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TheFranchiseVoice

Legal Digest

BY MICHAEL MELVIN AND PATRICK KERR

LEGISLATION

A. Bill 154, *Cutting Unnecessary Red Tape Act, 2017*

As mentioned in the Fall 2017 Legal Digest, the Legislative Assembly of Ontario introduced Bill 154, *Cutting Unnecessary Red Tape Act* on September 14, 2017 ("Bill 154"). Bill 154, which is part of a government initiative to cut unnecessary red tape for Ontario businesses, amends a number of current Ontario statutes including the *Arthur Wishart Act (Franchise Disclosure), 2000*, S.O. 2000, c. 3 (the "*Wishart Act*"). Bill 154 received Royal Assent on November 14, 2017, which brought into force some, but not all, of the amendments to the *Wishart Act*.

As of November 14, 2017 the *Wishart Act* has been amended to:

1. clarify the first branch of the "franchise" definition under the Act by:
   a. clarifying that a franchisee's business may be found to be substantially associated with a trademark of the franchisor or of a franchisor's associate, even if the franchisor or franchisor's associate are licensees of the trademark, rather than owners of the trademark;
   b. clarifying that the "significant control or assistance" element of the "franchise" definition will be satisfied if the franchisor "has the right to exercise or exercises" significant control or "has the right to provide or provides" significant assistance to the franchisee in the franchisee's method of operation (previously it was unclear if a "right to exercise" significant control or a "right to provide" or "providing" significant assistance satisfied this element of the definition);
2. eliminate the term "service mark," which has no meaning in Canadian trademark law, from the Act; and
3. clarify that the *Wishart Act* does not apply to the grant of a licence of a trademark or other commercial symbol to a single licensee where the license is the only one of its general type to be granted "in Canada."

The amendments that are not yet in force, but which will come into force on a day to be named by proclamation of the Lieutenant Governor will amend the *Wishart Act* to:

1. permit franchisors to enter into confidentiality and site selection agreements with prospective franchisees prior to delivery of a disclosure document;
2. permit franchisors to accept fully refundable, non-binding deposits, that do not exceed a prescribed amount, from prospective franchisees prior to delivery of a disclosure document;
3. permit the Lieutenant Governor in Council to make regulations prescribing the content that must be included in a statement of material change;
4. broaden the disclosure exemption that applies when the franchisor grants a franchise to one of its officers or directors, or to an officer of director of the franchisor's associate, so that the exemption applies to recently departed officers and directors as well as current ones, and covers the grant of a franchise to a corporation controlled by the officer or director, rather than only a grant to an individual;
5. clarify the "fractional franchise" disclosure exemption so that a franchisor will not be required to provide a disclosure document if the projected sales of the franchise do not exceed a certain percentage of the overall revenue of the franchisee's business "during the first year of operation of the franchise," rather than on an indefinite basis;
6. clarify the "small investment" disclosure exemption, so that a franchisor may rely on the exemption if the prospective franchisee's "initial" investment does not exceed the prescribed amount. Currently, the franchisee's "annual investment to acquire and operate the franchise" may not exceed the prescribed amount;
7. clarify the "large investment" disclosure exemption so that eligibility for the exemption depends on the franchisee's "initial investment" exceeding the prescribed amount. Currently, eligibility depends on the prospective franchisee "investing in the acquisition and operation of the franchise, over a prescribed period" an amount that exceeds the prescribed amount; and
8. broaden the Lieutenant Governor's in Council's power to make regulations relating to the amendments referred to above.

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CASELAW

A. Court of Appeal Overturns *Raibex Canada Ltd. v. ASWR Franchising Corp.*

In a decision sure to reduce the stress levels of franchisors and their counsel, the Ontario Court of Appeal, in *Raibex Canada Ltd. v ASWR Franchising Corp.*, 2018 ONCA 62 ("Raibex"), overturned a 2016 summary judgment decision in which the motion judge confirmed the rescission of an AllStar Wings & Ribs franchise by the franchisee.

The franchisee sought to acquire and operate an AllStar Wings & Ribs franchise in Mississauga, Ontario. However, as is often done in the franchise industry, the parties completed the disclosure process under the *Arthur Wishart Act (Franchise Disclosure), 2000*, S.O. 2000, c. 3 and signed the franchise agreement before a site for the franchise had been located and before a head lease had been negotiated and signed.

After signing the franchise agreement, the franchisee and the franchisor chose a mutually suitable location for the franchise outlet and the franchisee agreed to a head lease condition requiring payment of a $120,000 deposit, without reviewing the head lease in full. The franchise outlet was substantially completed in March 2014. The approximate development costs were in excess of $1 million, which was higher than the franchisee expected. The franchisee refused to resolve unpaid construction invoices totaling approximately $110,000 and refused to pay the $120,000 deposit under the lease, to which it had initially agreed. The franchisee served the franchisor with a notice of rescission 20 months after signing the franchise agreement. The franchisor refused to accept the validity of the rescission notice, terminated the franchise and took over operation of the franchised location.

On a motion for summary judgment, the judge granted the franchisee's motion to rescind the franchisee agreement pursuant to s. 6(2) of the Act. In arriving at her decision, the motion judge held, among other things, that, because the franchise disclosure document did not include the terms of the head lease and did not provide cost estimates tailored to the conversion of an existing restaurant into an AllStar Wings & Ribs outlet (the estimates given were based on the build-out of a shell, rather than a conversion), the franchisor's disclosure document was so inadequate as to amount to no disclosure at all.

In response to the franchisor's submission that it could not have been expected to disclose the terms of the head lease because they were not known until after the franchise agreement was signed, the motion judge held that the franchisor could not be excused from disclosing such material facts, stating "[i]f it is simply impossible to make proper disclosure because material facts are not yet known, then the franchisor is not yet ready to deliver the statutorily required disclosure document. The franchisor must wait – it does not get excused from its statutory obligations."

The Ontario Court of Appeal allowed the franchisor's appeal. The Court of Appeal confirmed that the underlying purpose of section 5 of the *Wishart Act* was "to obligate a franchisor to make full and accurate disclosure to a potential franchisee so that the latter can make a properly informed decision about whether or not to invest in a franchise."

In determining whether a franchise disclosure document is so deficient as to amount to no disclosure at all, the Court of Appeal held that there are two guiding principles:

1. the franchisor's failure to comply with s. 5 of the act will not always amount to sufficient grounds for rescission under s. 6 (2) of the Act; and
2. "a purported 'disclosure document' may be so deficient as to effectively amount to a complete lack of disclosure, thereby permitting rescission under s.6(2)."

In applying the above principles, the Ontario Court of Appeal held that the motion judge erred in her interpretation and application of s. 6(2) of the Act in relation to both the head lease and the conversion cost estimates. In considering the matter of the head lease, the Court of Appeal found that the motion judge's failure to consider the terms of the franchise agreement was an extricable error of law, stating (at para. 52):

> "…whether a breach of s. 5 is sufficiently serious to engage s. 6(2) should be determined on a case-by-case basis, with a view to all relevant circumstances bearing on whether the franchisee can make a properly informed decision about whether or not to invest. This inquiry requires, where appropriate, taking into account the terms of the parties' franchise agreement."

The franchise agreement provided that both the franchisee and the franchisor were required to exercise reasonable best efforts in selecting a location for the franchise outlet. The "best efforts" clause constrained the franchisor's ability to enter into a lease without considering the franchisee's legitimate interests. Moreover, the franchise agreement contained an opt out clause. If the franchisee found the location unsuitable or the lease deposit amount too onerous, the franchisee was entitled, under the opt-out clause, to reject the location and either search for another location or receive its money back, neither of which it did. The Court stated (at para. 54):

> "[t]hese safeguards, in my view, provide a complete answer to the complaint that the Franchisor's failure to disclose the head lease justified rescission under s. 6(2). The absence of that information had little impact on the Franchisee's ability to make an informed investment decision…"

With respect to the estimates of start-up costs contained in the franchise disclosure document, the Ontario Court of Appeal held that cautionary statements in the disclosure document put the franchisee on notice that pursuing a conversion opportunity would not necessarily lead to lower start-up costs. Moreover, the franchise disclosure document included an estimate of costs to develop a franchise from a shell, which provided a useful upper range reference point for the start-up costs (which was not exceeded), as well as:

1. "a strongly worded warning that cost estimates associated with a conversion could vary greatly from site to site"; and
2. "a warning to the franchisee to maintain a significant contingency reserve."

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The Court of Appeal noted that the although the franchisor could, and perhaps should, have disclosed cost information the franchisor had from prior conversions, that "…given the wide variance in the costs associated with the franchisor's three prior conversions, I do not believe disclosing those figures would have significantly improved the franchisee's ability to make an informed investment decision."

Based on the foregoing, the Ontario Court of Appeal allowed the franchisor's appeal and its cross claim for moneys the franchisor had expended to pay the construction invoices and lease deposit when it took over the franchised premises. The franchisor was awarded $230,221.45 in damages, subject to deduction for any benefits the franchisor obtained as a result of operating the franchise on the premises during the lease after the franchisee gave its notice of rescission.

B. Ontario Court of Appeal Confirms Rescission Regime under the *Arthur Wishart Act* is Not a "Net Loss" Regime

In *2122994 Ontario Inc. v Lettieri*, 2016 ONSC 6209, the franchisee successfully rescinded its franchise agreement based on three material deficiencies in the document, namely: failure to include the franchisor's financial statements, failure to sign the franchisor's certificate, and failure to include a copy of the head lease for the franchisee's premises in the disclosure document. The trial judge awarded the franchisee $287,289.63 in damages.

In *2122994 Ontario Inc. v Lettieri*, 2017 ONCA 830, the franchisor appealed the trial judge's decision with respect to both liability and quantum. With respect to quantum, the franchisor appealed on the basis that the funds used to pay for the franchisee's leasehold improvements (over $163,000) should not be refunded to the franchisee, as the franchisee had borrowed the money from TD. The trial judge held:

> "4 The language of the statute is clear. On rescission the franchisor is, under ss. 6(6)(a), to 'refund to the franchisee any money received from or on behalf of the franchisee, other than money for inventory, supplies or equipment.' Whether the franchisee paid these monies from her funds, borrowed funds or inherited funds is irrelevant to her claim against the franchisor. Her entitlement is statutory and the language of the legislation is clear. Whatever she paid to him, he must pay back.
>
> 5 Unlike legislation in other jurisdictions, as the respondent points out in her factum, Ontario has a specific legislated payback scheme. It is not a "net loss" regime. And whether the leasehold improvements are properly categorized under s. 6(6)(a) or s. 6(6)(c) is immaterial from the appellant's perspective. No matter the category, the result is the same: pay back what the franchisee paid."

The Court of Appeal also dismissed an argument by the franchisor that the franchisee was not entitled to rescission because it breached its duty of fair dealing under Section 3 of the *Wishart Act*. This argument had been raised at trial on the grounds that the franchisee misrepresented the ownership of the franchisee corporation to the franchisor. In dismissing this ground of appeal, the Ontario Court of Appeal referred to the *Beer v Personal Service Coffee Corp.*, [2005] OJ No 3043, 141 ACWS (3d) 410 (ONSC) decision, which stands for the proposition that a franchisee's right to rescission under section 6(2) of the Act is unconditional, and confirmed that a franchisor cannot avoid the remedy available to a franchisee under s. 6(2) of the Act by raising issues about the franchisee's conduct.

C. Court Comments on Multiple Franchise Disclosure Issues in Rescission Case

In *Giroux et al. v 1073355 Ont. Ltd. et al*, 2018 ONSC 143 ("*Giroux*'), the franchisees sought a declaration, on a summary judgment basis, that they were entitled to rescind their franchise agreement under the Act. The franchisor had delivered a franchise disclosure document to the prospective franchisees, following which the parties engaged in negotiations. Partially as a result of these negotiations, the franchisor subsequently delivered further documents to the prospective franchisees, including an addendum, financing offer, spreadsheet containing growth projections, projection worksheets, and testimonial letters from existing franchisees. The franchisor then issued a second franchise disclosure document to the prospective franchisee's lawyer, which contained certain updates relative to the first disclosure document. The second disclosure document was reviewed by the prospective franchisee's legal counsel, following which the franchisee signed the franchise agreement. The franchisee issued a notice of rescission a little less than two years later.

The franchisee alleged material deficiencies in both disclosure documents, including that:

1. The financial statements were not prepared to a minimum review engagement standard in either disclosure document;
2. Disclosure had not been delivered as one document at one time, as there had been two disclosure documents, together with piecemeal disclosure of other agreements and documents as described above;
3. The earnings projections did not include a statement of the assumptions and bases underlying them or of a location where supporting documents verifying those assumptions could be viewed;
4. The disclosure documents failed to disclose any material terms of financing the franchisor had offered the prospective franchisees; and
5. The disclosure documents omitted other material facts, regarding the list of former franchisees, regarding the founder of the franchisor, who was a franchisor's associate, regarding legal penalties that had been incurred by the founder in the past, which involved providing inaccurate reporting forms, and regarding the history of the franchise system, including when the system had been transferred from the founder to the current owner.

The Court dismissed the plaintiff's argument that disclosure had not been provided in one document at one time, as required by the *Arthur Wishart Act*, finding that, on the evidence, the franchisees had relied on the second disclosure document, which was

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reviewed by their counsel. The Court stated, "…on the evidence before me it appears that the process to purchase a franchise essentially started anew with the second disclosure document." The Court found that agreements negotiated after the delivery of the first disclosure document did not appear to be material facts, particularly since a number of the negotiated matters were in the nature of benefits to the franchisee. In this respect, the Court appears to have conflated the concept of "material facts," which must be disclosed whether they are positive or negative, with "material changes," which are only required to be disclosed if they are negative.

The Court granted rescission on the basis that the unaudited financial statements included in the second disclosure document were not prepared to a review engagement standard. While the financial statements themselves did not indicate the applicable accounting standard, the franchisor's failure to lead evidence on this point led the Court to make a negative inference that the financial statements did not meet the minimum review engagement standard. Although this finding was sufficient to dispose of the claim, the Court went on to comment on a number of the franchisee's additional arguments.

With respect to the earnings projections that were provided in the second Disclosure Document, the Court held that the failure by the franchisor to provide substantiating information and to list a location where information substantiating the earnings projection could be viewed by the franchisee also gave rise to a material deficiency. With respect to the argument that the second disclosure document should have included information about the financing arrangements the franchisee and franchisor negotiated after delivery of the first disclosure document, the Court stated: "[o]n the facts of this case, I do not find that this financing, which was negotiated independently after the first disclosure document, should have been included in the second disclosure document which was essentially a new start in the process." With respect to the other material facts, described in item 5 above, that the franchisee alleged were not disclosed in the disclosure document(s), the Court held that the second disclosure document contained an accurate list of former franchisees, which meant that the franchisor did not breach the disclosure regulations with respect to this information, that information regarding the founder of the franchise, although a franchisor's associate, was not a material fact, that past convictions against the founder, being more than 10 years in the past, were not required to be disclosed, and that the prior ownership history of the franchisor, also approximately 10 years in the past, was not required to be disclosed, especially since the identity of the current director and officer had been disclosed.

D. Principals of a Franchisee Corporation Not Subject to the Franchise Agreement's Arbitration Clause

In *Kanda Franchising Inc. and Kanda Franchising Leaseholds Inc. v 1795517 Ontario Inc., Iftikhar Hossain and Parveen Hussain*, 2017 ONSC 7064 ("Kanda"), the franchisor brought an application for an order appointing an arbitrator to hear an arbitration initiated by the franchisor against the franchisee corporation and its two principals. The franchise agreement in question required that all disputes, claims, etc. regarding the rights and obligations of the franchisor or the franchisee arising from the terms of the franchise agreement be submitted to arbitration. However, the principals of the franchisee corporation were not parties to the franchise agreement, which was entered into only by the franchisor and franchisee corporation. The franchisee corporation argued that only it was subject to arbitration with the franchisor and that the Court should not order the franchisee's principals to participate in the arbitration.

The franchisor argued that the question of whether the franchisee's principals were subject to the arbitration clause in the franchise agreement should not be answered by the Court, but should be answered by the arbitrator pursuant to the "competence-competence" principle of arbitration law. The "competence-competence" principle provides that a challenge to the arbitrator's jurisdiction (i.e., whether the arbitrator had jurisdiction over the franchisee principals) must be resolved first by the arbitrator. The franchisee argued that because the arbitrator's jurisdiction arose solely from the agreement to arbitrate, i.e., the arbitration clause in the franchise agreement, and franchisee's principals were not parties to that agreement, the Court should decline to order the principals to participate in the arbitration. The Court determined that, since the question of the arbitrator's jurisdiction over the principals was a question of law or mixed fact and law, which required the Court to refer only superficially to the documentary record, the Court could decide whether the franchisee principals were subject to the arbitrator's jurisdiction pursuant to the arbitration clause.

The Court concluded that the words of the franchise agreement were clear, and that the arbitration clause applied only to the franchisor and franchisee corporation, not to the franchise's principals. On that basis, the Court appointed an arbitrator to resolve the dispute between the franchisee and franchisor.

E. Franchisor Not Liable for Fraudulent Actions of Master Franchisee

In *1738937 Alberta Ltd. v Fair Waves Coffee Inc (Waves Coffee House)*, 2017 ABQB 714 ("*Fair Waves*"), the main question was whether a franchisor could be found vicariously liable for a fraud committed by its Alberta master franchisee, the principal of which had absconded with $250,000 of a franchisee's money.

Justice Topolniski held that the current approach for determining whether an entity will be vicariously liable encompasses the following two-stage analysis:

1. Determine whether there are unambiguous precedents which determine in this case whether there should be vicarious liability or no liability, but if not,
2. the analysis turns to whether vicarious liability should be imposed in light of the broader policy rationales behind strict liability.

Justice Topolniski also held that "The key policy concerns for imposing vicarious liability are to provide a just and practical remedy for the plaintiff's harm and to encourage the deterrence of future harm" (*Fair Waves*, at para 26). Justice Topolniski held that "this policy does not apply to an independent contractor scenario

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because the independent contractor is in business on his or her own account."

Justice Topolniski then held that given that the contract between the master franchisee and the franchisor defined the master franchisee as an independent contractor, and given that the franchisor's control over the master franchisee's operation was limited, the master franchisee was in fact an independent contractor. Justice Topolniski then turned to whether the master franchisee (or its principal) was an ostensible or apparent agent of the franchisor. Justice Topolniski held that "Representations about the authority of the agent must come from the principal; an agent cannot clothe himself or herself with authority."

After reviewing considerable case law, Justice Topolniski provided the following summary of the franchisee's arguments as to why it was reasonable for them to infer that the master franchisee (or its principal) acted on behalf of the franchisor:

1. [the franchisor's] website directed applications to the British Columbia head office;
2. [the franchisor's] promotional material spoke of a "team" and offered a form of business loan application;
3. the Disclosure mentioned [the franchisors] and included a list of British Columbia and Alberta franchises; and
4. [the master franchisee's principal] commented that "it [the organization] was a big family," and no one had said that he did not have authority to speak for [the franchisor].

Justice Topolniski held that while an inference could be drawn from the first two arguments that the master franchisee was the franchisor's agent, there was no agency relationship between the franchisor and the master franchisee for the following reasons:

1. the disclosure document, when viewed as a whole, clearly indicated that the relationship between the franchisor and master franchisee was not that of agent/principal;
2. while the representations listed in item 4 above may have lulled an unsophisticated and/or "vulnerable customer" into believing that the franchisor authorized the master franchisee or its principal to speak on its behalf, the franchisees were experienced franchisees; and
3. the franchisees did not take steps to discover the true nature of the relationship between the master franchisee and the franchisor, despite multiple opportunities to do so.

Accordingly, the franchisor was held not to be liable for the $250,000 the master franchisee had stolen from the franchisee.

ABOUT THE AUTHORS

Michael Melvin is a Partner at McInnes Cooper, and can be reached at michael.melvin@mcinnescooper.com or 506-458-1666.

Patrick Kerr is an Associate at McInnes Cooper, and can be contacted at patrick.kerr@mcinnescooper.com or 506-877-0851.

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