

HAVE YOU THOUGHT ABOUT FRANCHISING?

PETER VIITRE AND DAVID SHAW

In recent years, franchising has increasingly become a method of choice for many corporations and individuals to expand their businesses. When undertaken and implemented properly, franchising can be a relatively fast and comparatively inexpensive way to extend the reach of a successful business concept, while sharing at least some of the risk of that expansion with entrepreneurs in target markets beyond those currently being pursued.

Not surprisingly, the increase in popularity of franchising as a business model has also brought with it a heightened interest in its regulation. While increased regulation has generally been accepted by traditional franchisors (and welcomed by traditional franchisees) as providing a useful framework for their business relations, the legislation has been drafted very broadly and introduces the possibility of capturing distribution and other relationships not considered by the parties to be franchisees, as the term is commonly understood.

At present, two Canadian provinces have franchise legislation in force: Ontario, whose *Arthur Wishart Act (Franchise Disclosure), 2000* (the Wishart Act) came into force in 2001, and Alberta, whose *Franchises Act* has been in place in its current form since 1995. However, in recent months, two other provinces have taken significant steps in this direction: Prince Edward Island, whose *Franchises Act* was enacted in 2005 and currently awaits proclamation in force pending the drafting and adoption of its regulations, and New Brunswick, whose own franchise bill recently passed first reading and is now the subject of public consultation. In addition, in the summer of 2005, the Uniform Law Conference of Canada adopted a Model Franchise Law, based heavily on Ontario's Wishart Act, which the ULCC hopes will form the basis of franchise legislation to be adopted across Canada.

WHAT DOES FRANCHISE LEGISLATION DO?

Canadian provincial franchise legislation, much like its counterparts in the United States and elsewhere around the world, is designed primarily to protect franchisees by giving them the tools they need to make an informed decision about whether to invest in a given franchise, as well as a commercial framework that assures they will be treated fairly by their (typically, much larger) franchisors.

The Wishart Act, which is typical of Canadian provincial franchise legislation, contains three basic elements: disclosure by the franchisor to its prospective franchisees, a duty of good faith and fair dealing on all parties to the franchise agreement, and a right of association on the part of franchisees.

DISCLOSURE. Under the Wishart Act, a franchisor is required to deliver to each proposed franchisee a disclosure document, which meets the detailed requirements set out in the regulations made under the Wishart Act (the Regulations), not later than 14 days prior to the earlier of the franchisee's signing the relevant franchise agreement and its paying any consideration to the franchisor in relation to the franchise. In accordance with the Regulations, that document must be certified as true and complete by two officers or directors of the franchisor.

There is a long list of information, set out in the Regulations, that must be set out in the disclosure document, including the business background of the franchisor, its finances, its bankruptcy and insolvency history, the franchisee's expected costs associated with establishing the franchise and contact particulars for both current and former franchisees. The overarching requirement is that the document contain all "material facts",

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which include any information about the business, operations, capital or control of the franchisor or about the franchise system, that would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the decision to acquire it.

GOOD FAITH AND FAIR DEALING. The Wishart Act also imposes a duty of fair dealing, including a duty to act in good faith in accordance with reasonable commercial standards, on all parties to a franchise agreement (including the franchisee!). While Canadian courts have held that this duty is not fiduciary in nature, they have also held that it at least requires one party to consider the interests of the other in making decisions and exercising discretion. The courts have also used the duty to prevent a franchisor from professing its support for a franchisee one moment, and then turning its back on the franchisee when the franchisee needs it most.

FRANCHISEES' RIGHT OF ASSOCIATION. Finally, franchisees are guaranteed the right to associate with one another without interference (or fear of reprisal) by the franchisor.

WHAT IF I DON'T COMPLY? WHO ENFORCES THE RULES?

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

First, Canadian provincial franchise legislation typically provides that a breach by a franchisor of its statutory obligations will give the franchisee a right of action for damages against it. For example, section 7 of the Wishart Act contains such a right in favour of the franchisee where it suffers a loss because of a misrepresentation contained in the franchisor's disclosure document or as a result of the franchisor's failure to comply in any way with its disclosure obligations under the Act. Furthermore, that right of action lies not just against the franchisor, but also against every person who signed the disclosure document, thereby potentially visiting personal liability on the directors or officers who certified the document.

Second, and more importantly, if a franchisor fails to deliver a disclosure document to a prospective franchisee (or delivers a seriously deficient document) within the time specified under the Act, the franchisee will have the right to rescind the franchise agreement at any time in the 60 days following the franchisor's delivery of the document and to recover its fees and any losses from the franchisor. If the franchisor does not deliver the document at all, the franchisee's right to rescind (and recover) runs for two years from the date it signed the franchise agreement. Late or non-delivery of a franchise disclosure document can thus prove to be a costly error on the part of the franchisor (and a material concern for anyone considering an acquisition of a franchisor), and highlights the importance of considering the applicability of franchise legislation to a given commercial arrangement, even when the parties do not intend to engage in franchising.

COULD I BE FRANCHISING WITHOUT KNOWING IT?

The short answer is "Yes". The long answer begins with the idea that Canada's provincial franchise legislation has been drafted very broadly to cast the net of regulatory protection, not only over those persons who seek to buy into a traditional "out-of-the-box" franchise business, but also those seeking to invest in opportunities that are sufficiently similar to the traditional franchise as to place them, potentially, into similarly vulnerable circumstances.

Under the Wishart Act, for example, the term "franchise" is defined to include a right to engage in a business: (1) where the "franchisee" is required to make a payment or continuing payments, whether direct or indirect, or a commitment to make such payments, to the "franchisor", in the course of operating the business or as a condition of acquiring the franchise or commencing operations; and (2) in which (a) the franchisor grants the franchisee the right to sell, offer for sale or distribute goods or services substantially associated with the franchisor's trade-mark, service mark, trade name, logo or advertising or other commercial symbol; and (b) the franchisor exercises significant control over, or offers significant assistance in, the franchisee's method of operation, including building design and furnishings, locations, business organization, marketing techniques or training.

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On this definition, any business that involves the sale or distribution of branded goods or services is potentially a “franchise” for the purposes of the Wishart Act. In particular, it should be noted that there is no express exception from the payment requirement, in paragraph 1 above, for purchases of reasonable amounts of inventory. It is also unclear how much control or assistance will be considered “significant” for the purposes of paragraph 2(b).

You should also be aware that it does not matter whether the parties to a given commercial arrangement have intended or desire to engage in franchising, and that what they choose to call their arrangement is equally irrelevant. The practical effect of the Act in those circumstances may well be that, unless the parties are aware of the Act and its possible application at the time they are negotiating their arrangement, the Act may intervene to re-balance their deal at a later date, typically after one side has experienced losses and is looking for a way out of the bargain.

HOW CAN I AVOID IT?

There are a number of relationships that are exempted from the application of the Wishart Act. Employer-employee relationships are expressly exempt; as are partnerships. Entirely oral arrangements or relationships (i.e., where no material aspect thereof is evidenced in writing) are also not subject to the Act.

In addition, there are a number of exemptions from the disclosure requirements under the Act. For example, grants of additional franchises to existing franchisees may be exempt, provided that the additional franchise is substantially the same as the existing franchise and there has been no material change from the existing franchise agreement. Similarly, grants to directors or officers of the franchisor may be exempt. Exemptions also exist with respect to grants where the franchisee’s total annual investment to acquire and operate the franchise is below CAD 5,000, where the franchise agreement is not valid for more than one year (and does not involve the payment of a non-refundable franchise fee) or where the franchisee will invest more than CAD 5,000,000 in one year in the acquisition and operation of the franchise.

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

Furthermore, the Act contains an effective prohibition on contracting out, providing specifically that any purported waiver or release by a franchisee of a right given under the Act, or of an obligation or requirement imposed on a franchisor under the Act, is void. It should be noted that there is no size-based or other exception from this restriction. Accordingly, even the largest and most sophisticated of parties may not have an enforceable means of mitigating any unwanted implications of the legislation on their bargain, and so should in any event be aware of such possible implications before striking their deal (or at least in time to make any required disclosure before closing).

CONCLUSION

Given the attractiveness and increasing popularity of franchising as a method of doing business, one might conclude that it is at least worth considering as a means of growing any successful retail or other business. On the other hand, given the continuing proliferation of franchise legislation across Canada, at least some thought should be given to the potential application of such legislation (for better or worse) by virtually anyone seeking to sell their products or otherwise do business in Canada.

In the end, therefore, whether you have an interesting business concept that you are seeking to expand or you are negotiating a complex commercial arrangement and are seeking to avoid uncertainty in your bargain, the above considerations should form at least a part of your business and legal investigations and analysis, and the best answer to the question, “Have you thought about Franchising?” should, in most cases, be “Yes”.

PROFESSIONAL NOTES

DONE DEALS

Clients we have recently advised include the following:

Royal Group Technologies Limited – the agreement by Royal Alliance Inc. to buy 60 per cent of Royal Group Technologies in connection with a management buyout

Geac Computer Corporation Limited – the USD 1 billion acquisition of Geac by Golden Gate Capital

Hudson's Bay Company – the CAD 1.3 billion agreement by GE Money to acquire Hudson's Bay Company's financial services business

Clarington Corp. Directors' Special Committee – advised the special committee of the board of directors of asset management company Clarington Corporation during Industrial Alliance Insurance and Financial Services Inc.'s successful take-over bid, valued at over CAD 200 million

Hudson's Bay Company – the acquisition of Hudson's Bay Company by Maple Leaf Heritage Investments

Videsh Sanchar Nigam Limited – the USD 178 million agreement to acquire Teleglobe International Holdings Ltd.

PUMA Canada – acquisition of 100 per cent of its Canadian licensee, Authentic Team Holdings Inc.

Sun Capital Partners Inc. – its affiliate's acquisition of Indalex Aluminium Solutions Group from Honeywell International

Macquarie Bank Limited – its indirect acquisition of an 81 per cent equity interest in two major P3 Assets from ABN AMRO

Sun Capital Partners Inc. – its affiliates' acquisition of Canadian Grocery Business from Kraft Canada

Performx Group Ltd. – its acquisition of a majority of the outstanding shares of Vitesse Learning Inc.

Agrium Inc. – the CAD 600 million successful take-over bid by Agrium of Royster-Clark Ltd. and Royster-Clark ULC

Sea-to-Sky Highway Investment Limited Partnership – the CAD 600 million public private partnership to upgrade the Sea-to-Sky Highway

Belron S.A. – its indirect acquisition, through Belron Canada Inc. (Standard Auto Glass), of the Canadian glass operations of TCG International Inc. (Speedy Glass and Apple Auto Glass)

Mail Boxes Etc., Inc. – advised MBE on the rebranding of its Canadian franchise network to The UPS Store®

INDUSTRY RECOGNITION

Bloomberg 2005 Q1, Q2 & Q3 Global Legal Mergers & Acquisitions Rankings – Number one in deal volume and market share in Canadian Announced Deals

Thomson Financial 2005 Q3 Legal Advisor Mergers & Acquisitions Review – Number one in rank value and market share in Canadian Announced Deals

Chambers Global: The World's Leading Lawyers for Business 2006 – Top ranked in Canadian Mergers & Acquisitions

The Canadian Legal Lexpert Directory 2006

PLC Which Lawyer? Yearbook 2006

The 2006 Lexpert/American Lawyer Guide to the Leading 500 Lawyers in Canada

Law Business Research's The International Who's Who of Business Lawyers 2005

PLC Cross-border Mergers and Acquisitions Handbook 2006/2007

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