

Canadian Franchise Disclosure Laws: Exemptions and Exclusions: Analysis and Recommendations

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I. INTRODUCTION

To date in Canada, only Alberta, New Brunswick, Ontario and Prince Edward Island have enacted franchise-specific laws.¹ Among other things, these laws require a franchisor to give a prospective franchisee a disclosure document that clearly and concisely states all "material facts", and that also includes prescribed financial statements, contracts, other documents, ancillary information and a certificate of disclosure.² Included in the many disclosure requirements under these laws is prescribed, minimal disclosure concerning rebates, commissions, payments or other benefits which the franchisor or its associate may receive as a result of the purchase of goods or services by franchisees. These laws provide certain exemptions from these disclosure requirements, and exclude altogether from their ambit certain types of commercial arrangements.

In this paper we briefly describe these statutory exemptions and exclusions and the rebates disclosure, then express our concerns about them and our recommendations for improvement.

¹ Alberta: *Franchises Act*, R.S.A. 2000, c.F-23 ["Alberta Act"]; New Brunswick: *Franchises Act*, S.N.B. 2007, c. F-23.5 ["New Brunswick Act"]; Ontario: *Arthur Wishart Act (Franchise Disclosure)*, 2000, S.O. 2000, c.3 ["Ontario Act"]; Prince Edward Island: *Franchises Act*, S.P.E.I. 2005, c. 36 ["PEI Act"]. Proclamation of the disclosure sections of the New Brunswick Act awaits finalization of the Act's disclosure regulation.

² Alberta Act, s. 4; New Brunswick, Ontario and PEI Acts, s. 5.

II. THE STATUTORY EXEMPTIONS

A. Franchisee Transfers

The Alberta, New Brunswick, Ontario and PEI Acts each exempt from their disclosure requirements the transfer of a franchise by a franchisee for his own account, if the transfer is not effected by or through the franchisor.³ The language in the Ontario Act typifies this "franchisee transfer" exemption:

- 5(7) [The statutory disclosure obligation] does not apply to,
- (a) the grant of a franchise by a franchisee if,
 - (i) the franchisee is not the franchisor, an associate of the franchisor or a director, officer or employee of the franchisor or of the franchisor's associate,
 - (ii) the grant of the franchise is for the franchisee's own account,
 - (iii) in the case of a master franchise, the entire franchise is granted, and
 - (iv) the grant of the franchise is not effected by or through the franchisor."

Note that the franchisee's disposition of his interest in the franchise falls squarely within the Ontario Act's definition of "grant",⁴ and so for this type of transaction the transferring franchisee falls within the statutory definition of "franchisor".⁵ Without the exemption, then, the *franchisee* would have to provide the proposed transferee with a disclosure document!

Note also that the "real" franchisor is not "granting" anything,⁶ and so does *not* fall within the statutory definition of "franchisor". So even without the exemption the "real" franchisor *does not* have to provide a disclosure document!

The franchisee transfer exemption originated in 1970 with California's Franchise Investment Law.⁷ The policy underlying the "franchisee transfer"

³ Alberta Act, ss. 5(1)(a) and 5(2); New Brunswick Act, ss. 5(8) and 5(9); Ontario and PEI Acts, ss. 5(7)(a) and 5(8).

⁴ Ontario Act, s. 1(1): "grant", in respect of a franchise, includes the sale or disposition of...an interest in the franchise." Similar definitions appear in the other three Acts (the Alberta Act defines "sale" and its franchisee transfer exemption uses that word, rather than "grant").

⁵ Ontario Act, s. 1(1): "'franchisor' means one or more persons who grant...a franchise."

⁶ Unless, of course, it does something amounting to a "grant" of franchise. The simplest example would be requiring the transferee to sign a new franchise agreement that imposes on him obligations that are significantly different from those in the transferor's franchise agreement.

⁷ *California Corporations Code*, Cal. Stats. 1947, c. 1038 §31102 (2007) ["California Corporations Code"]: "The offer or sale of a franchise by a franchisee for his own account or the offer or sale of the entire area franchise owned by a subfranchisor for his own account, is exempted from the provisions of Section 31100 if the sale is not effected by or through a franchisor. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee."

exemption is that there is no utility in requiring the transferring franchisee to disclose information that he does not know in the first place and can determine only at great expense.⁸

Sections 5(7)(a)(i) to (iii) of the Ontario Act exemption are simple "stop loss" provisions, designed to prevent a franchisor from directly or indirectly granting a franchise without providing a disclosure document.⁹

Section 5(7)(a)(iv) of the Ontario Act permits a franchisor to 'interfere' to a degree in the franchise transfer without 'tainting' the exemption. The interesting issue is the level of interference that will result in the franchise transfer being "effected by or through the franchisor." Section 5(8) of the Ontario Act purports to answer this question:

- 5(8) For the purposes of subclause (7)(a)(iv), a grant is not effected by or through a franchisor merely because,
- (a) the franchisor has a right, exercisable on reasonable grounds, to approve or disapprove the grant; or
- (b) a fee must be paid to the franchisor in an amount set out in the franchise agreement or in an amount that does not exceed the reasonable actual costs incurred by the franchisor to process the grant.

The other three Acts have similar sections.¹⁰

Because of the word "merely", sections 5(8)(a) and (b) evidently do not exhaust the ways in which a franchisor may become involved in a franchisee transfer without tainting the exemption.¹¹ But where does one draw the line? To date the only reported Canadian case on this issue is *1518628 Ontario Inc., Nancy van Dorp and Dean McCoy v. Tutor Time Learning Centers, LLC et. al.*¹² In that case, plaintiff 1518628 acquired the shares of a corporate franchisee of

⁸ Most of the information that must be in the disclosure document would not be known by the transferring franchisee, who would have to collect it from the "real" franchisor. The franchisee would have to spend a lot of time and money independently verifying the accuracy and completeness of this information, since he would be strictly liable if the buying franchisee suffered a loss because of a misrepresentation in the disclosure document: Alberta Act, s. 9; New Brunswick, Ontario and PEI Acts, s. 7.

⁹ For example, if subclause (iii) was not there a franchisor could grant a master franchise to its affiliate (without disclosure, since the affiliate won't complain), and the affiliate could then grant disclosure-free sub-franchises using the exemption. See the definitions of 'master franchise', 'subfranchisor' and 'subfranchisee' in the four Acts.

¹⁰ Alberta Act, s. 5(2); New Brunswick Act, s. 5(10); PEI Act, s. 5(8).

¹¹ For example, the grant will not be "effected by or through the franchisor" merely because the franchisor provides material information to a prospective buyer, or refers prospective buyers to the franchisee: *Fox v. Ehrmantraut*, 28 Cal.3d 127; 615 P.2d 1383.

¹² [2006] O.J. 3011 (Sup.Ct.J.).

Tutor Time Learning Centers, LLC. As a condition of approving this share transfer, Tutor Time required van Dorp (the sole director, officer and shareholder of 1518628) and McCoy (her spouse and an employee of 1518628) to indemnify Tutor Time against a breach of the franchisee's obligations. Subsequently, the plaintiffs sought to rescind because Tutor Time did not provide them with a disclosure document. Among other defences, Tutor Time relied on section 5(7)(a) of the Ontario Act. Regarding this defence, Cumming J. held that to require van Dorp's indemnity fell within section 5(8)(a), because pursuant to the franchise agreement, anyone who held a 10% or greater interest in a corporate transferee had to provide his indemnity. He also held that to require McCoy's indemnity was not within 5(8)(a), because while Tutor Time had the *power* to require McCoy's indemnity, and while it was reasonable to require that indemnity, a "power" is not the same as a "right", and "right" in 5(8)(a) means a contractual right.¹³ Thus the share transfer to 1518628 was effected through Tutor Time without proper disclosure.¹⁴

We have three concerns about the franchise transfer exemptions in the four Acts (section references below are to the Ontario Act).

- The exemption should be redrafted so that if it does not apply, then it is the franchisor who must provide the statutory disclosure document.¹⁵
- Section 5(7)(a)(i) covers an affiliate of the franchisor, because the transferring affiliate obviously approves the grant, and thereby automatically becomes the franchisor's associate. But it does not cover a director or officer of a franchisor's affiliate, unless the affiliate is already a franchisor's associate. Therefore a franchisor wishing to avoid disclosure could simply incorporate a new affiliate, then grant a franchise (without disclosure) to a director or officer of that affiliate, and that individual could then transfer his franchise without disclosure using the 5(7)(a) exemption (unless, of course, he was also a director or officer of the franchisor or a franchisor's associate).
- Section 5(8)(b) speaks of "an amount set out in the franchise agreement." There is no principled reason for denying the transfer exemption if the franchise agreement charges a transfer fee equal to an amount that cannot be ascertained until a later date (e.g. "You must pay us a transfer fee equal

¹³ *Ibid.* at para. 44.

¹⁴ It is evident from the judgement that both the litigants and the Court assumed that if the exemption didn't apply, then it was Tutor Time that had to provide the disclosure document. We have seen above that the wording of the statute suggests otherwise.

¹⁵ The transferee will be acquiring either the franchisee's assets or its shares, and so can adequately protect himself through suitable representations and warranties in the asset or share purchase agreement.

to 50% of whatever initial franchise fee we regularly charge for new XYZ franchises at the time of your transfer").

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include a "franchisee transfer" exemption similar to that in the Ontario Act, suitably modified to deal with our concerns.

B. Grant to a Director or Officer

Each of the four Acts exempts from its disclosure requirements the grant of a franchise to an individual for his own account, if he has been a director or officer of the franchisor or the franchisor's associate for at least six months.¹⁶ The language in the PEI Act typifies this "director/officer" exemption:

5(7) [The statutory disclosure obligation] does not apply to,

...

(b) The grant of a franchise to a person who has been an officer or director of the franchisor or the franchisor's associate for at least six months immediately before the grant of the franchise, for that person's own account.

The director/officer exemption also appears to have its origin in California's *Franchise Investment Act*.¹⁷ The policy underlying the director/officer exemption is that disclosure has little utility if the prospective franchisee is already familiar with the franchisor, its management, the franchise system and the attendant risks.

We have three concerns about the director/officer exemptions in the four Acts:

- We suggest that six months is insufficient time for a director or officer to gain appropriate familiarity with the franchise system and its risks. If

¹⁶ Alberta Act, s. 5(1)(c); New Brunswick Act, s. 5(8)(b); Ontario and PEI Acts, s. 5(7)(b).

¹⁷ *California Corporations Code*, *supra* note 7, at §31106: "There shall be exempted from the [disclosure and registration requirements] any offer, sale or other transfer of a franchise or an interest in a franchise, provided that the offer, sale or transfer meets the requirements in subdivisions (a) and (b):

(a) Any of the following conditions apply:

...

(2) One or more of the owners of the prospective franchisee owning at least a 50% interest in the prospective franchisee meet both of the following:

(a) The owner or owners are, or have been within 60 days prior to the sale...an officer, director, managing agent, or an owner of at least a 25% interest in the franchisor for at least 24 months.

(B) The owner or owners are not controlled by the franchisor...

(b) [File a notice with and pay a fee to the Commissioner of Corporations]."

Manitoba chooses to implement a director/officer exemption, then we recommend that it follow California's two-year requirement.

- The Alberta and Ontario exemptions do not state when the six-month period ends, so presumably the exemption in those two provinces is available to someone who resigned as director or officer 25 years ago! The New Brunswick and PEI Acts do better by requiring that the six-month period end immediately before the franchise grant, but surely passage of a 30-, 60-, or even 90-day period should not significantly affect the familiarity one has gained. If Manitoba chooses to implement a director/officer exemption, then we recommend that the familiarity period (be it six months or something else) end no more than 60 days before the grant of the franchise.
- Why limit the exemption to directors and officers? Surely it should also be available (as in California and other states) if the franchise will be granted to anyone else who has had at least two years direct management experience with the franchisor or its associate.

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include a "director, officer or manager" exemption that responds to our concerns.

C. Grant of an Additional Franchise

Each of the four Acts exempts from its disclosure requirements the grant of an additional franchise to the owner of an existing franchise that is substantially the same as that to be granted.¹⁸ The language in the New Brunswick Act typifies this "additional franchise" exemption:

5(8) [The statutory disclosure obligation] does not apply to,

...

(c) the grant of an additional franchise to an existing franchisee if that additional franchise is substantially the same as the existing franchise that the franchisee is operating and if there has been no material change since the existing franchise agreement or most recent renewal or extension of the existing franchise agreement was entered into.

The additional franchise exemption appears to have originated in 1976, in Hawaii's *Franchise Investment Law*.¹⁹ The policy underlying the additional franchise exemption mirrors that underlying the director/officer exemption: disclosure has little utility if the prospective franchisee is already familiar with the franchisor, its management, the franchise system and the attendant risks.

¹⁸ Alberta Act, s. 5(1)(c); New Brunswick Act, s. 5(8)(c); Ontario and PEI Acts, s. 5(7)(c).

¹⁹ 2 Hawaii Rev. Stat. tit. 26 §482E-4(a)(6) (2007) ["Hawaii Rev. Stat."]: "[The disclosure requirements shall not apply to] the offer or sale of an additional franchise to an existing franchisee of the same franchisor."

We have three concerns about the additional franchise exemptions appearing in the four Acts:

- Some franchisors encourage poorly-performing franchisees to open additional units in order to reduce their costs by taking advantage of the synergies of operating multiple units. But these vulnerable franchisees are exactly whom the franchise disclosure statutes are supposed to protect.
- Likely some material changes will have occurred in the period between the grant of the original franchise and the grant of the additional franchise. Because of this, a franchisor is unlikely to agree to grant the additional franchise on the original franchise terms. But even if the franchisor did agree to grant on the original terms, the franchisor would have to incur significant costs to modify its then-current "plain vanilla" disclosure document: to reflect (i) the location-specific information about the additional franchise (of course it must expend these costs even if the existing franchisee rejects the offer of the additional franchise), and (ii) the pertinent information about the original franchise (because the additional franchise must be substantially the same as the original franchise). It would be cheaper for the franchisor to grant the additional franchise on current terms.
- There is no minimum franchisee operating experience requirement.

For these reasons we recommend that if Manitoba decides to enact franchise disclosure legislation, the legislation not include an additional franchise exemption.

If Manitoba nevertheless decides to enact the exemption, then we suggest that the government ensure that the existing franchisee has operated his existing franchise for sufficient time to become reasonably familiar with its operation within the franchise system. Therefore we recommend that the exemption be available only to a franchisee who has operated the existing franchise continuously for at least two years ending on a date no more than 60 days before the grant of the additional franchise.

D. Grant by Trustee, Etc.

Each of the four Acts exempts from its disclosure requirements the grant of a franchise on behalf of a franchisee who has become legally incapable of managing his affairs due to physical, mental or financial circumstances.²⁰ The language of the Ontario Act typifies this "trustee" exemption:

5(7) [The statutory disclosure obligation] does not apply to,
...

²⁰ Alberta Act, s. 5(1)(f); New Brunswick Act, s. 5(8)(d); Ontario and PEI Acts, s. 5(7)(d).

(d) the grant of a franchise by an executor, administrator, sheriff, receiver, trustee, trustee in bankruptcy or guardian on behalf of a person other than the franchisor or the estate of the franchisor.

As was the case with a franchisee transfer transaction, the disposition by the trustee of the franchisee's interest in the franchise falls squarely within the statutory definition of "grant";²¹ and thus in this transaction the trustee falls within the statutory definition of "franchisor".²² Therefore, without the exemption, the trustee would have to provide a disclosure document. But what information would the trustee's disclosure document contain? If we construe "franchisor" (as used in the disclosure content parts of the Act and its Regulation) as referring to the trustee himself, then part of the required information is completely irrelevant (e.g. the trustee's financial statement, his criminal, litigation and insolvency history, etc.), part is immaterial (*i.e.* unlikely to significantly affect a decision to acquire the franchise), and the rest is simply unknown to the trustee (e.g. use of the advertising fund during the previous two fiscal years), who would have to spend an enormous amount to collect and verify it.²³ On the other hand, if we construe "franchisor" (as used in the disclosure content parts of the Act and its Regulation) as referring to the "real" franchisor, then almost all of the required information is unknown to the trustee, who again would have to spend enormous amounts to collect and verify it.

Again, similar to the franchisee transfer transaction, since the "real" franchisor isn't "granting" anything,²⁴ the "real" franchisor does *not* fall within the statutory definition of "franchisor" for the purposes of this transaction, and therefore has no disclosure obligation even without the exemption.

The trustee exemption also has its origin in Hawaii's *Franchise Investment Law*.²⁵ The policy underlying the exemption is similar to that for the franchisee transfer exemption: there is no utility in requiring an executor, sheriff, trustee, etc. to disclose information that is irrelevant, immaterial, or that the trustee does not know in the first place and can determine only at enormous expense.

²¹ Ontario Act, s. 1(1): "'grant', in respect of a franchise, includes the sale or disposition of...an interest in the franchise."

²² Ontario Act 1(1): "'franchisor' means one or more persons who grant...a franchise."

²³ See *supra* note 8.

²⁴ See *supra* note 7.

²⁵ Hawaii Rev. Stat., *supra* note 19 §482E-4(a)(1): "[The disclosure requirements shall not apply to] any transaction by an executor, administrator, sheriff, marshal, receiver, trustee in bankruptcy, guardian or conservator."

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include a "trustee" exemption that has requirements similar to those in section 5(7)(d) of the Ontario Act.

E. Grant of a Fractional Franchise

Each of the four Acts exempts from its disclosure requirements the grant of a franchise to an established distributor to carry an additional, minor line that comprises the goods or services of the franchisor.²⁶ For example, under the Alberta Act:

1(1)(c) 'fractional franchise' means a franchise granted to a person to sell goods or services within a business in which that person has an interest, the sales arising from which, as anticipated by the parties at the time the franchise is entered into, do not exceed, in relation to the total sales of the business, the percentage prescribed by the regulations.

...

5(1) The following are exempt from [the statutory disclosure obligation]:

...

(h) the sale of a fractional franchise.

The "fractional franchise" exemption originated with the FTC Rule.²⁷ The policy underlying the fractional franchise exemption is that disclosure has little utility if there will only be a limited course of dealing between franchisor and distributor such that the distributor will not be substantially dependent on the franchisor for his business success.

We have three concerns about the fractional franchise exemptions appearing in the four Acts:

- We believe that an inexperienced distributor may very well be substantially dependent on the franchisor's line of goods or services for his success during at least a reasonable start-up period (i.e. until the distributor has gained sufficient experience of the sales, costs, profit and risks attendant to distributing any line of goods and services). The "fractional franchise" exemptions in the Acts do not require the distributor to have had any previous distribution experience.
- The Alberta and Ontario Acts do not specify a measurement period for determining sales for the 20% comparison test (presumably the period is over the lifetime of the franchise). The New Brunswick and PEI Acts

²⁶ Alberta Act, ss. 5(1)(h) and 1(1)(c); Alta.Reg. 240/95, s. 4 ["Alberta Regulation"]; New Brunswick Act, s. 5(8)(e); Ontario Act, s. 5(7)(e); O.Reg. 581/00, s. 8 ["Ontario Regulation"]; PEI Act, s. 5(7)(e).

²⁷ Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. Part 436, §436.2(a)(3)(i).

both specify as a measurement period the first year of operation of the franchise.

- The New Brunswick and PEI Acts have 'hard coded' the 20% level of the threshold test into the Act, making it very difficult to change that number (both Alberta and Ontario have put the 20% number in their disclosure Regulations).

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include a fractional franchise exemption, but that:

- The exemption not be available unless the distributor (or one of its directors, officers or others having management authority, if the distributor is an entity) has had at least two consecutive years management experience (at any time) in a business that was distributing goods and services competitive with or similar to those of the franchisor, or was of a type that ordinarily would be expected to offer such goods or services;
- The measurement period for determining sales for the threshold test be the greater of the first year of operation of the franchise and the reasonably foreseeable future; and
- The threshold level be coded into the disclosure regulation rather than into the disclosure statute.

F. Renewal or Extension of a Franchise Agreement

The Alberta Act exempts from its disclosure requirements the renewal or extension of a franchise agreement.²⁸ The New Brunswick, Ontario and PEI Acts impose two conditions on the availability of this "renewal" exemption:²⁹

- There has been no interruption in the operation of the franchisee's business, and
- There has been no material change since the franchise agreement or its most recent renewal or extension was entered into.

The renewal exemption has its origin in California's *Franchise Investment Act*.³⁰ The policy underlying the renewal exemption is that disclosure has little

²⁸ Alberta Act, s. 5(1)(d).

²⁹ New Brunswick Act, s. 5(8)(f); Ontario and PEI Acts, s. 5(7)(f).

³⁰ California Corporations Code, *supra* note 7 at §31018(c): "[The terms 'offer', 'offer to sell', 'sale' and 'sell'] do not include the renewal or extension of an existing franchise where there is no interruption in the operation of the franchised business by the franchisee; provided, that a material modification of an existing franchise, whether upon renewal or otherwise, is a 'sale' within the meaning of [the statutory disclosure requirement]."

utility if the business environment upon renewal is not likely to be substantially different from that in which the franchisee has been conducting his business.

We have the following concerns about the two renewal exemption conditions:

- Neither a starting date nor a duration for the business interruption is specified. Surely a business interruption for a few weeks that occurred some years ago for remodeling is quite irrelevant to availability of the exemption.
- In any real life franchise system, a material change is likely to occur if the term of the franchise extends for more than a couple of years.³¹
- In our view, the two existing renewal exemption conditions virtually eliminate the availability of the renewal exemption.

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include a renewal exemption that is available only if:

- The franchisee's operation of his franchise business was not interrupted for a period or periods exceeding a cumulative total of 60 days within the 24 months immediately preceding the renewal or extension, and
- The franchisee's business environment immediately following the renewal or extension is not substantially different from that in which the franchisee has been conducting his franchise business.

G. Minimal Investment

Each of the four Acts exempts from its disclosure requirements the grant of a franchise involving a total annual investment by the franchisee of less than \$5 000.³² The language of the Ontario Act typifies this "minimal investment" exemption:

5(7) [The statutory disclosure obligation] does not apply to,
...
(g) the grant of a franchise if,

³¹ Especially if the franchisee operates wholly or partly in New Brunswick or Prince Edward Island, because the franchise that is to be renewed or extended could have experienced a material change during the term. See the definitions of "material change" in New Brunswick Act, s. 1(1); PEI Act, s. 1(1)(k). The Alberta and Ontario Act definitions do not include changes to the franchise.

³² Alberta Act, s. 5(1)(e) and Alberta Regulation, s. 6; Ontario Act, s. 5(7)(g)(i) and Ontario Regulation, s. 9; PEI Act, s. 5(7)(e) and P.E.I. Reg. EC2006-231, s. 7; New Brunswick Act, s. 5(8)(g). New Brunswick has not completed drafting its disclosure Regulation, but we presume that Regulation will also specify a \$5,000 amount.

(i) the prospective franchisee is required to make a total annual investment to acquire and operate the franchise in an amount that does not exceed a prescribed amount [the amount is prescribed by Regulation as \$5,000].

The minimal investment exemption has its origin in the FTC Rule.³³ The policy underlying the minimal investment exemption is that the franchisee's financial risk in acquiring and operating the franchise does not warrant the expense in time and money of preparing a disclosure document.

Our concern about the minimal investment exemptions in the four Acts is their use of the word "required", which to us suggests a *contractual* requirement; in our view "require" should be replaced with "required, either by agreement or by practical necessity."

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include a minimal investment exemption similar to that in the Ontario Act, but that responds to our concern.

H. Short-Term Franchise

The Ontario Act exempts from its disclosure requirements the grant of any type of franchises having a term no longer than one year and not involving a non-refundable franchise fee.³⁴ The New Brunswick and PEI Acts exempt from their disclosure requirements the grant of a "business opportunity" type of franchise having a term no longer than one year and not involving a non-refundable franchise fee.³⁵ The language of the PEI Act typifies the latter "short-term" exemption:

5(7) [The statutory disclosure obligation] does not apply to,
 (h) the grant of a franchise if the franchise agreement is not valid for longer than one year and does not involve the payment of a non-refundable fee and if the franchisor or franchisor's associate provides location assistance to the franchisee, including securing retail outlets or accounts for the goods or services to be sold, offered for sale or distributed or securing locations or sites for vending machines, display racks or other product sales displays used by the franchisee.

The Ontario Act exemption simply omits the location assistance feature. The Alberta Act has no short-term exemption.

³³ *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*, supra note 27 at §436.2(a)(3)(iii) exempts the franchisor from disclosure:

"Where the total of [the payments made by the franchisee to the franchisor to acquire and commence the franchise business] made during a period from any time before to within six months after commencing operation of the franchisee's business is less than \$500."

³⁴ Ontario Act, s. 5(7)(g)(ii).

³⁵ New Brunswick Act, s. 5(8)(i); PEI Act, s. 5(7)(i). A "business opportunity" franchise is the type of franchise described by 1(1)(b)(ii) of the PEI Act, in which the franchisor, its associate or a person designated by the franchisor provides location assistance to the franchisee.

The policy underlying the business opportunity short-term exemption is that the expense in time and money of preparing a disclosure document is not warranted because the financial risk of the business opportunity franchisee is minimal: he is committed for one year at most, paying no non-refundable fees, and (presumably) he can sell for cash the equipment, goods, supplies, etc. that he bought to operate the business, should his franchisor or supplier disappear.

The policy underlying Ontario's "short-term" exemption only has some of these features, and in our view is on far shakier ground. Should Manitoba decide to enact franchise disclosure legislation, then we recommend that the legislation include a short-term exemption only for business opportunity-type franchises.

I. MLM Plans

Section 55 of the *Competition Act* defines a "multi-level marketing plan" as a plan for the supply of goods or services whereby a participant in the plan receives compensation for the supply of the goods or services to another participant in the plan who, in turn, receives compensation for the supply of the same or different goods or services to other participants in the plan. Since certain types of MLM plans could also be "franchises", each of the New Brunswick, Ontario and PEI Acts exempts an MLM plan from its disclosure requirements.³⁶ Alberta has no MLM exemption.

The policy underlying this MLM exemption is that MLM plans are already sufficiently regulated by the *Competition Act*.

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation exempt MLM plans from the disclosure requirements.

J. Substantial Initial Investment

The Ontario Act exempts from its disclosure requirements the grant of a franchise to a franchisee who invests more than \$5 000 000 in one year to acquire and operate the franchise.³⁷ The Alberta, New Brunswick and PEI Acts have no such "substantial initial investment" exemption.

The substantial initial investment exemption appears to have originated in 1982 with an amendment to Michigan's *Franchise Investment Law*.³⁸ The policy underlying the substantial initial investment exemption is that the expense in

³⁶ New Brunswick Act, s. 5(8)(h); Ontario Act, s. 5(7)(g)(iii); PEI Act, s. 5(7)(h).

³⁷ Ontario Act, s. 5(7)(h).

³⁸ *Franchise Investment Law*, Mich. Comp. Laws. Ann. §445.1506(2)(b) (Supp. 1982-83). The required initial investment threshold was \$100 000.

time and money of preparing a disclosure document is not warranted where the prospective franchisee is likely to demand and obtain the material information he feels he needs in order to make an informed investment decision.

We have six concerns about substantial initial investment exemption in the Ontario Act:

- The \$5 000 000 threshold excludes almost all franchises except larger new car dealerships a few hotel systems.
- Because the cost of real estate varies so markedly as a function of both time and location, franchisors must recalculate each franchise offering to ensure that the threshold amount is reached.
- The exemption does not exclude financing provided by the franchisor, its affiliate or a selling franchisee.
- The exemption does not prevent a franchisor from requiring a number of small investors to pool their money in order to attain the required \$5 000 000 threshold.
- Since it is the size of the total investment that counts, the exemption should be available for multiple grants made over a reasonably short time to the same franchisee, provided that the total amount being invested is at least \$5 000 000.
- The exemption should be available only if the prospective franchisee signs a separate acknowledgement that specifically refers to the disclosure statute, its substantial initial investment exemption section, and the required threshold amount, thus alerting the prospective franchisee to both the statute and its exemption, so that he is likely to read and understand them.

We recommend that if Manitoba decides to enact franchise disclosure legislation, then the legislation not include a substantial initial investment exemption. But if Manitoba nevertheless decides to include such an exemption, then we recommend that the threshold amount be set at \$2 000 000, excluding the cost of real estate, and that the legislation address our five other concerns.

K. Ministerial Discretion

Each of the Alberta and New Brunswick Acts gives the Minister (in Alberta) or Lieutenant-Governor in Council (in New Brunswick) discretion to exempt by regulation any person or class of persons, any grant or class of grants of a franchise, or any franchise or class of franchises, from any or all requirements of

the Act or its regulations.³⁹ The Ontario and PEI Acts have no such "ministerial discretion" exemption.⁴⁰

The policy underlying the ministerial discretion exemption for disclosure is that the Crown has investigated appropriately and determined that, in the circumstances, disclosure is not necessary to prevent misrepresentation (either by misstatement or omission) of the nature, value and price of the franchise.

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation not include a ministerial discretion exemption similar to that in the Ontario and PEI Acts.

L. Financial Disclosure

Each of the Ontario and PEI Acts gives the Lieutenant-Governor in Council the power to make regulations exempting franchisors generally from the requirement to include specified financial information in the disclosure document.⁴¹ In addition, the PEI Act gives the Minister, upon application by a specific franchisor, the power to issue an order exempting that franchisor from having to include its financial statement in the disclosure document, upon such terms and conditions as the Minister may require.⁴²

The Ontario and PEI disclosure Regulations implement their Acts' "general financial disclosure" exemptions: a franchisor need not include its financial statement in the disclosure document if it meets and continues to meet certain net worth and "good operating experience" requirements.⁴³

The policy underlying this "general financial disclosure" exemption is that such "reliable" franchisors are unlikely to experience a disastrous financial reverse before the prospective franchisee has established his franchise business. Therefore these franchisors should not be unfairly disadvantaged in the market by having to disclose their financial statements.

³⁹ Alberta Act: 6; New Brunswick Act: 14(1)(j).

⁴⁰ But see their financial statement exemption, described in the next section of this Paper.

⁴¹ Ontario Act, s. 13; PEI Act, s. 14(1)(g).

⁴² PEI Act, s. 8.

⁴³ Ontario Regulation, s. 11; PEI Regulation, s. 6. The net worth requirement is either: (a) having a net worth on a consolidated basis of at least \$2 000 000 (PEI)/\$5 000 000 (ON), or (b) of at least \$1 000 000, if controlled by a parent who meets the \$2 000 000 (PEI)/\$5 000 000 (ON) requirement. The operating experience requirement is: (a) having either: (i) at least 25 franchisees operating at all times within a single jurisdiction during the five years preceding the date of the disclosure document, or (ii) having a controlling parent meeting that requirement, *and* (b) having (or such parent having) no Canadian judgement, order or award made in Canada made against it in Canada within the previous five years relating to fraud, unfair or deceptive acts or practices, or a law regulating franchises.

The same policy underlies PEI's "specific financial disclosure" exemption, since the Minister, having investigated appropriately, has determined that the franchisor will be sufficiently "reliable" if it complies with the terms and conditions attached to the minister's order.

We have a concern with the net worth test in the general financial exemptions appearing in the Ontario and PEI Acts. Exempting a franchisor whose parent has the required \$2 000 000 or \$5 000 000 net worth, without more, allows an unscrupulous foreign franchisor with sufficient net worth and operating experience (based on its foreign operation) to totally eliminate its financial risk of expanding to Canada, simply by incorporating a wholly-owned "shell" subsidiary to act as the Canadian franchisor. Since the Canadian franchisor's disclosure document need not include its financial statement, should the disclosure document fail to reveal the franchisor's under-capitalization (a material fact) and the Canadian implementation fail (as many do, the first time), the franchisees may be "burned". One way to address this problem is to require the foreign franchisor to unconditionally guarantee the Canadian franchisor's obligations under the franchise agreement, and to make both franchisors liable for a misrepresentation in the Canadian franchise disclosure document.

If Manitoba decides to enact franchise disclosure legislation that includes a "general financial disclosure" exemption, then we recommend that the net worth test of that exemption be available only if:

- The parent/affiliate unconditionally indemnifies the franchisee in writing against the franchisor's failure to perform the franchisor's obligations in the franchise agreement, and
- The certificate of disclosure (which we assume the legislation will require be included in the franchisor's disclosure document) is also signed by two of the indemnifying parent/affiliate's directors or officers, so that they, too, become personally liable (together with the franchisor's two directors and officers) under the statutory cause of action remedy which we assume the legislation will provide.

III. THE STATUTORY EXCLUSIONS

A. Employment, Partnership and Co-operatives

Each of the New Brunswick, Ontario and PEI Acts states that it does not apply to an employer-employee relationship, or to a partnership, or to membership in certain defined co-operatives.⁴⁴ Without these exclusions many of these

⁴⁴ New Brunswick Act, ss. 2(4)(a) to (c); Ontario Act, ss. 2(3)1. to 3. and Ontario Regulation, s. 1; PEI Act, ss. 2(3)(a) to (c).

relationships could be franchises because of the "significant assistance/control" element in the statutory definitions of "franchise". The Alberta Act has no such exclusion (of course it has a different definition of "franchise").

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include exclusions for employment, partnership and co-operative types of business arrangement.

B. Single Trade-Mark License

Each of the New Brunswick, Ontario and PEI Acts states that it does not apply to:

[A]n arrangement arising from an agreement between a licensor and a single licensee to license a specific trade-mark, service mark, trade name, logo or advertising or other commercial symbol were such license is the only one of its general nature and type to be granted by the licensor *in Canada* with respect to that trade-mark, service mark, trade name, logo or advertising or other commercial symbol.⁴⁵

The Alberta Act has no such "single license" exclusion.

The single license exemption originated with the FTC Rule.⁴⁶ The policy underlying the exclusion is to ensure that the statute does not apply to three important, recurring types of commercial arrangement:

- "One-on-one" licensing, in which a trade-mark is licensed to a manufacturer who produces the trade-marked goods in accordance with the licensor's specifications.
- "Collateral" licensing, in which a trade-mark that is well-known in one context (e.g. designer clothing) is licensed for use in an entirely different context (e.g. women's purses and luggage).
- Arrangements to settle trade-mark litigation, in which the plaintiff licenses its trade-mark to the defendant.

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include a single license exclusion.

C. Certification Marks

Each of the New Brunswick, Ontario and PEI Acts states that it does not apply to:

[A]n arrangement arising from an agreement to use a trade-mark, service mark, trade name, logo or advertising or other commercial symbol designating a person who offers on

⁴⁵ New Brunswick Act, s. 2(4)(e); Ontario Act, s. 2(3)5; PEI Act, s. 2(3)(e). The exclusion in the Ontario Act does not have the italicized words.

⁴⁶ Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, *supra* note 27 at §436.2(a)(4)(iv).

a general basis, for consideration, a service for the evaluation, testing or certification of goods, commodities or services.⁴⁷

The policy underlying the "certification marks" exclusion is that although the goods, etc. are certainly "substantially associated" with the certification mark, that association has a different purpose than the trade-mark association referred to in the statutory definitions of "franchise", since *anyone* whose goods, etc. meet the licensor's standards and who pays the fee can use the certification mark.

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include certification marks exclusion.

D. Leased Departments

A "leased department" is an arrangement in which an independent retailer sells his own goods or services from space that he leases from a larger retailer within or adjacent to the larger retailer's premises, and the independent retailer is not required to purchase goods or services from the larger retailer or its affiliate. This type of arrangement is typical in large department stores for the sale of tobacco, shoes, watches and jewellery, cosmetics, sunglasses, etc.

A leased department may fall within the statutory definitions of "franchise", depending on the details of the arrangement. The Ontario Act states that it does not apply to leased departments,⁴⁸ whereas the Alberta Act merely exempts leased departments from its disclosure requirements.⁴⁹ The New Brunswick and PEI Acts do neither.

The leased department exclusion originated with the FTC Rule.⁵⁰ The policy underlying the Alberta Act's exemption is that the expense in time and money of preparing a disclosure document is not warranted where a smaller retailer is merely leasing space in which to offer and sell his own merchandise acquired from third parties, provided that the only payments made to the larger retailer or its affiliate are for renting the space.

Ontario's choice to exclude leased departments altogether from the Ontario Act's ambit means that the Act's fair dealing and right of association obligations do not apply to a leased department arrangement, even if the arrangement otherwise qualifies as a "franchise". We can see no principled reason for this.

⁴⁷ In other words, the licensing of a certification mark. See New Brunswick Act, s. 2(4)(d); Ontario Act, s. 2(3)4; PEI Act, s. 2(3)(d).

⁴⁸ Ontario Act, s. 2(3)6.

⁴⁹ Alberta Act, s. 5(1)(g).

⁵⁰ Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, *supra* note 27 at §436.2(a)(3)(ii).

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation exempt leased departments from the disclosure requirements. If Manitoba decides to adopt fair dealing, right of association or other franchise relationship legislation, then we recommend that the legislation *not* exclude leased departments that qualify as "franchises".

E. Oral Franchise

Each of the New Brunswick, Ontario and PEI Acts states that it does not apply to an oral commercial arrangement that might otherwise be a "franchise", if there is nothing in writing evidencing any material term of the arrangement.⁵¹ The policy underlying this "oral franchise" exclusion is simply to avoid problems of proof.

If Manitoba decides to enact franchise disclosure legislation, then we recommend that the legislation include an oral franchise exclusion.

F. *Bona Fide* Wholesale Price

Each of the New Brunswick and PEI Acts states that it does not apply to an arrangement arising from an agreement to purchase a reasonable amount of goods or services at a reasonable wholesale price (goods) or a reasonable price (services).⁵² The Alberta Act accomplishes the same result by excluding such purchases from its definition of "franchise fee".⁵³

The Ontario Act has neither exclusion, thereby including within its ambit many commercial distribution arrangements that, in our view, ought not be so regulated.

The policy underlying the "bona fide wholesale price" exclusion is that the purchaser incurs no real risk in buying the goods or services, since ordinarily he needs the services and can readily re-sell the goods.

Our concern with this exclusion is that it does not prevent a franchisor from requiring franchisees to purchase unneeded services or excessive, obsolete or otherwise unmarketable goods.

If Manitoba decides to enact franchise disclosure legislation, then we recommend that legislation include a "bona fide wholesale price" exclusion, but that the exclusion not be available if the franchisee is required (either by agreement or practical necessity) to purchase goods or services in quantities exceeding those which a reasonable person, operating a similar-size business in

⁵¹ New Brunswick Act, s. 2(4)(f); Ontario Act, s. 2(3)(7); PEI Act, s. 2(3)(f).

⁵² New Brunswick Act, s. 2(4)(g); PEI Act, s. 2(3)(g).

⁵³ Alberta Act, s. 1(1)(f).

the same general market, normally would purchase in order to start up or maintain the business.

G. Crown Arrangements

Each of the Ontario and PEI Acts states that it does not apply to a service contract or other franchise-like arrangement with the Crown or a Crown agent. Neither the Alberta Act nor the New Brunswick Act has this exclusion.⁵⁴

The policy underlying the "Crown arrangement" exclusion is, first, that the expense in time and money of preparing and delivering a disclosure document to the Crown is not warranted, since the Crown will always demand and obtain whatever material information it needs before committing itself to the business arrangement, and, second, that since the Crown can do no wrong, it will always provide appropriate disclosure to the other party to the arrangement.

We have no comment or recommendation concerning the Crown arrangements exclusion.

If Manitoba decides to enact franchise legislation, then we recommend that the legislation not provide for this exclusion similar to the Alberta and New Brunswick Acts.

⁵⁴ The New Brunswick Act binds the Crown. See section 2(1).