, the term "franchisor" means one or more persons who grant or offer to grant a franchise. The term "franchise", as discussed earlier, is quite extensive, and in certain cases a franchisor may include a franchisor's associate as being a party involved in the grant of a franchise or exercising control or offering assistance in the method of operation. Therefore, in certain situations there may be more than one entity constituting the "franchisor", and the disclosure document must be provided on behalf of all such entities.

2. Who is the Franchisee

Another issue pertaining to the franchise disclosure process pertains to the actual persons to whom the disclosure document should be delivered. Section 5 of the *Act* requires the delivery of a disclosure document to a "prospective franchisee". The term "prospective franchisee" means a person who has indicated, directly or indirectly, to a franchisor or a franchisor's associate, agent or broker an interest in entering into a franchise agreement, and a person whom a franchisor or a franchisor's associate, agent or broker, directly or indirectly, invites to enter into a franchise agreement. In many cases, a prospective franchisee will be an individual inquiring about a franchise, prior to any consideration being given to the ultimate form or constitution of ownership of the franchise. Most franchisees will eventually incorporate a corporation to act as franchisee for business, tax and liability reasons. Further, there may be one or more individuals who intend to operate the franchise, or who will be shareholders in the corporate franchisee. This information is frequently not known to either the franchisor or the franchisee at the time of delivery of the disclosure document. Therefore, it has become common practice for a franchisor to deliver the disclosure document to the individual franchisee candidate known to the franchisor at the time of delivery, on his or her own behalf and on behalf of a corporation which may be incorporated by that person. If it becomes known to the franchisor at a subsequent date that other individuals would be involved in the operation of the franchise or as shareholders or even guarantors of the corporate franchisee, it is recommended that the franchisor provide disclosure to such additional persons prior to the time at which they execute the franchise agreement or any other agreement pertaining to the franchise.

As discussed earlier, there are a number of types of arrangements which may constitute a "franchise". It should be noted that the *Act* states in Section 1(2) that the franchise includes a master franchise and a subfranchise, each of which term is separately described. However, the courts have often been forced to address these issues within the context of unusual facts which did not easily fall within the literal wording of the *Act*.

In *Bekah v. Three for One Pizza & Wings (Canada) Inc.*[42], the issue before the court was whether a purchaser of a franchise in a transaction that had not yet closed was a franchisee within the meaning of the *Act* and accordingly entitled to the right of rescission for breach of the disclosure obligations set out in section 5 of the *Act.*

In determining that the plaintiffs were franchisees within the meaning of the *Act,* the presiding judge noted that even though a franchisee is defined as a "person to whom a franchise is granted", this did not require the closing of the franchise transaction.

On the facts of this case, the presiding judge found that the purchasers were franchisees because they had entered into a binding agreement for the purchase and sale of a franchise business, under which they were obligated to enter into a full franchise relationship, and monies were paid under said agreement.

[42] *Bekah v. Three for One Pizza & Wings (Canada) Inc*. (2003) 67 OR (3d) 305 (Ont SCJ).

3. Timing of Disclosure

With respect to the timing of disclosure, the *Act* requires that a disclosure document be received by a prospective franchisee at least 14 days before the earlier of the signing by the prospective franchisee of any agreement relating to the franchise, or the payment of any consideration by or on behalf of prospective franchisee to the franchisor or its associate relating to the franchise.[43]

It is uncertain whether the payment requirement is triggered if the franchisee makes the payment of any consideration to a third party in respect of the franchise such as a landlord, supplier or service provider.

There are no exceptions in the *Act* with respect to the timing of disclosure prior to the execution of an agreement. Therefore, a disclosure document must be provided to a prospective franchisee prior to the execution of a binding letter of intent or option, or the payment of money under a letter of intent or option. Further, preliminary agreements are not excepted, and therefore may not be signed in advance of disclosure. This would include the execution of a deposit agreement, a territorial reservation agreement, a confidentiality agreement, a location agreement or any other form of preliminary agreement. The Ontario Regulations specify a certain ordering of disclosure items in the disclosure document, particularly the disclosure of risk statements. Therefore, while it has not been determined whether inappropriate ordering of disclosure items would constitute non-disclosure or incomplete disclosure, franchisors should follow the ordering of disclosure items as required under the Ontario Regulations.

In *4287975 Canada Inc. v. Imvescor Restaurants Inc.*[44], the issue on appeal was whether the appellant had a right of rescission under the *Act*. The motion judge had held that the rescission rights provided for in s. 6 of the *Act* were not available to the appellant. The franchisee had paid a fee to the franchisor two months before receiving a disclosure document. Six months after delivery of the disclosure document, the franchisee executed a franchise agreement. Almost two years later, the franchisee sought to rescind the franchise agreement. The motions judge held that the appellant did not have a right to rescind the franchise agreement under s. 6(2) because that section only applied where the franchisor never provides disclosure. He conversely also found that the appellant also did not have a right to rescind under s. 6(1) of the *Act* because the appellant had six months to consider the disclosure document before signing the franchise agreement. The decision was upheld on appeal. The Court of Appeal stated that s. 6(2) cannot be triggered in cases where a disclosure document is provided, because it expressly applies only when a disclosure document was "never provided". S. 6(1) of the *Act* deals directly with the consequences of a franchisor's failure to provide a disclosure document that meets the timing and/or content requirements of the *Act*.

4. Delivery Requirements

With respect to the methods of delivery of disclosure document, the *Act* requires that a disclosure document be one document, delivered as one document and at one time. The disclosure document must be delivered either by personal delivery, registered mail or any other method permitted by the Ontario Regulations (at present, no other methods are prescribed). The practice has arisen to deliver a disclosure document in paper form, and possibly on CD-Rom, as that facilitates receiving a signed receipt for delivery of the disclosure document. There is no authority or practice for delivery of a disclosure document by e-mail or through a website. Section 5(7) of the *Act* specifies certain exemptions from the obligation to provide a disclosure document. Each of these exemptions is described in a very specific language, and must be carefully reviewed if the franchisor determines to rely on an exemption. Co-

[43] *Act*, *supra* note 1 at s. 6.
[44] *4287975 Canada Inc. v Imvescor Restaurants Inc* 2009 ONCA 308; aff'g (2008), 91 OR (3d) 705 (Ont SCJ).

incident with the exemptions is the fact that Section 12 of the *Act* states that in any proceeding under the *Act* the burden of proving an exemption or exclusion from a requirement or provision is on the person claiming it.

5. Exemptions

In view of the uncertainties and ambiguities of various definitions and provisions in the *Act*, and the consequences of failure to disclose or improper disclosure, franchisors do not generally rely on exemptions from disclosure unless there is absolute certainty that an exemption will apply. The following are the specific types of exemption provided for in the *Act*, each of which must be carefully reviewed for language, content and applicability:[45]

- resale exemption
- sale to an insider
- sale of an additional franchise
- sale by a trustee or similar custodian
- sale of a factual franchise
- renewal or extension of a franchise agreement
- small franchise exemption
- sophisticated purchaser exemption

It should also be noted that there are no exemptions provided for specific industries. Therefore, and by way of example, petroleum dealers, motor vehicle dealers, farm implement dealers, credit card service agreements, and wholesale arrangements are covered by the *Act* if the relationship otherwise falls within the definition of a franchise.

In *2189205 Ontario Inc. v. Springdale Pizza Depot Ltd.*[46], the appellant franchisor had executed a franchise agreement with the previous franchisees of the respondent franchisee's business. The franchise agreement included transfer provisions which stated that if the franchisee wished to sell its franchise, it had to obtain the franchisor's consent and provide the franchisor with certain specific documents executed by the new franchisee. When the previous franchisee sold its business to the respondent, the franchisor did not provide the purchasers with a disclosure document but required that the purchasers execute documents not listed in the transfer provisions of the franchise agreement.

The respondent later sought to rescind the franchise agreement. The franchisor took the position that it was exempt from the disclosure requirements as the transaction constituted a resale, which was exempted where the "grant of a franchise" is "not effected by or through the franchisor." The motions court granted rescission. The appeal was dismissed and the court found that where a franchisor imposes conditions on a

[45] *Act*, *supra* note 1 at s. 5(7)

[46] *2189205 Ontario Inc. v Springdale Pizza Depot Ltd* 2011 ONCA 467; aff'g 2010 ONSC 3695 (Ont SCJ).

new buyer that extend beyond those in the franchise agreement, and where it is more than a passive participant in the resale, disclosure obligations are triggered.

In *TA&K Enterprises Inc. v. Suncor Energy Products*[47], the issue was whether the franchisor was exempt from disclosure where the franchisor entered into agreements which had a term of not more than 1 year and repeatedly renewed these agreements. There was also no requirement for the franchisee to pay any up-front fees to the franchisor. The franchisor relied upon s. 5(7)(g)(ii) of the *Act* which provides an exemption where "the franchise agreement is not valid for longer than one year" and "does not involve the payment of a non-refundable franchise fee." The court held that the term "franchise fee" meant a fee for the purposes of acquiring membership in the franchise chain, stating that the term did not encompass every fee paid to a franchisor from a franchisee. The court also held that month to month extensions of an agreement that was otherwise valid for one year did not change the validity of the exemption. The franchisee's appeal was dismissed on the basis that the obligations were not stated to be for a period of more than one year, and therefore the agreement fell within the exemption as not being "valid" for longer than this period.

6. Disclosure Specific to Each Franchise

A frequently overlooked requirement pertaining to the franchise disclosure process under the *Act* is the fact that disclosure must be relevant to the particular franchise being offered. Therefore, there may be different disclosure documents, or different items contained in a disclosure document, pertaining to the following types of franchise sales:

- new franchise
- renewal or extension of an existing franchise
- resale or transfer of a franchise
- a conversion franchise
- a franchisor operated unit

As each disclosure will be specific to the particular franchise or location, although there may be general disclosure items common to new franchise sales, any particular information pertaining to the specific location of a franchise must be included in the relevant disclosure item or as a material fact.

As discussed above, the concept of determining whether a material fact exists is dependent upon the definition of the term "material fact" and the judgment of the franchisor in assessing the implication of the facts of a particular franchise to the perspective franchisee. Proof of delivery of a disclosure document is problematic for some franchisors who do not take the time to obtain receipts, properly document the specific contents of the disclosure document delivered, and maintain reliable and satisfactory proof of delivery and the contents of the franchise disclosure document.

D. MISREPRESENTATIONS IN FRANCHISING

1. Pre-Contractual Common Law Misrepresentations and Exclusionary Clauses

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[47] *TA&K Enterprises Inc. v. Suncor Energy Products Inc.*, 2010 ONSC 7022; aff'd 2011 ONCA 613

With the enactment of the *Act*, the dynamic between franchisors and franchisees was significantly and permanently altered. Extensive disclosure obligations[48], franchisees' rights of rescission[49], restitution and damages where franchisors have failed to comply with their disclosure obligations[50], the prohibition against contracting out of the *Act*[51] and the statutory embodiment of the common law duty of good faith through the imposition of a similar, but extended duty of "fair dealing"[52], have changed the landscape for franchisors in a manner and to a degree that was wholly unprecedented. Even though one might have thought that the requirement to provide a written disclosure document should, in theory, limit issues surrounding pre-contractual representations made to prospective franchisees, in practice that has not turned out to be the case.

Such results ought not to be surprising due to the very structure and nature of the business of selling franchises, which inherently creates tension between franchisors' marketing or sales departments and those entrusted with ensuring that proper compliance with appropriate standards are met. The sales teams have targets to meet and are under pressure to sell franchises. Their job is to persuade prospective franchisees to purchase their employers' franchises, rather than a competitors and this often gives rise to continued pre-contractual communications between franchisors' representatives and franchisees relating to the franchise, the likelihood of its future success and its perceived attractiveness. Invariably, certain franchisees will later claim that some of those communications were untrue, and were made negligently or fraudulently in order to induce the franchisee to enter the franchise agreement in question. Not surprisingly, these claims usually arise when the business purchase has not performed as expected or has actually failed.

The claims of misrepresentations may arise from the distribution of marketing materials, information sessions with prospective franchisees, brochures and, most often, financial or earnings projections (or, as referred to in the United States, Financial Performance Representations or "FPR"s) made to convince the prospective franchisee that he or she will earn a substantial income from buying into that particular franchise system.

Such misrepresentations may be negligent, innocent or fraudulent and each type requires that certain constituent elements be proven in order to be actionable. The two most frequently alleged misrepresentations are those which are fraudulent or negligent. One of the reasons for this relates to the remedies available to the plaintiff depending upon what kind of misrepresentation is found to exist.

In the case of a pure innocent misrepresentation [being an untrue statement made by one party with the honest belief, based on reasonable grounds, that the statement is true], the aggrieved party may be limited to a claim for common law rescission and be deprived of claims for damages. Conversely, claims for rescission, with or without damages, are available where negligent or fraudulent misrepresentations have been made, depending on the facts of the matter in issue.

So, for instance, in the decision of the Ontario Superior Court of Justice in *Murray v. TDL Group Ltd.*[53], the court found that for a claim based upon negligent misrepresentations within a franchise context to succeed, the plaintiff must establish the following 5 basic elements:

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[48] *Act*, *supra* note 1 at s. 5
[49] *Act*, *supra* note 1 at s. 6
[50] *Act*, *supra* note 1 at s. 7
[51] *Act*, *supra* note 1 at s. 11
[52] *Act*, *supra* note 1 at s. 3
[53] *Murray v TDL Group Ltd* [2002] OTC 1024 (Ont SCJ).

- There must a duty of care based on a "*special relationship*" between the defendant and the plaintiff;
- The representation in issue must be untrue, inaccurate or misleading;
- The defendant must have acted negligently in making the representation;
- The plaintiff must have relied, in a reasonable manner, on the representation; and
- The reliance must have been detrimental to the plaintiff in the sense that damages resulted.

In the *Murray* decision, while the court found that there was a special relationship giving rise to a duty of care, it also found that no misrepresentation had been made and the plaintiff was unsuccessful.

In its reasons, the court in *Murray* relied upon the decision of the Supreme Court of Canada in *Queen v. Cognos*[54]. In that case, the court stated the following propositions:

1. There are five general requirements for a successful claim for the tort of negligent misrepresentation: (1) there must be a duty of care based on a "special relationship" between the representor and the representee; (2) the representation in question must be untrue, inaccurate, or misleading; (3) the representor must have acted negligently in making the misrepresentation; (4) the representee must have relied, in a reasonable manner, on the negligent misrepresentation; and (5) the reliance must have been detrimental to the representee in the sense that damages resulted;

2. An action in tort for negligent misrepresentation may lie even though the relevant parties to the action are in a contractual relationship. The fact that the alleged negligent misrepresentations are made in a pre-contractual setting, such as during negotiations or in the course of an employment hiring interview, and the fact that a contract is subsequently entered into by the parties do not, in themselves, bar an action in tort for damages caused by the misrepresentations.

3. Depending on the circumstances, however, the subsequent contract may play a very important role in determining whether or not, and to what extent, a claim for negligent misrepresentation will succeed. Such a contract can have the effect of negating the action in tort and of confining the plaintiff to whatever remedies are available under the law of contract. Moreover, even if the tort claim is not barred altogether by the contract, the duty or liability of the defendant with respect to negligent misrepresentations may be limited or excluded by a term of the subsequent contract so as to diminish or extinguish the plaintiff's remedy in tort. Equally, however, there are cases where the subsequent contract will have no effect whatsoever on the plaintiff's claim for damages in tort.

Moreover, although addressed elsewhere in this paper, even absent the fair dealing obligations set out in section 3 of the *Act*, the good faith requirements of common law may require a franchisor to advise the prospective franchisee of potential difficulties by providing accurate financial disclosure, particularly given that such information is available to the franchisor alone.[55]

Knowing that allegations of misrepresentations will continue to be asserted by franchisees, how have franchisors attempted to protect themselves? As, or more importantly, how effective have such methods

[54] *Queen v Cognos Inc* [1993] 1 SCR 87.

[55] See for example, *Machias v Mr. Submarine Ltd.* (2002), 24 B.L.R. (3d) 228 (Ont SCJ) [*Machias*]; *Perfect Portions Holding Co. v New Futures Ltd.* [1995] OJ No. 2113 (Gen Div) [*Perfect Portions*].

been? These strategies employed generally fall into one of two categories. The first is the inclusion of certain provisions in the franchise agreement and related documents. The second is what I would refer to as a "best practices" approach to dealing with franchisees.

I have not chosen to segregate these topics in "defensive drafting" and "best practices" sections below, simply because there is often overlap between them and some of the topics tend to extend or lead into others. It will be quite obvious from the context however, into which general approach the strategies fall.

It should also be noted that while it may seem that the decision to employ some or all of these strategies ought to be a simple one, there will inevitably be a number of factors that may lead to a franchisor deciding not to do so. Some will be perceived as too costly to implement. Others may tend to make the franchise appear less attractive to prospective franchisees, and therefore will no doubt trigger strong resistance from the franchisor's sales staff, particularly where such staff's income is dependent on sales performance. For the purposes of this paper, these business decisions are not addressed and the strategies discussed below are considered only insofar as they insulate the franchisor from later attack.

In the end result, each franchisor will determine what works best for it and whether the additional protections some of these strategies may provide are outweighed by the perceived or actual disadvantages attendant thereto.

Accordingly, keeping in mind these cautionary observations, consideration should be given to the following:

2. Exclusionary Clauses: Non Waiver and Entire Agreement Clauses

Historically, the franchisors' most frequently used tool to limit claims based on allegations of conduct inconsistent with the provisions of its franchise agreement has been the use of various exclusion clauses, such as those which require that changes to the agreement to be in writing, what are referred to as the "non-waiver" provisions, and the ever present "entire agreement clauses".

While these provisions have been of some assistance in limiting franchisees' successes, their efficacy is, by their very nature, limited and cannot be relied upon.

A decision which clearly illustrates this point is the seminal decision of the Ontario Court of Appeal in *Shelanu Inc. v. Print Three Franchising Corp*[56]. In this case, the court had occasion to review the applicability of various exclusion clauses in a franchise agreement, as they related to oral representations made *after* the execution of the said agreement. In addressing this issue, the Honourable Justice Weiler stated the following:

> 28 The paragraphs in the written franchise agreement which the appellant submits are contrary to the oral agreement are paragraph 20 (delay in exercising a right or breach of default is not waiver of right), paragraph 26 (no waiver, amendment or change of any terms unless signed by all parties) and paragraph 27 (this [written] agreement constitutes the entire agreement between the parties with respect to all matters herein)…
>
> 31 Paragraphs 20, 26, and 27 are not limitation or exclusion clauses in the traditional sense that they limit or exclude liability for damages for breach of contract or for a tort connected to the contract. Their purpose is, rather, to limit the parties' duties to each other to what has been reduced to writing and, as a corollary, to exclude any other duties. More specifically, an entire

[56] *Shelanu Inc. v Print Three Franchising Corp* [2003] 172 O.A.C. 78 (Ont CA); rev'g in part (2000), BLR (3d) 69 (Ont SCJ) [*Shelanu*]

> agreement clause seeks to exclude liability for statements other than those set out in the written contract and is sometimes referred to as an exclusion clause…
>
> 32 … In construing an exclusion clause, the issue to be addressed is whether, as a matter of construction, the exclusion clause covers the alleged occurrence or breach in question. **Exclusion clauses are to be approached with the aid of the cardinal rules of contractual construction: t****hey must be read *contra proferentem* and clear words are necessary for the exclusion clause to apply.** See *Photo Production Ltd. v. Securicor Transport Ltd.*, [1980] A.C. 827 (U.K. H.L.) per Lord Wilberforce at 846, cited by Dickson C.J. at 458-459 of his judgment.
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> 33. **When the exclusion clause covers the alleged occurrence or breach, the question is whether to enforce the exclusion clause. Where the court is of the opinion extreme unfairness would result from the enforcement of an exclusion clause, such as, for example, where there was inequality of bargaining power, this concern should be addressed directly through the doctrine of unconscionability**…(emphasis added)[57]

In the end result, Justice Weiler found that paragraphs 20 and 26, strictly construed, did not apply to the facts of the matter before her. She also observed that entire agreement clauses are normally used to try to exclude representations made *prior* to the signing of written agreements. In this instance, she determined that nothing in this provision suggested that an oral agreement made *subsequently* would be excluded.

Although the court acknowledged that the foregoing findings were sufficient to have disposed of the matter, Justice Weiler also commented on the enforceability of such exclusion clauses. The court found that enforcing the exclusionary clauses in this instance, where they were contrary to the reasonable expectation and understanding of the parties, would not be fair or reasonable. In coming to that conclusion, she observed the following:

> 58 **I would also note that the agreement that we are dealing with is a franchise agreement. A franchise agreement is a type of contract of adhesion, that is, a type of contract whose main provisions are presented on a "take it or leave it basis". In such situations, the case for holding that an exclusion clause represents the intention of the signer and that the signer should be bound by it is weaker because there is usually an inherent inequality of bargaining power between the parties.**..[emphasis added][58]

In addition to these comments, courts have often refused to apply an entire agreement clause if the contract in which it was found was induced by misrepresentation. Typical of this judicial approach is this statement of the Honourable Justice Wilson in *Machias v Mr. Submarine Ltd.*[59] where she reviewed the jurisprudence and found that:

> 107. Many of the noted cases share a common theme. Specific misrepresentations were made to a potential franchisee with respect to projected earnings and/or expenses of the franchise. The result was a distorted, overly optimistic financial projection that did not accord with reality. **In all of these decisions, the courts refused to apply the entire agreement, independent investigation or disclaimer clauses and found that the independent tort of misrepresentation had been established. Alternatively, the courts concluded that to strictly enforce the governing agreement would be unconscionable. The franchisees in these cases were successful in their claims for rescission or damages.** [emphasis added]
>
> 108. […]

[57] *Shelanu, supra* note 23 at paras 28-33.
[58] *Ibid* at para 58.
[59] *Machias, supra* note 22.

> 109. A recurrent theme in these cases is the inherent inequality of bargaining power between an established franchisor and an individual franchisee, as well as the unique inter-dependant relationship between franchisor and franchisee. [60]

Given that franchisors can assume that in a dispute, their exclusionary clauses will generally be interpreted in a manner consistent with the approaches taken in the *Shelanu* and *Machias* decisions, it would be easy to conclude that clauses of this nature in franchise agreements will be of limited or possibly no utility. What therefore can be done to maximize their effect?

It is clear that it will be very difficult to convince a court that although the impugned representations are found to have been made, the exclusion clauses should act to insulate the franchisor from their effect. However, what a franchisor can do is add to the various exclusionary clauses, a provision which limits the liability that a franchisor may face should claims of misrepresentation be asserted. While the courts will likely view such a clause critically and continue to apply the principle of *contra proferentem,* at least the franchisor will not be faced with the conundrum created where a clause says that certain representations were not made but the evidence clearly reflects otherwise.

Moreover, some of these clauses, suitably modified and coupled with several other steps available to franchisors may convince a court that the representation were either not made, or if made, not relied upon. For instance, instead of having the exclusionary clauses buried somewhere in the "General Provisions" section near the end of the Franchise Agreement, a franchisor could have terms placed in one or more pages, in capitalized, bold print, attached to the front of the Franchise Agreement. The franchisor could also insist that the franchisee confirm that he or she has read each exclusionary clause by providing his or her initials in the appropriate space beside each such clause.

In addition, the franchisor can have the franchisee execute an acknowledgment on the page where such clauses appear, confirming that he or she has read and understood such provisions and has consulted counsel, or at least been given the opportunity to do so, before affixing his or her signature.

All of these strategies may be of limited utility. One strategy, however, which may be effectively used to rebut an allegation that the execution of the franchise agreement was induced by misrepresentations, is the use of a questionnaire.

In using such a mechanism, the franchisor would require, as a condition of executing the franchise agreement, that the franchisee be obliged to complete the questionnaire. The questionnaire may be structured so that the franchisee is obliged to check a "yes" or "no" box beside specific questions relating to alleged representations. Undoubtedly, that will lead to allegations that the franchisor checked off the various boxes and required the franchisee to place his or her initials beside them. In the alternative, it may be alleged that the franchisee's initials were signed to a blank questionnaire, which the franchisor completed later. Accordingly, a better and more persuasive way of implementing this strategy is to require an answer that will force the franchisee to read the question and to take affirmative steps to respond. An example of this approach might be to ask the franchisee whether he or she was told anything about future anticipated income, sales or expenses concerning the prospective franchise. If an affirmative answer is provided, then the next question should require the franchisee to provide details about what was allegedly said and to identify the person who made the representation.

The best approach however, in terms of demonstrating that conscious, considered and voluntary responses were given, is simply to ask the franchisee to briefly describe what he or she was told about the

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[60] *Machias, supra* note 22 at paras 107-09.

franchise's future sales, income and expenses at a later time. If the franchisee responds by stating that there were no such representations, it may be difficult for them to make claims later to the opposite effect.

3. Statutory Misrepresentations

There are various rights of rescission provided under section 6 of the *Act*. These must be enacted under very strictly enforced time periods. Without presently addressing the issue of when the courts have found that no disclosure document has been provided (even when documents containing many of both the prescribed and defined material facts are included), a franchisee's rights to rescission must be asserted within:

(a) 60 days after receipt of a disclosure document "if the franchisor failed to provide the disclosure document or a statement of material change within the time required by section 5 or if the contents of the disclosure document did not meet the requirements of section 5." [add footnote] or

(b) 2 years "after entering into the franchise agreement if the franchisor never provided the disclosure document" [61]

The law is clear that where a specific period of time is provided within which certain actions must be taken and starting from a clearly described event, then the issue of "discoverability" which would normally apply to determine whether a limitation period has expired, is irrelevant.[62]

However, all is not lost since the strict temporal provisions of subsections 6(1) and (2) do not apply to section 7 of the *Act*, which provides a franchisee with a remedy of damages against the franchisor, the franchisor's agent, broker or associate and anyone who signed the disclosure document or statement of material change, where a franchisee suffers a loss because of:

(a) A misrepresentation contained in the disclosure document;
(b) A misrepresentation contained in a statement of a material change; or
(c) The franchisor's failure to comply in any way with section 5 of the *Act*.[63]

Section 7 must be read carefully because of, among other things, the following:

- The misrepresentation must be contained in a disclosure document or in a statement of material change. Common law misrepresentations, unless they also fall within the obligations relating to a disclosure document, are not included;

- The misrepresentation does not need to be one of commission or omission in that if there is a failure to comply with the section 5 disclosure obligations "in any way", then the relief in section 7 is triggered;

- Because of the fact that there is no period of time set out within which to act, the usual provisions under section 4 of the Ontario *Limitations Act*[64] apply. This brings into play the principle of discoverability and accordingly would extend the period in which to commence a claim from the date when the cause of action was "discovered" as that term is used in the *Limitations Act*. This,

[61] *Act, supra* note 1 at s.6.
[62] See for example, *Waschkowski v. Hopkinson Estate* [2000] 47 OR (3d) 370 (Ont CA).
[63] *Act, supra* note 1 at s.7
[64] *Limitations Act*, 2002, S.O. 2002, c. 24, Sched. B.

of course, raises a number of issues since actual discovery is not required and the period of limitations would also start to run when the cause of action ought reasonably to have been discovered; [65]

- The claims that can be asserted are not limited just to the franchisor, but also to the franchisor's agent, the franchisor's broker and every person who signs the disclosure document or statement of material change. This would include, where a corporation has more than 1 officer and director, 2 officers or directors thereof ; and [66]

- Of significant important, subsection 7(2) of the *Act*, provides that there is deemed reliance by the franchisee on the misrepresentation. Moreover, there is no reference in the subsection to the deemed reliance being rebuttable. Other statutes, which have used similar concepts, have employed clear and unambiguous language in this regard. For instance, sections 95(1) and (2) of the *Bankruptcy and Insolvency Act* (the "*BIA*")[67] as amended, dealing with preferences, provide as follows:

> 95(1) A transfer of property made, a provision of services made, a charge on property made, an obligation incurred or a judicial proceeding taken or suffered by an insolvent person:
>
> (a) In favour of a creditor who is dealing at arm's length with the insolvent person…with a view to giving that creditor a preference over another creditor is void as against…the trustee if it is made, incurred, taken or suffered, as the case may be, during the period beginning on the date that is three months before the date of the initial bankruptcy event and ending on the date of the bankruptcy; and
>
> (b) In favour of a creditor who is not dealing at arm's length with the insolvent person…that has the effect of giving that creditor a preference over another creditor is void as against…the trustee if it is made, incurred, taken or suffered…during the period beginning on the day that is 12 months before the date of the initial bankruptcy event and ending on the date of the bankruptcy;
>
> (2) If the transfer, charge, payment, obligation or judicial proceeding referred to in paragraph 1(a) has the effect of giving any creditor a preference, it is, *in the absence of evidence to the contrary, presumed to have been made*, incurred, taken or suffered with a view to giving the creditor the preference – even if it was made, incurred, taken or suffered…under pressure – and evidence of pressure is not admissible to support the transaction[68] [emphasis added]

First, it may be argued that as a matter of law, there is a difference between "deemed" and "presumed". Regardless however, the absence of any provision in the *Act* comparable to section 95(2) of the *BIA*, might suggest that the "deeming" provision in section 7(2) is not rebuttable. Conversely however, given that the draftsman simply didn't address the issue at all, it is equally arguable that if such presumption was to be absolute, the *Act* would have said so.

- Subsection 7(3) provides a similar right of relief relating to the franchisor's failure to comply with the obligations under section 5 of the *Act*.

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[65] *Limitations Act, supra* note 30 at s.5
[66] O. Reg. *supra* note 2 at s. 7.2
[67] *Bankruptcy and Insolvency Act*, R.S.C., 1985, c. B-3 [*BIA*]
[68] *BIA, supra* note 33 at s. 95.

- Subsection 7(4) provides that a person is not liable under section 7 if it can be proven that the franchisee acquired the franchise with knowledge of the misrepresentation or a failure to comply with the disclosure obligations under section 5 of the *Act*.

- Next, subsection 7(5) provides other defences to a "person" in regard to claims made under section 7. Subsections 7(5) (a) and (b) address such person's lack of knowledge of the misrepresentation in the disclosure document or statement of material change and require the person to provide notice to the franchisee of the person's lack of knowledge or to withdraw any consent, if one had been provided.

- Subsection 7(5) (c) is a little different in that if a statement in the disclosure document or statement of material change was made on the authority of an expert, or purports to be a copy of or an extract of an expert's report or opinion, the "person" will not be liable if he or she had no reasonable grounds to believe that such statement was not a misrepresentation and did not believe that there had been a misrepresentation, the disclosure document did not fairly represent the report or opinion or that the portion included was not a fair copy or extract form the report or opinion of the expert.

4. Hot Spots-An Example

One of the most contentious areas of dispute is that relating to earnings projections or representations made about the future success of the franchise. Although the *Act* requires that when earnings projections are made, certain other disclosure obligations, addressed earlier in this paper, are triggered, this still remains an area fraught with danger.

The quality of the new franchisee as a business operator may not be what was expected. New competitors may move into areas in close proximity with the franchise. Economic conditions may change. Where the franchise depends on a specific population of customers, such as a food service operation situated in a stand-alone office tower, a major tenant may be in the process of leaving.

Other potential problems, not always recognized, include the differences between mall locations and store fronts and large metropolitan areas and smaller urban centres. Experienced franchisors provide a detailed breakdown recognizing these differences. Other less experienced or less upstanding franchisors do not.

In some of the instances cited above, the franchisor could not reasonably be expected to know of the existence of factors that leads to later problems. Nonetheless, earnings projections, even with the appropriate *caveats*, may give rise to subsequent litigation.

Specific problems also arise where a corporate store is being sold to a franchisee. With or without earning projections or representations, the past financial performance of that particular store is a material fact under the *Act* and ought to be disclosed.

While it is beyond the scope of this paper to outline all of the hotspots giving rise to misrepresentation claims, or even a significant number arising from earnings claims, in today's world franchisors have to carefully consider whether the possible business advantages gained in including information, even if wholly factual, relating to financial performance is worth the risks.

F. DISPUTES RELATING TO THE DUTY OF GOOD FAITH AND THE RIGHT TO ASSOCIATE

1. Common Law Duty of Good Faith

The courts in Canada have long accepted the proposition that quite aside from any requirements imposed by statute, an implied duty of good faith is imposed on the parties to a contract to ensure that their respective obligations are carried out in good faith. However, this duty of good faith is tied to the provisions of the agreement, does not exist in the air and cannot create or undo the terms and provisions of the contract in question. [69]

The duty of good faith has been defined in many different ways by the courts. For instance, it has stated that good faith must include, at a minimum, that a party be candid, reasonable, honest, forthright and fair[70]. Conversely, the courts have determined that one party must have regard to the legitimate interests of the other, and have inserted as component elements thereof, the concepts of loyalty and respect.[71] However, although this duty exists in regard to carrying out the terms of an existing contract, the law is clear that there is no duty to negotiate such contract in good faith. [72]

In addition, the courts have not always been consistent in their interpretation of how far the common law duty of good faith extends. For instance, in *Perfect Portions*[73], the Honourable Justice Fleury characterized the duty owed between franchisors and franchisees as one of the "utmost good faith", somewhat akin to the duty imposed on insurers in regard to how they deal with their insureds. Somewhat surprisingly, this description was subsequently adopted in *Machias*[74] and also in *1176560 Ontario Ltd. v. Great Atlantic & Pacific Company of Canada Ltd.*[75]

However, notwithstanding these repeated references to the "utmost good faith", it has now generally been accepted that such higher duty does not exist within the contractual framework of a franchise relationship.[76]

The common law duty of good faith imposed on the parties to a contract, ought not to be confused with the duties imposed on fiduciaries. That is not to say that under certain circumstances, a fiduciary duty could not arise within the context of a franchise relationship. So, for example, if:

a. The franchisor has power or discretion;
b. The franchisor can exercise such power or discretion unilaterally so as to affect the franchisee's legal or practical interests; and
c. The franchisee is particularly vulnerable or dependent on the franchisor,

then fiduciary obligations may arise.

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[69] See for example, *Agribrands Purina Canada Inc. v Kasamekas* 2011 ONCA 460 at para 51; *Transamerica Life Canada Inc. v ING Canada Inc.* (2003), 68 OR (3d) 457 (Ont CA) [*Transamerica*]; *1193430 Ontario Inc. v. Boa-Franc Inc*. [2005], 78 OR (3d) 81 (CA) leave to appeal to S.C.C. refused [2006] SCCA No 2.

[70] *Wallace v. United Grain Growers Ltd.* [1979] SCR 701.

[71] *Machias, supra* note 22; *Shelanu, supra* note 23.

[72] See for example, *978011 Ontario Ltd. v Cornell Engineering Co.* (2001), 53 O.R. (3d) 783 (Ont CA) and *Transamerica, supra* note 35 at paras 52- 53 and 56.

[73] *Perfect Portions, supra* note 22 at para 14.

[74] *Machias, supra* note 22 at para 121.

[75] *1176560 Ontario Ltd v Great Atlantic & Pacific Company of Canada Ltd* (2002), 62 OR (3d) 535 (Ont SCJ) at paras 86-88.

[76] See for example, *TDL Group Ltd. v. Zabco Holdings Inc,* 2008 MBQB 239.

In the absence of the foregoing however, the courts have consistently found that unlike relationships which by their very nature carry with them fiduciary obligations (i.e. lawyer-client), no fiduciary relationship arises merely out the execution of a franchise agreement.[77]

In this regard, the comments of the Court of Appeal in *Shelanu* are of particular interest. At paragraphs 68 to 71 of its decision, Justice Weiler, writing for the court, stated the following:

> 68 The imposition of a duty of good faith and a fiduciary duty are closely related. As stated in *Cornell Engineering Co.*, *supra* at para. 33 they, along with the standard of unconscionability:
>
> [a]re points on a continuum in which the law acknowledges a limitation on the principle of self-reliance and imposes an obligation to respect the interests of the other. They are defined by P. Finn, "The Fiduciary Principle" in T. Youdan, ed., *Equity, Fiduciaries and Trusts*, (1989), 1 at 4 as follows:
>
> "Unconscionability" accepts that one party is entitled as of course to act self-interestedly in his actions towards the other. Yet in deference to that other's interests, it then proscribes excessively self-interested or exploitative conduct. *"Good faith," while permitting a party to act self-interestedly, nonetheless qualifies this by positively requiring that party, in his decision and action, to have regard to the legitimate interests therein of the other*. The "fiduciary" standard for its part enjoins one party to act in the interests of the other — to act selflessly and with undivided loyalty. There is, in other words, a progression from the first to the third: from selfish behaviour to selfless behaviour. Much the most contentious of the trio is the second, "good faith." It often goes unacknowledged. It does embody characteristics to be found in the other two [footnotes omitted].
>
> 69 There is at least one important difference between the duty of good faith and a fiduciary duty. If, for example, A owes a fiduciary duty to B, A must act only in accordance with B's interests when A exercises its powers or exercises a discretion arising out of the relationship: see *York Condominium Corp. No. 167 v. Newrey Holdings Ltd.* (1981), 122 D.L.R. (3d) 280 (Ont. C.A.), at 289, leave to appeal to the Supreme Court of Canada refused [1981] 1 S.C.R. xi (S.C.C.); *Hodgkinson v. Simms*, [1994] 3 S.C.R. 377 (S.C.C.). If, on the other hand, A owes a duty of good faith to B, A must give consideration to B's interests as well as to its own interests before exercising its power. Thus, if A owes a duty of good faith to B, so long as A deals honestly and reasonably with B, B's interests are not necessarily paramount: see for example *Freedman v. Mason*, [1958] S.C.R. 483 (S.C.C.).
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> 70 The trial judge recognized that the relationship between a franchisor and a franchisee would not normally be characterized as a fiduciary one in accordance with *Jirna Ltd. v. Mister Donut of Canada Ltd.* (1971), [1972] 1 O.R. 251 (Ont. C.A.), aff'd, (1973), [1975] 1 S.C.R. 2 (S.C.C.). I do not agree that it logically follows from the trial judge's reference to partners that he applied the fiduciary standard in this case. At a later point in his reasons, the trial judge reiterated that a franchise relationship was akin to that of a partnership and, accordingly, like a partnership required mutual respect. He quoted from the decision of Kelly J. in *Gateway Realty Ltd. v. Arton Holdings Ltd. (No. 3)* (1991), 106 N.S.R. (2d) 180 (N.S. T.D.), at 191-192, aff'd (1992), 112 N.S.R. (2d) 180 (N.S. C.A.), to the effect that parties to a contract are required to exercise their rights under that agreement honestly, fairly, and in good faith, and that, when a party acts contrary to community standards of honesty and reasonableness or fairness, he acts in bad faith. The trial judge well knew the distinction between a duty of good faith and a fiduciary duty and did not hold Print Three to a fiduciary duty.
>
> 71 Moreover, the fact that contractual terms are ultimately complied with, does not mean that

[77] See for example, *887574 Ontario Inc. v Pizza Pizza Ltd*. (1994), 23 BLR (2d) 239 (Gen. Div.), leave to appeal ref'd [1994], 35 C.P.C. (3d) 323; *Jirna Ltd. v Mister Donut of Canada Ltd*. (1973), 40 DLR (3d) 303 (SCC); *Shelanu, supra* note 23.

there has been no breach of the duty of good faith.[78]

Not surprisingly, although different courts have at different times tried to define good faith, such definitions have not always been consistent.

Statutory Duty of Fair Dealing

Section 3 of the *Act* provides that a duty of fair dealing is imposed on each party in its performance and enforcement of a franchise agreement.[79] It also provides that the duty of fair dealing *includes* good faith and reasonable commercial standards. It is hard to imagine at this stage what other duty might be included as a component of fair dealing and to date, no case has addressed this issue.[80]

Of significant importance is the fact that Section 3 also provides a party to a franchise agreement with an independent right of action against another party to the franchise agreement who breaches the duty of fair dealing in the performance or enforcement of that franchise agreement. More is set out about this right of action below.

Moreover, unlike most of the provisions of the *Act*, which take effect from the date the statute came into effect, section 3 applies, in accordance with subsection 2(2) of the *Act*, retroactively with respect to a franchise agreement entered into before the coming into force of the section if the business operated by the franchisee under such agreement, is operated or to be operated, partly or wholly in Ontario.

As mentioned above, Canadian courts have not recognized a stand-alone duty of good faith independent from the terms of the contract or from the objectives that emerge from those terms.[81] In this regard, the provisions of section 3 of the *Act* clearly reflect this principle and limit the duty of fair dealing to the "performance and enforcement" of the terms of the franchise agreement.

Accordingly, the courts have held that while the duty of fair dealing applies to the conduct of the parties in the implementation of the contractual terms, it does not affect the interpretation of renewal provisions in a franchise agreement and is not intended to change the terms of the contract.[82]

The requirement to comply with the fair dealing provisions in section 3 permeates not only the *Act*, but has repercussions to the franchisor-franchisee relationship as well as how franchise agreements are and will be drafted.

By way of example, many franchise agreements formerly referred to franchisors having certain rights which they could exercise "in their sole and unfettered discretion". Given the fair dealing obligations, coupled with section 11 of the *Act*, which makes any purported waiver or release by a franchisee of a right given thereunder, or any obligation or requirement imposed on a franchisor under the said *Act*, void, the word "unfettered" may have become essentially meaningless. Lawyers who are drafting franchise agreements should accordingly be well advised to frame the franchisor's rights in absolute terms, with the word "discretion" nowhere to be found. If discretion is to be exercised, given the duty of fair dealing, it must be for proper and defendable purposes and not to punish a franchisee perceived as wayward or as an instigator of system wide complaints.

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[78] *Shelanu*, *supra* note 23 at paras 68-71.
[79] *Act*, *supra* note 1 at s. 3(1).
[80] *Act*, *supra* note 1 at s. 3(3).
[81] *Transamerica*, *supra* note 35.
[82] *Pointts Advisory Ltd v 754974 Ontario Inc*, 2006 CarswellOnt 5293 (Ont SCJ).

As briefly referenced herein, the duty of fair dealing in section 3 may become of central importance when a renewal of a franchise agreement is in issue. It is clear that where the term of the contract is for a set or stipulated time with no right of renewal contained therein, the obligations of fair dealing will not create such a right. In *Retail Inc. v Blanaru*[83], quoted in *33177447 Manitoba Ltd. v. Beaver Lumber Inc*.[84], the court made the following statement:

> It is one thing to say that good faith may be employed so that one party cannot harm the other in exercising the other's rights under the agreement or, to put it another way, that one party cannot prevent the other from securing bargained benefits. It is another to say that, absent elements of this character, good faith can be utilized to provide for something unbargained.[85]

However, the issue becomes significantly more complicated when a franchisee has been lead by the franchisor, by words or actions, to believe that a new term will be provided at the expiration of the old, even where no express right of renewal exists. One example would be the franchisor forcing the franchisee to engage in a major, extensive and costly renovation 2 years prior the expiration of the term under circumstances where the costs of such renovation could never be recouped absent a new term being provided.

Lastly, in the Court of Appeal's decision in *Salah v Timothy's Coffees of the World Inc*.[86], an Ontario Court awarded damages specifically for a breach of the duty of fair dealing. The decision was written by Winkler, CJO, who stated, among other things, the following:

> In summary, I am in agreement with the trial judge that s. 3(2) of the Wishart Act permits an award of damages for the breach of the duty of good faith, separate and in addition to any award in compensation of pecuniary losses...[87]

Statutory Right to Associate

Section 4 of the *Act* creates a new right for franchisees-the right to associate.

More particularly, the section:

(a) Permits franchisees to associate with other franchisees and to form or join an organization of franchisees[88];
(b) Prevents franchisors from interfering with, prohibiting or restricting, by contract or otherwise, a franchisee from forming or joining an organization of franchisees or from associating with other franchisees[89];
(c) Prevents a franchisor from, whether directly or indirectly, penalizing, attempting to penalize or threatening to penalize a franchisee from exercising its rights under this section[90]; and
(d) Provides that any provision in a franchise agreement "or any other agreement relating to a franchise" which purports to interfere with, prohibits or restrict a franchisee from exercising any right under this section, is void.[91]

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[83] *Imasco Retail Inc. v Blanaru* (1995), 9 W.W.R. 44 (Man QB).
[84] *33177447 Manitoba Ltd. v Beaver Lumber Inc*. 2006 SKQB 414 [*Beaver Lumber*].
[85] *Beaver Lumber*, *supra* note 50 at para 26.
[86] *Salah v Timothy's Coffees of the World Inc*. 2010 ONCA 673; aff'g (2010), 65 BLR (4th) 235.

[87] *Ibid* at para 29.
[88] *Act*, *supra* note 1 at s. 4(1).
[89] *Act*, *supra* note 1 at s. 4(2).
[90] *Act*, *supra* note 1 at s. 4(3).

This section has also been the subject of significant judicial attention recently.

In *405341 Ontario Limited v. Midas Canada Inc.*[92] a number of issues relating to the rights afforded under section 4 were canvassed.

Although this was a class proceeding which dealt with various other issues, one of the disputes that arose during the pendency of the matter related to the expiration of the representative plaintiff's franchise agreement. As is the case in virtually every franchise agreement, the right to renew was conditional upon the franchisee providing a general release of the franchisor.

The motion judge, from whose decision Midas had appealed, found that the pre-existing provision in the franchise agreement which required delivery of such a release was subject to the overriding provisions of the *Act*. He also found that if such provision interfered with the franchisees' right of association and if it required the franchisees to release rights under the *Act*, then it was void. Conversely, the motions judge rejected the franchisor's argument that the franchisees were not obliged to exercise their rights of renewal and thereby bring the release requirement into play, referring to the same as being "of no relevance". Accordingly, for various reasons, including breach of section 4(4) of the *Act*, the motion judge found the impugned provision void.

More particularly, the motions judge found that when read within the context of the *Act*, the right of association in section 4 does encompass the right of franchisees to participate in a class action for the purpose of enforcing their rights. He concluded by finding that section 4's inclusion in the statute would be inexplicable if it was not intended to permit franchisees to associate for the purpose of protecting their interests and enforcing their rights through collective action.

All of the findings of the motions judge were upheld on appeal.

In *1318214 Ontario Ltd. v. Sobeys Capital Inc.*[93], certain franchisees were concerned about the defendant's *pro forma* projections for the upcoming year and hired counsel to represent them to address this issue. Sobeys however, under its low equity program in which these franchisees were involved, restricted each store to paying a maximum of $2,000 per year to outside counsel. The franchisees in question withdrew significantly more than the $2,000 each for the purpose of funding counsel. Sobeys indicated it intended to terminate the franchise agreements after sending notices of default concerning the withdrawal of such amounts. It also advised that if the excess funds were not returned, it would terminate and re-possess the franchises in question. The franchisees-plaintiff commenced an action and brought a motion for injunctive relief.

In addressing the first part of the test for injunctive relief, the court found that there was a serious issue to be tried concerning whether the franchisees had breached the provision relating to the removal of corporate funds for litigation purposes, as well as the interpretation, scope and enforceability of such provision.

Justice Conway also addressed the franchisees' submission that by restricting their access to funds for legal fees and terminating the agreements of those franchisees who withdrew such funds, Sobeys was

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[91] *Act*, *supra* note 1 at s. 4(4).
[92] *405341 Ontario Limited v Midas Canada Inc.* [2009], 64 BLR (4th) 251; aff'd 2010 ONCA 478.

[93] *1318214 Ontario Ltd. v Sobeys Capital Inc*. 2010 ONSC 4141.

interfering with their right of association contrary to section 4 of the *Act.* After quoting from the decision in *Midas*, she stated the following:

> 31 This is not a class proceeding, but it is a collective effort of the Franchisees to enforce their rights. I find that there is a serious issue to be tried as to whether the issuance of the Notices and proposed terminations under these circumstances amount to an interference with the Franchisees' ability to pursue collective action against the franchisor contrary to the Act.[94]

So where will section 4 take us next? It has been used to form a triable issue on such seemingly unrelated subjects as whether a franchisor can restrict the use of its franchisees' in regard to litigation brought against it. It has been applied to support the proposition that franchisees had a right to associate to protect their interests and enforce their rights through collective action.

G. COMMON CONTRACTUAL TROUBLE SPOTS, INCLUDING CLAIMS RELATING TO ADVERTISING FUNDS, THE SUPPLY CHAIN, RENEWALS AND RE-SALES

Franchise disputes may include one or more of the following types of claims:

- pre-contractual misrepresentations (innocent, negligent or fraudulent)
- contractual breach
- contractual failure to perform
- fundamental breach
- breach of the duty of fair dealing
- breach of the right to associate
- no disclosure
- incomplete disclosure

As most franchise disputes are factually dependent, and pertain to specific provisions of the franchise agreement, it is difficult to generalize the exact nature of all such disputes. However, there are a number of provisions in a typical franchise agreement which can be the source of disputes between the parties. The fundamental principal for both parties is to ensure that the provisions of the agreement with respect to these items are clear, unambiguous and drafted with certainty. While the parties will be subject to the duty of fair dealing in respect of their performance and enforcement of the franchise agreement, where the agreement is precise and unambiguous in its wording, the duty of fair dealing will only apply to the enforcement and performance of the specific provisions, and will not be used by a court to modify or interpret the provisions in what would be considered to be a "fair manner". However, the courts have clearly stated that, in the event of ambiguity or uncertainty, they will interpret the agreement against the interest of the party that prepared, which consequentially means in favour of the franchisee.

The following are typical provisions of a franchise agreement which may give rise to a dispute between the parties:

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[94] *Ibid* at Para 31.

- grant of rights, including reserved rights and territorial exclusivity
- encroachment by the franchisor, including operation of corporate locations
- conflict between the period of time for which the franchise is granted and the period of time for which the franchisee is permitted under a lease or sublease to occupy premises
- renewals and renewal conditions, including
    - right to renew
    - term
    - fees
    - conditions of renewal
    - execution of then current form of agreement
    - releases (subject to *Midas* decision)
- obligations of franchisee, including
    - upgrading and renovations
    - products and services
    - full time and attention
- pricing of products and/or services
    - competitive prices
    - full line purchasing
- supply arrangements
    - approved suppliers
    - pricing and terms of purchase and supply
- non-competition
    - in-term
    - post-term
    - parties
- confidentiality

  - parties
- transfers and assignments for franchise
  - by franchisees
  - by franchisee owners
  - by franchisor
- trade-marks
  - current status
  - indemnity
  - right of franchisor to change
- system changes
  - application of operations manual
  - right of franchisor to make changes
- defaults
- remedies on defaults
  - cure periods
  - self-help remedies
  - common law remedies
  - cross-default with other agreements
- termination
- entire agreement clause

D. LAWYERS' DUTIES RELATED TO THE CONTENT OF AND PROCESS RELATED TO FRANCHISE DISCLOSURE DOCUMENTS

Whether advising a franchisor or a franchisee, the scope of the lawyer's retainer and engagement, and the nature of the advice to be given by a lawyer, is dependent upon any specifics in the engagement and the duty of care which a reasonably prudent solicitor would exercise in carrying out the solicitor's responsibilities. Franchise law, as a specific practice area, is relatively new and constantly evolving. In view of the considerable risks to both parties should the relationship deteriorate or a dispute result, lawyers acting for either party must exercise diligence and due care to ensure that their clients are properly advised and aware of the rights and obligations for which they contract under the franchise agreement and which are available to either party under common law or statute. Further, for lawyers

acting for a franchisor, in view of the considerable exposure of franchisors to claims for rescission by franchisees alleging no or improper disclosure, and the magnitude of damages associated with such claims, combined with the propensity of franchisees in large systems to commence class actions, lawyers representing franchisors must ensure that they provide comprehensive and, ideally, written explanations of the processes involved in preparing franchise agreements, ancillary documents and disclosure documents, and the appropriate use of and requirements with respect to disclosure documents on an ongoing basis.

The following are a number of items pertaining to lawyers' duties relating to the content and use of franchise disclosure documents which lawyers should consider in respect of their client responsibility and due diligence:

- explaining the legal requirements for disclosure to the franchisor client
- explaining the consequences of failure to disclose or incomplete disclosure to the franchisor client
- the lawyer's duty to assist or give direction in gathering facts for preparation of disclosure documents
- the responsibility of the lawyer to verify or review facts contained in a disclosure document and to obtain confirmation from the franchisor regarding same
- the responsibility of the lawyer to ensure that the franchisor client is aware of the requirement to canvass the possibility of other material facts for inclusion in disclosure document
- the lawyer's duty to review and comment on draft disclosure documents for a franchisor client
- the lawyer's role in explaining the disclosure process to a franchisor and ensuring strict compliance with same
- advising a franchisor client on execution and delivery of a disclosure document, retention of duplicate documents, and obtaining confirmation of receipt
- the contents of a solicitor's report to a franchisor client on the preparation, maintenance, use and updating of a disclosure document
- the responsibility of a lawyer to advise a franchisor client on modifications to a standard disclosure document required for specific situations including renewals or extensions, re-sales or transfers, new franchises, and corporate sales
- the lawyer's duty if the lawyer suspects incomplete or inaccurate disclosure
- the lawyer's duty if the lawyer suspects improper, misleading or fraudulent disclosure
- should a franchisor lawyer advise the lawyer's client to require a certificate of independent legal advice from each franchisee and explain the consequences of not obtaining same
- the role of a franchisee lawyer in reviewing a disclosure document with the franchisee client
- the obligation of a franchisee lawyer to inform the franchisor or the franchisor's lawyer if the franchisee lawyer is aware of incomplete, misleading or non-disclosure.

- what should a franchisor lawyer do if the lawyer is aware that a franchisee has not received legal advice before signing a franchise agreement or paying consideration for a franchise
- what reporting should a lawyer do to a franchisee client
- what limitations should a lawyer include in an engagement letter when acting for a franchisor
- what limitations should a lawyer include in an engagement letter when acting for a franchisee
- if a lawyer acts for a franchisee in a particular system, is the lawyer precluded from acting for the franchisor on another matter not specifically related to the original franchisee client

Authors' Disclosure

Teplitsky, Colson LLP was counsel of record in the following cases noted above:

4287975 Canada Inc. v Imvescor Restaurants Inc. 2009 ONCA 308; aff'g (2008), 91 OR (3d) 705 (Ont SCJ).

2189205 Ontario Inc. v Springdale Pizza Depot Ltd. 2011 ONCA 467; aff'g 2010 ONSC 3695 (Ont SCJ).

Osler LLP was counsel of record in the following cases noted above:

TA&K Enterprises Inc. v. Suncor Energy Products Inc., 2010 ONSC 7022; aff'd 2011 ONCA 613

1176560 Ontario Ltd v Great Atlantic & Pacific Company of Canada Ltd. (2002), 62 OR (3d) 535 (Ont SCJ)

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1176560 Ontario Ltd v Great Atlantic & Pacific Company of Canada Ltd (2002), 62 OR (3d) 535 (Ont SCJ)

1193430 Ontario Inc. v. Boa-Franc Inc. [2005], 78 OR (3d) 81 (CA) leave to appeal to S.C.C. refused [2006] SCCA No 2

1230995 Ontario Inc. v Badger Daylighting Inc. 2010 ONSC 1587; aff'd 2011 ONCA 442

1318214 Ontario Ltd. v Sobeys Capital Inc. 2010 ONSC 4141

1490664 Ontario Ltd. v Dig This Garden Retailers Ltd. (2005), 256 DLR (4th) 1 (Ont CA) [*Dig This Garden*] aff'g [2004] O.J. No. 3008 (Ont SCJ)

1518628 Ontario Inc. v Tutor Time Learning Centres LLC (2006), 150 ACWS (3d) 93 (Ont SCJ)

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2189205 Ontario Inc. v Springdale Pizza Depot Ltd 2011 ONCA 467; aff'g 2010 ONSC 3695 (Ont SCJ)

33177447 Manitoba Ltd. v Beaver Lumber Inc. 2006 SKQB 414

405341 Ontario Limited v Midas Canada Inc. [2009], 64 BLR (4th) 251; aff'd 2010 ONCA 478

4287975 Canada Inc. v Imvescor Restaurants Inc 2009 ONCA 308; aff'g (2008), 91 OR (3d) 705 (Ont SCJ)

6792341 Canada Inc. v Dollar It Ltd 2009 ONCA 385

887574 Ontario Inc. v Pizza Pizza Ltd. (1994), 23 BLR (2d) 239 (Gen. Div.), leave to appeal ref'd [1994], 35 C.P.C. (3d) 323

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Murray v TDL Group Ltd [2002] OTC 1024 (Ont SCJ)

Perfect Portions Holding Co. v New Futures Ltd. [1995] OJ No. 2113 (Gen Div)

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Salah v Timothy's Coffees of the World Inc. 2010 ONCA 673; aff'g (2010), 65 BLR (4th) 235

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