Franchise Law: Consultation Paper 2007

MANITOBA LAW REFORM COMMISSION

CHAPTER 1: INTRODUCTION

A. Background to the Project

The Manitoba Law Reform Commission has noted that franchising is a growing and relatively unregulated field of business activity; there has been occasional media attention focusing on the inequality between franchisors and franchisees and recently, on alleged franchising frauds in Manitoba.[1] In recent years, three provinces and several countries have enacted new or revised franchise legislation. In January 2006, the Commission received a suggestion that a review of possible reforms to franchise law would be valuable in Manitoba,[2] and the Commission agreed to undertake the project.

B. Scope

This paper considers whether the regulation of franchises is desirable in Manitoba. It provides an introduction to the history and various models of franchising, an overview of existing franchise regulation in Canada and other countries and a comparison of the elements of Canadian legislative regimes. Finally, it asks whether franchise legislation is needed in Manitoba, and if so, what elements should be included in the legislation.

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1 For example, A. Paul, "City man burned by pizza franchise scam" *Winnipeg Free Press* (February 12, 2007); P. Turenne, "Bitter business tale: Pizza franchise turned out to be scam" *Winnipeg Sun* (February 12, 2007). See also T. Davis, "A town tackles a giant" *Winnipeg Free Press* (June 17, 1995) A17; residents of the Town of Oakville organized a rally to protest a new General Motors policy that was forcing a dealer to close his dealership and to press for legislation that would make it more difficult for franchisors to dictate terms to franchisees. According to the report, GM was requiring dealers to undertake expensive renovations, and had refused approval for the Oakville dealer to sell his dealership instead. In the article, NDP MLA Jim Maloway and the President of the Manitoba Motor Dealers Association advocated for franchise legislation in Manitoba.

2 The review was suggested by A.L. Weinberg, Q.C., Myers Weinberg LLP, Winnipeg, Manitoba.

C. Invitation to Comment

The Commission invites public comment in the matters discussed in this paper and hopes that all interested persons and organizations will accept the invitation to share their thoughts on the issues raised. Once comments have been received, the Commission will consider them and prepare its final report. In accordance with *The Law Reform Commission Act*,[3] the Commission will then submit the report to the Minister of Justice and Attorney General for consideration.

Anyone wishing to respond to the issues raised, or to comment on any other relevant issue, is invited to write to the Commission at the following address: Manitoba Law Reform Commission, 432-405 Broadway, Winnipeg, Manitoba, R3C 3L6

Submissions may also be sent by fax to (204) 948-2184 or by email to lawreform@gov.mb.ca. We regret that we are unable to receive oral submissions.

Unless clearly marked to the contrary, the Commission will assume that comments received are not confidential, and that respondents consent to our quoting from or referring to their comments, in whole or in part, and attributing the comments to them. Requests for confidentiality or anonymity will be respected to the extent permitted by freedom of information legislation.

The deadline for submissions is August 20, 2007.

CHAPTER 2: FRANCHISING OVERVIEW

A. General

Franchises are widespread in today's society. Consumers do business daily with a broad range of franchised brands - buying fast-food, coffee, gas, and real estate, hiring cleaning services, booking vacations, and having their taxes prepared. However, the prevalence of franchising as a way of doing business is a relatively recent phenomenon.

In its earliest sense, a franchise was a "special privilege to do certain things conferred by government on an individual or corporation, and which does not belong to citizens generally of common right".[4] This meaning is still relevant; the government grants franchises to companies such as telecommunications and utility service providers to encourage the development of a 'public good' by the

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3 *The Law Reform Commission Act*, C.C.S.M. c. L95.

4 *Black's Law Dictionary*, 6th ed., *s.v.* "franchise." For example, in ancient England the monarchy would grant a subject the right to collect taxes; in more recent times a government may grant a utility company a monopoly franchise to encourage the development of a 'public good' by the private sector.

private sector. In the modern commercial environment, however, franchising now generally refers to a specific and prevalent method of doing business.

> In its simplest terms, a franchise is a license from [the] owner of a trademark or trade name permitting another to sell a product under that name or mark. More broadly stated, a "franchise" has evolved into an elaborate agreement under which the franchisee undertakes to conduct a business or sell a product or service in accordance with methods and procedures prescribed by the franchisor, and the franchisor undertakes to assist the franchisee through advertising, promotion and other advisory services.[5]

A franchise is a contract between two businesses, in which the franchisor grants the franchisee the right to operate its business system in return for payment of fees and royalties. The business system typically includes intellectual property (such as trademarks, trade names and logos), the right to sell products or services, access to business knowledge and methods, and other physical and intangible assets.[6] Franchisors may operate some of their units directly and franchise others.

A key element of a franchise is the ongoing relationship between the parties. The franchisor often provides continuing support or direction regarding the operation of the business. The franchisee agrees to sell the franchisor's product, often exclusively, and to comply with the franchisor's standards. While the franchisee is an independent business, it will usually be required to operate in a way that is substantially similar to or indistinguishable from the operation of the franchisor and its other franchisees.[7]

Franchising has been described as "an organizational choice for distributing goods and services."[8]

> As a form of business organization, franchising is seen as occupying a middle ground between two poles of the organizational continuum. At one end of the continuum is vertical integration (for example, a producer that owns its own retail outlets). At the other end is an isolated commercial transaction (for example, a producer that makes a one-time sale to a retailer). In franchising the vertical relationship, often between a supplier and a retailer, is continuous and sometimes intense. The franchisee may gain the good will associated with the franchisor's trademark, standards for the quality and style of operation associated with the mark, and perhaps from training and advice provided by the

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5 *Ibid.*

6 See A.J. Trebilcock, "Introduction to Franchising" in *Franchising 101*, Ontario Bar Association (2001), online: <http://www.oba.org/en/pdf/Franchising101.pdf> (date accessed May 3, 2007); J. Anthony Van Duzer, *The Law of Partnerships and Corporations* (2nd ed., 2003) at 20.

7 Trebilcock, *supra* note 3; E.N. Levitt, *Distribution Networks and Agreements*, Gowling Lafleur Henderson LLP, Toronto, Ontario (May 2002), online: <http://www.gowlings.com/resources/PublicationPDFs/Levitt_DistributionNetworks.pdf> (date accessed: May 3, 2007).

8 W. Grimes, "Perspectives on Franchising: When Do Franchisors Have Market Power? Anti-Trust Remedies for Franchisor Opportunism" (1996), 65 Antitrust L.J. 105 at 107.

> franchisor. Still, the capital and risk incentives for operation of individual outlets remain much like those of independently owned businesses. The franchisee risks its capital to own and operate an outlet. But, unlike in an independently owned business, a franchisee generally relinquishes a great deal of control over the outlet and must share with the franchisor the revenue generated by the outlet. Many franchisees pay an up-front franchise fee, continuing royalties based upon sales, and subject themselves to the franchisor's monitoring.[9]

B. History

The franchising concept dates back to the English Middle Ages, when the Crown, wanting to avoid the costs and administrative burden of hiring, paying and supervising tax collectors, granted to officials the right to collect and keep the Crown's taxes in return for a fee. Later, in North America, governments granted private individuals and corporations the right to carry out activities that would otherwise be restricted to the government, to facilitate the development of infrastructure and services such as railroads, utilities, and banking.[10]

Modern private sector franchising first appeared in the 1850s. The first franchise model is often attributed to the Singer Sewing Machine Company, which created an independent distributor network for its sewing machines. Although the business model ultimately failed for Singer, the private sector franchising concept began to take hold.[11]

One of the first businesses to successfully employ the franchising concept was Coca-Cola. As the company expanded across the U.S., it licensed regional franchisee bottlers to produce and bottle soft drinks under its trademark. Coca-Cola's rapid expansion was funded by the franchisees, who in return received exclusive distribution territories and support.[12]

General Motors began distributing automobile inventory across the country through individual dealers in 1898. Dealers could purchase vehicles at a discounted price for resale and were granted regional franchise rights; in return they were required to sell only the products of a single manufacturer. This distribution method shifted to dealers some of the risks of market downturns, and proved to be successful for the automobile industry.[13]

In the 1930s, oil refiners licensed franchisee gasoline stations to distribute their products. Oil companies that leased their service stations to their former

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9 *Ibid.*

10 See D.F. So, *Canadian Franchise Law Handbook* (2005) at 9–17; Trebilcock, *supra* note 3; F. Zaid, *Franchise Law* (2005) at 2.

11 So, *supra* note 7.

12 *Ibid.*; Trebilcock, *supra* note 3.

13 So, *supra* note 7.

managers found that the owner-dealers had a more personal interest in the success of their locations, resulting in larger profits through higher gas sales and from the rent from the properties. In Canada, the Canadian Tire franchise was also successfully established in the 1930s.[14]

During the Depression, individual retail merchants grouped together in order to cope more efficiently with the difficult economy and compete with large business chains.[15] Following the Second World War, franchising expanded to a number of new industries, including fast food restaurants, hardware, and drug retailing (including Shoppers' Drug Mart in Canada) and motel and hotel services. There were high-profile failures associated with rapid expansion "as growth continued unprincipled and unregulated,"[16] but by the 1970s, franchising had become a popular method of doing business and an enduring part of the U.S. and Canadian economies.

C. Franchise Economic Impact

Franchising represents a significant portion of the Canadian economy. The Canadian Franchise Association has reported that franchising accounts for $90 billion per year in sales nationally.[17] With respect to Ontario, Hoffman and Levitt have commented:

> The importance and impact of franchising on Ontario's economy today cannot be overstated. Franchising's share of the retail dollar is fast approaching 50%. It has moved from a somewhat novel alternative distribution option to one of the first distribution choices considered by a wide variety of businesses.[18]

In the U.S., a study commissioned by the International Franchise Association examining 2001 data found that there were more than 767 000 franchised businesses directly employing 9.8 million people, with a payroll of $229 billion and an economic output of nearly $625 billion. When the indirect impact of franchised businesses was measured, they generated more than 18

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14 *Ibid.*

15 Trebilcock, *supra* note 3.

16 Zaid, *supra* note 7 at 2.

17 According to the Canadian Franchise Association, franchising crosses 42 sectors of the economy: Ontario Legislative Assembly, Standing Committee on Regulations and Private Bills, *Hansard* (March 8, 2000: Hearing on Bill 33: *Franchise Disclosure Act,* 1999) at 1340 (R. Cunningham, Canadian Franchise Association), online: <http://www.ontla.on.ca/web/bills/bills_detail.do?locale=en&BillID=740%20%20%20%20%20%20&isCurrent=false&detailPage=bills_detail_related> (date accessed: May 8, 2007).

18 J.P Hoffman and E.N Levitt, *Recent Developments of Importance in Franchise Law* Gowling Lafleur Henderson, Toronto, Ontario (December 17, 2005), online: <http://gowlings.com/resources/publications.asp?pubid=1156> (date accessed: May 3, 2007).

million jobs, or nearly 14% of all private sector jobs, and accounted for 11% of the private sector payroll and 9.5% of the private sector economic output, or more than $1.53 trillion. According to the study, when both direct and indirect forms of employment were combined, franchising generated one out of every seven jobs in the private sector.[19]

In Canada, it was reported in 2004 that there were 1 327 franchisors, 63 642 franchisees and annual franchising industry sales equivalent to approximately $90 billion U.S.,[20] or approximately 10% of Canada's gross domestic product. Franchising has been reported to account for one out of every five consumer dollars spent in Canada on goods and services and to employ over one million Canadians.[21]

D. Types of Franchise Arrangements

There are two primary types of franchise arrangements: business format and product distribution franchises. Some commentators also include business opportunity franchises.

1. Business Format Franchise

The business format franchise is the modern type of franchising that emerged in the 1960s and is most commonly recognized as a franchise today. The franchisee exclusively identifies with the franchisor, and adopts its entire business system, including its product, brand name, operating manual and marketing strategy. There is "an almost complete merging of the business identity of franchisee and franchisor, so that the public perceives each franchised outlet as part of a larger chain of identical outlets, all offering the same high quality goods and services".[22] Examples include hotels and fast food outlets such as Tim Hortons™ and McDonalds™.

The unit franchise is the simplest and most popular business format franchise. In this model, the franchisor licenses the franchisee to operate a single

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19 PriceWaterhouseCoopers, *The Economic Impact of Franchised Businesses: A Study for the International Franchise Association Education Foundation, Part II* (March 2004), online: <http://www.franchise.org/Files/EIS6_2.pdf> (date accessed May 3, 2007); "Franchises provide big boost to nation's economy: study measures jobs, payroll, overall output" 38:5 *Franchising World* (May 2006), online: <http://www.allbusiness.com/retail-trade/1185340-3.html> (date accessed May 3, 2007).

20 So, *supra* note 7 at 5.

21 D. Caldarone and D.J. Gray, "Advising the Start-up Franchisor" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006) at 2.

22 Trebilcock, *supra* note 3 at 2.

franchise business in a specific location or territory. The franchisee usually pays an initial franchise fee and ongoing royalties based on a percentage of gross sales. The agreement usually requires the franchisee to contribute to an advertising fund, and may contemplate multiple franchises, so that the franchisee has the option to acquire additional franchises or rights of first refusal.[23] There are also variations:

In an affiliation or conversion franchise, the franchisor absorbs an independent business in the same field. The business agrees to conduct future operations under the franchisor's model.[24]

A combination franchise joins "two or more distinct and complementary franchise systems in physical or functional conjunction,"[25] usually involving the installation of an outlet of one system into an outlet of the 'host' franchise system.

There are also forms of territorial franchising, in which rights are granted for an entire territory, such as a city, province, or all of Canada:[26]

In an area representation franchise*,* the franchisor retains an independent representative to seek prospective franchisees and carry out the franchisor's obligations within a defined area, in return for a share of the revenue. However, the franchise agreement is between the franchisee and franchisor, and not the representative.[27]

In an area development franchise, the franchisor grants a franchisee the right to set up multiple outlets within a geographical area. The area development agreements generally deal with the terms of the franchise expansion and the number of outlets to be established, while the details of the individual outlets are governed by unit franchise agreements.[28]

In a master franchising arrangement, the franchisor grants a master franchisee the right to recruit others and sell and service sub-franchises within a specified territory. The maintenance of exclusive rights to the territory depends on a performance schedule being met.[29] A master franchise creates a three-tiered relationship between the franchisor, master franchisee (or sub-franchisor) and

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23 See L.H. Polsky, "Search continues for multiple unit franchisees," 24:21 *Lawyers Weekly* (October 8, 2004).

24 Trebilcock, *supra* note 3 at 3.

25 *Ibid.*

26 Polsky, *supra* note 20.

27 Trebilcock, *supra* note 3 at 3.

28 *Ibid* at 2.

29 Polsky, *supra* note 20.

sub-franchisee (or unit franchisee). There is a contract between the franchisor and the master franchisee and between the master franchisee and sub franchisees, but not between the sub-franchisee and the franchisor.[30] However, the franchisor receives revenues earned from the operations of the franchises and from sharing the franchise fees or royalty payments made to the master franchisee.

Finally, in a joint venture franchise, a franchisor and franchisee enter into a joint venture in which the franchisor grants a unit, area development, or master franchise to the joint venture entity.

2. Product Distribution Franchise

In a product distribution franchise, the franchisee is identified with the manufacturer or supplier to some degree, but also retains a distinct identity; examples are soft drink bottlers and automobile dealerships.[31] The franchisee obtains a license to market and sell products within an exclusive distribution area, and may be encouraged or required to deal primarily with the franchisor's goods or services. Otherwise, the franchisor exercises less control than in a business format franchise, and the franchisee is usually free to choose its business style and distribution technique.[32]

3. Business Opportunity Franchise

In a business opportunity franchise, the franchisor grants the franchisee the right to sell goods and services provided by the franchisor. The franchisor may also provide location assistance. Examples of business opportunity franchises are vending machines and amusement games.[33]

E. Franchise Advantages and Disadvantages

A significant attraction of the franchise arrangement for the franchisee, particularly for the first time business owner, is the opportunity to enter the marketplace without assuming the degree of risk usually associated with startup enterprises. Business risks can be reduced where there is an established franchisor that offers a solid image, a recognized product or service with a developed market and a successful business system for the marketing and sale of the product or service. The franchisor generally has a vested interest in the success of the franchisee, and often provides detailed training, ongoing advice

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[30] Trebilcock, *supra* note 3 at 2.

[31] Zaid, *supra* note 7 at 6; for example, an automotive group may operate a number of dealerships and be associated with several manufacturers, but maintain a distinct identity.

[32] Trebilcock, *supra* note 3 at 1-2.

[33] Zaid, *supra* note 7 at 6.

and mentoring and assistance in the event of a crisis.[34] The franchisee continues to benefit from the franchisor's ongoing product research and development and often from volume discounts available with bulk purchasing through the franchisor. Financial institutions are also often more willing to provide business loans to franchised businesses.[35]

For the franchisor, franchising allows business expansion with little capital investment; expansion can be more rapid, as it is largely financed by franchisees.[36] Franchising also provides an ongoing source of revenue from franchise fees or royalties. Franchise unit owners may have a higher stake and level of commitment to the success of the business than do employed managers, and in the long term, the franchisor benefits from a competent franchisee's ability to attract future franchisees and increase the goodwill of the overall system.

While there are many examples of successful and profitable franchise relationships, the model also has disadvantages and risks. The franchisor gives up some control and profit opportunity by not operating its own outlets, in the expectation of greater profits through expansion.[37] The franchisor's reputation is at risk, as the general public will often not distinguish between individual franchise outlets and the larger organization. Franchisee selection can be difficult and time consuming,[38] and an incompetent or unsuccessful franchisee can damage the established goodwill of the franchise by providing substandard products or services.

To manage these risks, the franchisor will usually attempt to ensure that each franchisee maintains minimum standards in relation to the appearance and operation of its business. Franchisees are generally required to comply strictly with the operational methods established by the franchisor,[39] and are frequently

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34 For a useful discussion of the advantages and disadvantages of buying a franchise see Canada Business Service Centre, *Tips on Buying a Franchise*, online: <http://www.cbsc.org/servlet/ContentServer?cid=1084286449074&pagename=CBSC_AB%2Fdisplay&lang=en&c=GuideFactSheet>.

35 So, *supra* note 7 at 7.

36 *Ibid.* at 5.

37 Caldarone and Gray, *supra* note 18 at 6-7.

38 *Ibid.* at 7.

39 Levitt, *supra* note 4. As a result franchise arrangements are frequently long and complex and include a large number of secondary agreements, such as subleases and trademark, security and confidentiality agreements.

required to purchase supplies and inventory directly from the franchisor or from a designated supplier.[40]

The requirements imposed by the franchisor increase its ability to exercise quality control, limit the ability of franchisees to attempt "free-riding" (a franchisee's attempt to benefit from the franchisor's reputation without doing its part to maintain standards)[41] and often increase the buying power of the franchisees. However, requirements for strict compliance may also stifle creative initiative by franchisees that otherwise could enhance the overall business and reputation of the franchise.[42] A franchisor may impose onerous obligations, exercise an excessive degree of control, fail to carry out effective marketing and promotion activities, or disproportionately shift business risks and impose unreasonable product costs to the franchisee, making it difficult or impossible for the franchisee to carry on the business effectively.

It has also been suggested that there is a "myth of high profitability".[43] While there is a widespread perception of reduced risk, and mature and established franchise businesses may present lower risk and higher return to the investor than an independent start-up business (and as a result, command higher fees), new franchise outlets tend to be in high-risk areas of business with marginal return, and fail at a rate at or above the rate for other small businesses.[44]

In the end, both parties to the franchise relationship assume the ultimate risk of costly litigation should the franchise relationship prove unsuccessful.

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40 So, *supra* note 7 at 7. So notes that volume purchasing is frequently a contentious issue; while the associated discounts may benefit franchisees, in some cases rebates are paid directly to the franchisor and the franchisees do not directly benefit.

41 Grimes, *supra* note 5 at 109-110.

42 *Ibid.* at 110.

43 *Ibid.* at 130.

44 *Ibid.* at 123-124 and 130-131. See also T. Bates, "Survival Patterns Among Newcomers to Franchising" (Paper prepared for the Center for Economic Studies, U.S. Bureau of the Census, May 1997, CES-WP-97-5), online: <http://www.ces.census.gov/index.php/ces/1.00/cespapers?limit=10&search_where=d2hlcmUgeWVhcihwdWJsaWNhdGlvbl9kYXRlKT0xOTk3#table> (date accessed May 7, 2007); the study found that among 'true newcomers' (young franchisee units not owned by mature multi-establishment franchisees), franchise survival rates were low and that the purchase of a franchise was not likely to reduce the risks faced by a new business.

F. The Franchise Legal Relationship

1. Potential for Conflict

The relationship between the parties to a franchise agreement is often compared to a marriage: the parties depend on each other for their continued well being, the relationship is intended to continue for a lengthy period of time, and the arrangement is intended to be satisfactory to both parties.[45]

While franchisors and franchisees generally share a common desire to succeed, there is also considerable potential for conflict between them. The parties frequently have dramatically unequal bargaining power: the franchisor is often a large, sophisticated business organization with significant franchising experience and control over the terms of the franchise agreement, while the franchisee may have little business experience and, in any event, often must 'take or leave' the franchise agreement as offered. The franchisee must rely to some extent on the franchisor's representations with respect to the potential for business success. In some cases, disreputable franchisors use high-pressure sales tactics and provide inaccurate or misleading financial information. When problems occur in the franchise, a franchisee suffering business difficulties will be less likely than the franchisor to have the financial resources available to fund litigation.

There can be a significant imbalance in the amount and quality of information available to the parties during negotiations and at the time the franchise agreement is signed. For a franchisor that is so inclined, the pre-contract period can be viewed as one with substantial incentives for opportunism.

> In recruiting an investor to open up a new franchise outlet a franchisor is, to a large degree, gambling with someone else's money… [F]ranchisors gain financially when an investor opens a new outlet, perhaps even if that outlet fails. Some franchisors may have invested minimally in the franchise system, but even those who have a large stake in the system may commit little or no resources to a new outlet. Indeed, the franchisor may receive an up-front franchise fee and, thus, may reap immediate financial gain even if the outlet fails quickly. In the event of failure the franchisor may be the only buyer for the

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45 L. Weinberg, "The Franchise Relationship" in *Franchising 101*, Ontario Bar Association (2001) at 1, online: <http://www.oba.org/en/pdf/Franchising101.pdf> (date accessed May 7, 2007); A 1995 review of the Canadian franchise industry noted "In some chains, especially those that are doing well, the connections can be quite strong, and stable. In others – and not necessarily just those franchises that are faring poorly – the relationship resembles a failing marriage, complete with suspicion, poor communications, and the presence of lawyers.": J. Lorinc, *Opportunity Knocks: The Truth About Canada's Franchise Industry* (1995).

franchisee's capital equipment, and may do so at a deeply discounted price, perhaps reselling it to a future franchisee at a substantial markup.[46]

The franchisee continues to be at a disadvantage in relation to the franchisor in terms of access to information and control of operations throughout the franchise relationship. In many cases, franchisees are somewhat locked into the relationship by high 'sunk costs', or invested funds that cannot be recovered if the franchise relationship ends. These costs mean that these franchisees will be disinclined to walk away from the franchise even in the case of reduced revenues and a poor relationship with the franchisor.[47]

Various reviews of franchisor-franchisee disputes in Canada, the U.S. and Australia have identified a number of areas of dispute relating to the information and power imbalance in the relationship.[48] The issues include:

- lack of pre-contract disclosure;
- deceptive practices, including misrepresentation of the nature of the franchise, the range of supplies, equipment and training to be provided in the franchise package, the value and profitability of the franchise and the franchisor's stability and prior experience;
- unfair contract terms arising from a refusal by franchisors to negotiate the terms and conditions of contracts (the 'take it or leave it' contract);
- complexity of documentation;
- excessive prices charged for mandatory goods and equipment supplied by franchisors or other providers to franchisees, even when items are available more cheaply from alternative suppliers;

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46 Grimes, *supra* note 5 at 124-125.

47 Grimes, *supra* note 5 at 125. Grimes presents a thorough discussion of the incentives that may exist for a franchisor to act contrary to the interests of a franchisee. For example, a franchisor may decide to open an additional outlet in a territory, even if it decreases the sales of existing outlets, if the franchisor's overall revenue will increase. On the other hand, while the incentives of the franchisor may lean toward too much expansion, franchisees may have incentives leading them to oppose expansion, even when it has a very favourable impact to the overall franchise.

48 See for example Lorinc, *supra* note 42; Grimes, *supra* note 5; U.S. Federal Trade Commission, "The Franchise Rule" (Statement before the U.S. House of Representatives Committee on Energy and Commerce, Subcommittee on Commerce, Trade and Consumer Protection, June 25, 2002), online: <http://www.ftc.gov/os/2002/06/020625bealesfranruletest.htm> (date accessed: May 7, 2007); Parliament of Australia House of Representatives Standing Committee on Industry, Science and Resources, *Finding a Balance: Towards Fair Trading in Australia* (May 1997), online: <http://www.aph.gov.au/HOUSE/committee/Isr/Fairtrad/report/contents.htm> (date accessed: May 7, 2007).

- secret rebates and commissions received by franchisors from required suppliers;
- encroachment by the franchisor on the franchisee's geographic trading area;
- franchisor-imposed system wide changes that bear significant cost;
- failure to provide adequate service and support to franchisees;
- substantial increases to renewal fees;
- use of advertising levies for non-advertising purposes;
- transfer and renewal restrictions and renewals on different and more onerous terms; and
- unfair terminations.[49]

On the other hand, franchisor representatives have noted that the characterization of franchising issues can be one-sided and ignore the difficulties that can be caused by franchisees.

> [L]ittle mention is made in debate about potential franchisees wanting to 'get into' the franchise system by misrepresentation of part or more of their small business history, financial position, work experience, level of commitment, product or service knowledge and other necessary criteria. In mature franchise systems, there appears to be an increase in incidents of this.[50]

One commentator eloquently summed up his views:

> Good franchising is very good. It is undoubtedly the most efficient, effective distribution system ever invented. It is the greatest invention of Western capitalism since the invention of the corporation. Good franchising is so much better than independent small business operation and bad franchising is so much worse.[51]

2. Legal Aspects

In the absence of franchise-specific legislation, the relationship between the franchisee and franchisor is governed by the terms of the franchise agreement and the law of contract. The rights and duties of each party arise from the

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49 Recent media reports of lawsuits filed by franchisees of the Quiznos food chain in the U.S. vividly illustrate some of the problems alleged by franchisees: see J. Creswell, "When Disillusion Sets In: Some Quiznos Franchisees Take Chain to Court" *The New York Times* (February 24, 2007), online: <http://www.nytimes.com/2007/02/24/business/24quiznos.html?ex=1329973200&en=2669991a0477e661&ei=5088&partner=rssnyt&emc=rss> (date accessed: May 7, 2007).

50 Franchise Association of Australia and New Zealand, Submission No. 143 to the Parliament of Australia House of Representatives Standing Committee on Industry, Science and Resources, quoted in Standing Committee on Industry, Science and Resources, *supra* note 45 at 93 note 16.

51 A. Terry, Transcript of Evidence to the Parliament of Australia House of Representatives Standing Committee on Industry, Science and Resources at 92, quoted in Standing Committee on Industry, Science and Resources, *supra* note 45 at 83.

contract, and general contract law principles, such as *caveat emptor* (buyer beware) and the right to act in one's own interests, apply. A party may have a right to rescission of the franchise agreement or to damages on grounds such as breach of contract, misrepresentation, breach of warranty or *error in substantialibus* (a fundamental error in the character or substance of a thing sold).[52]

Franchises have at times been asserted to create employment relationships (for example, in cases where the franchisor exercises significant control over daily operations),[53] and a study of Australian franchise failures found that "despite the franchise agreement stating very clearly that the franchisee is not an employee of the franchisor, it appears that some franchisees regard themselves as employees".[54] As well, in some circumstances the franchisor-franchisee relationship has been argued to be fiduciary in nature, so that the franchisor owes a special duty of care toward the franchisee.[55] The Supreme Court of Canada addressed this issue in 1975, in *Jirna v. Mister Donut*,[56] affirming the finding of the Ontario Court of Appeal that no fiduciary relationship existed in the circumstances. Jirna's representatives in the negotiations were experienced businessmen under no serious disparity relative to the franchisor, and the provisions in the agreement fell considerably short of the relationship of trust and confidence that would be necessary to create a fiduciary obligation. However, the Court did not rule out the possibility of a fiduciary relationship existing in a different franchise situation.

In most circumstances, a franchise agreement is a commercial contract between independent parties with no fiduciary or employment obligations. However, there is no hard and fast rule; a commercial agreement is not immune from the imposition of fiduciary duties,[57] and it is possible that fiduciary or

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52 See for example *Esso Petroleum v. Mardon*, [1976] 2 All E.R. 5 (C.A.); *Kim v. Shefield & Sons – Tobacconists Inc.* (1990), 30 C.P.R. (3d) 111 (B.C.C.A.); *Hossain Nasirbegh v. Triple 3 Holdings Inc. (c.o.b. 3 for 1 Pizza & Wings)*, [2003] O.J. No 751 (Ont. S.C.J.).

53 Weinberg, *supra* note 42 at 3. Weinberg notes that claims of an employment relationship most frequently arise where employment-type severance and other termination benefits are being claimed by the franchisee, especially where the franchisee has little to no capital invested. In some cases, involving restrictive franchise agreements, the arguments have been successful: see *Head v. Inter Tan Canada Ltd.* (1991), 5 O.R. (3d) 192 (Gen. Div).

54 J. Buchan, *When the Franchisor Fails* (Report prepared for CPA Australia, January 2006) at 3, online: <http://www.cpaaustralia.com.au/cps/rde/xbcr/SID-3F57FEDE-E9D973D1/cpa/200602_franchisor.pdf> (date accessed: May 7, 2007).

55 Weinberg, *supra* note 42.

56 [1975] 1 S.C.R. 2, aff'g (1971), 22 D.L.R. (3d) 639 (Ont. C.A.).

57 *530888 Ontario Ltd. v. Sobeys Inc.*, [2001] O.J. No. 318 (S.C.J.) at paragraph. 9.

employment obligations might be found to exist in a franchise relationship in exceptional circumstances.

The typical franchise relationship is distinct from other commercial relationships in some respects, however. In *Shelanu*,[58] a leading 2003 case, the Ontario Court of Appeal noted that, in accordance with *Jirna*,[59] the relationship between a franchisor and franchisee would not normally be characterized as a fiduciary one, but it does have unique characteristics that set it apart from an ordinary commercial relationship. The characteristics are similar to those outlined by the Supreme Court of Canada in *Wallace v. United Grain Growers*[60] that give rise to a good faith obligation in the context of an employment contract. A franchisee does not usually have equal bargaining power to the franchisor, the franchise contract is imposed on the franchisee, who is usually unable to negotiate more favourable terms, and the relationship continues to be affected by the power imbalance, in that the franchisee must submit to inspections and audits and otherwise comply with the franchisor's requirements. In *Shelanu*, the Court held that, in the absence of franchise legislation, these characteristics give rise to a common law duty upon the parties to a franchise relationship to act in good faith. The franchisor must have regard to the legitimate interests of the franchisee, but may act in its own interests so long as it deals promptly, honestly, fairly and reasonably with the franchisee. The Court found that the franchisor in *Shelanu* had breached its duty of good faith, but the breaches did not amount to a fundamental breach of the franchise agreement, and so the franchisee was not entitled to treat the agreement as at an end.

The distinctive nature of the franchise agreement also leads to certain principles of interpretation. Under the principle of *contra proferentem*, a court will construe an ambiguous clause in a contract against the person who prepared it.[61] A franchise agreement is also often a 'contract of adhesion'. This is, in general, a written contract drafted by one party on a form regularly used by the drafter and presented to the other party on a 'take it or leave it' basis; the other party enters into relatively few such transactions in comparison with the drafter and his or her principal obligation is the payment of money. *Contra proferentem*

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58 *Shelanu Inc. v. Print Three Franchising Corp.* (2003), 226 D.L.R. (4th) 577 (Ont. C.A.). Ontario's *Arthur Wishart Act (Franchise Disclosure), 2000*, S.O. 2000, c. 3 requires parties to a franchise agreement to act in good faith. However, the facts giving rise to the dispute occurred before the Act came into force and the Court found that it was not necessary to decide whether the Act applied in this case.

59 *Supra* note 53.

60 *Wallace v. United Grain Growers Ltd. (c.o.b. Public Press),* [1997] 3 S.C.R. 701.

61 *Black's Law Dictionary*, 6th ed., *s.v.* "contra proferentem."

applies, but even in the absence of ambiguity a contract of adhesion is interpreted strictly against the party presenting it.[62]

As well, many other areas of law may affect a franchise, depending on the circumstances and the nature of the business conducted; these may include competition, consumer protection, privacy, tax, bankruptcy, intellectual property, and personal property security law.[63]

3. Manitoba Experience

There do not appear to be reliable data on the experience of franchisors and franchisees in Manitoba. A review of court decisions does illustrate the nature of some disputes that reached resolution through litigation. For example, the recent case of *Halligan v. Liberty Tax Service Inc.*[64] provides a glaring example of franchisor intimidation tactics. The franchisor had decided to change the name of the franchise, and pressured the franchisee to change its business name. The franchisee refused, as he was entitled to do under the franchise agreement. The franchisor then withdrew its funding for tax discounting services without notice, purported to terminate the franchise agreement, and established its own tax services within the franchisee's exclusive territories. The franchisor breached a court injunction that restrained it from acting in a manner inconsistent with the franchisee's rights and harassed the franchisee in a manner that the court noted "is indicative of the disdain Liberty has shown for Halligan and the court process throughout."[65] The court found that there was an attempt by the franchisor to "bludgeon Halligan into submission,"[66] along with flagrant and repetitive breaches of the injunction. Liberty's actions were outrageous and high-handed and the imbalance of power was stark. In light of this, in addition to compensatory damages of nearly $85 000, the court granted punitive damages of $200 000.

The case of *Prairie Petroleum Products Ltd. v. Husky Oil Ltd.*[67] dealt with a unilateral change to business operations by an oil company.[68] A change in

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62 See the discussion in *Halligan v. Liberty Tax Service Inc.*, [2003] M.J. 289 (Man. QB) at paragraphs. 15-16.

63 For a thorough discussion of these areas of law as they may impact on a franchise, see Zaid, *supra* note 7, and Snell and Weinberg, eds., *Fundamentals of Franchising – Canada* (2005). See also J. Rogers and A. Frith, "Piling On: Other Laws Affecting Franchising" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006).

64 *Halligan v. Liberty Tax Service Inc., supra* note 52 and supplementary judgment [2006] 8 W.W.R. 97 (Man. Q.B.).

65 *Supra* note 52 at paragraph. 11.

66 *Supra* note 52 at paragraph. 2.

67 [2006] 11 W.W.R. 606 (QB).

Husky's pricing formula for fuel meant that the distributor could not offer a competitive price during the peak agricultural season, and the distributor lost sales. The court held that the change was a fundamental breach of contract and that the clauses in the contract that purported to exclude Husky's liability were not enforceable on the basis of unconscionability, unfairness and unreasonableness; the clauses benefited the large and commercially sophisticated company that had prepared the agreement, and enforcing them would lead to an unfair and unreasonable result. The plaintiffs were entitled to treat the agreement as terminated. In *2909333 Manitoba Ltd. v. 616768 Saskatchewan Ltd.*,[69] the matter under consideration was a motion related to examinations for discovery, but the allegations of the franchisees[70] included that the franchisor received benefits from suppliers contrary to its representations, wrongfully appropriated allowances for tenants' improvements, did not provide the required accounting and manuals and misrepresented sales and profits. In another case dealing with preliminary matters regarding where and how multiple claims would proceed, franchisee claims included "inaccurate forecast numbers, misrepresentation of profit, unreasonable construction costs, misrepresentation with respect to tenant inducements or improvements, payment of excess rent over actual rental costs, overstocking and failure to obtain the best possible prices from suppliers."[71]

A review of court decisions is unlikely to provide an accurate representation of franchise disputes, however. Some franchise agreements require arbitration and do not reach the courts. More importantly, litigation is costly, and the ability of a party to an unsuccessful business relationship, particularly the franchisee, to fund an action may be very limited.

Additional case examples were provided to the Commission during the preparation for this Consultation Paper. Among the franchisee allegations were statements that franchisors:

- used pressure tactics upon the signing of the agreement and failed to provide contact information for other franchisees as requested;
- misrepresented that business assets were free of liens and trade accounts were satisfied;

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68 Although the agreement between the parties is not described as a franchise, many distributorship agreements are included in the definition of "franchise" in franchise legislation.

69 (2006), 200 Man. R. (2d) 161(QB).

70 Note that the facts had not been determined by the court.

71 *1279022 Ontario Ltd. v. Posen* (2003), 179 Man. R. (2d) 108 (QB), rev'd (2004) 184 Man. R. (2d) 308 (C.A.). See also *Print Three Franchising Corp. v. McLennan Printing Inc.* (2001), 153 Man. R. (2d) 32 (C.A.)

- did not provide promised business support and training;
- misrepresented establishment and operating costs;
- required the use of suppliers that provided substandard equipment and that paid a rebate to the franchisor;
- did not supply promised equipment or supplied faulty equipment; and
- did not respond to requests for a meeting to discuss the problems.

The Commission is very interested in receiving the views of those with franchise experience in Manitoba, whether from the point of view of franchisors or franchisees.

CHAPTER 3: CANADIAN FRANCHISE REGULATION

A. Background

Governments in Canada, the U.S., and several other countries have taken legislative measures to regulate franchising activity. The early U.S. and Canadian statutes created registration schemes, modeled after U.S. securities legislation. These statutes required a franchisor to register documents relating to the sale and operation of a franchise with a governing body, and the governing body carried out activities to regulate and oversee franchise activity.

More recent statutes have adopted the disclosure model, which requires franchisors to disclose specific detailed information to prospective franchisees before the sale of a franchise, but does not include government registration or oversight. The legislation may also include provisions that govern to various degrees the ongoing relationship between the parties, incorporating principles such as the duty to deal fairly and the right of the franchisee to associate freely with other franchisees.

B. Canadian Franchise Regulation

1. Alberta Franchises Act

Alberta was the first Canadian jurisdiction to enact franchise legislation, in 1971. The *Alberta Act* was modeled after the first U.S. franchise statute, in California, which was in turn modeled on California securities legislation.[72] The

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72 F. Zaid, *Canadian Franchise Guide*, loose-leaf (1993) at 2-101 and 113-114; Alberta Ministry of Consumer and Corporate Affairs, *Discussion Paper on the Alberta Securities Commission* (1987) in Zaid at 2-114 – the Alberta Discussion Paper identifies the California statute as Alberta's model. California was the first U.S. state to enact franchise-specific legislation in 1970, with the *California Franchise Investment Law, California Corporations Code, Division 5, Parts 1-6*, §§31000-31516, online: <http://www.corp.ca.gov/srd/ccfil.htm> (date accessed: May 8, 2007).

1971 *Alberta Act* was a registration statute that required prospective franchisors to register with the Alberta Securities Commission and to file certain documents, including a prospectus. The Act prohibited trading in a franchise without registration. Franchise salespersons were also required to register with the Commission.[73]

Under the 1971 Act, the Alberta Securities Commission carried out activities to oversee and regulate franchise activity, including reviewing prospectuses to determine compliance, investigating complaints and imposing sanctions for breaches of the Act. In addition, the Commission set policies that governed franchisor-franchisee conduct, covering matters such as standards for additional franchisor disclosure and for the termination of franchise agreements.[74]

By the late 1980s, concerns had arisen about the cost, administrative burden and delay associated with the registration and disclosure requirements.[75] The Alberta Securities Commission requested public comment on amendments to the Act in 1991, which was followed by the introduction of a bill to replace the Act in 1992.[76] However, the 1992 bill did not receive second reading. In 1995, following further public consultation and advice from a committee including representatives of the Canadian Franchise Association, the former Alberta Franchisors' Institute and the Franchisee Association of Alberta,[77] the Alberta Government replaced its regulatory structure with a new *Franchises Act* and regulations.[78]

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73 *Franchises Act,* R.S.A. 1980, c. F-17 (repealed).

74 Zaid, *supra* note 1 at 2-110 to 118M. Zaid argues, at 25, that with these policies, "the Agency's mandate [had], in some instances … been taken beyond the realm of administering and into the realm of franchise relationship legislating".

75 Alberta Ministry of Consumer and Corporate Affairs, *Discussion Paper on the Alberta Securities Commission* (1987) in Zaid, *supra* note 1 at 2-114. Typical registration costs for franchisors were reported to range between $10,000 and $20,000, and these costs, along with the inconvenience of registration, were thought to discourage potential franchisors from carrying on business in Alberta. The government also incurred costs in administering the Act.

76 F. Zaid, *Franchise Law* (2005) at 25-26; Bill 45, *Franchises Act*, 22nd Legislature, 4th Session, Alberta, 1992-93.

77 Zaid, *supra* note 5 at 26.

78 *Franchises Act,* R.S.A. 2000, c. F-23 [Alberta Act]; *Franchises Regulation*, Alta. Reg. 240/95 [Alberta regulations]. Dillon notes that the 1995 Alberta Act closely resembles the Model Franchise Investment Act developed by the North American Securities Administrators Association [NASAA], a body that addresses the harmonization of securities laws in North America: P. M. Dillon, *Ontario's Franchise Regulatory Regime: Why Ontario Should Get Active in NASAA*, Siskind, Cromarty, Ivey and Dowler LLP, London, Ontario, online: <https://www.siskinds.com/content/Articles/Ont_Franchise_Regulatory_Regime.pdf> (date accessed: May 8, 2007)

The 1995 Act represented a significant departure in approach, and eliminated the oversight by the Alberta Securities Commission and the relationship standards enforced by Commission policy. The Act is a disclosure statute, and requires franchisors to provide a specified level of financial and other material fact disclosure to prospective franchisees, but does not require franchisor registration or document filing. The Act also includes provisions governing the franchise relationship, imposing a duty of fair dealing and protecting the freedom of franchisees to associate, and provides remedies for breaches of the legislation. As well, the Act includes provisions for self-government, which had been strongly supported by the Canadian Franchise Association[79] - the Lieutenant Governor in Council may designate one or more bodies to govern franchising and to promote fair dealing among franchisors and franchisees. However, a self-governing body has not been designated.

2. Ontario Arthur Wishart Act (Franchise Disclosure) 2000

Ontario became the second Canadian jurisdiction to enact franchise legislation, the *Arthur Wishart Act (Franchise Disclosure) 2000*,[80] in 2000. The Act is named for the former Ontario Minister of Financial and Commercial Affairs, who established the first public inquiry into franchising in Canada in 1971. The resulting *Grange Report* had called for franchise legislation along the lines of the early Alberta Act, with a Franchise Bureau and Registrar.[81]

Franchising disputes were brought to public attention in Ontario in the early 1990s, when media reports highlighted the litigation between the Pizza Pizza organization and a large number of its franchisees, who said that they were subjected to an arbitrary cost structure and 'feudal-style' management.[82] In 1994, the Ontario Government announced the formation of a Franchise Sector Working Team, comprising representatives of franchisors, franchisees, and government, to make recommendations on franchise regulation. The Team recommended that the Ontario Government enact legislation generally similar to the 1995 Alberta Act, although the franchisee representatives preferred to include additional provisions governing the franchise relationship. The Team

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79 Zaid, *supra* note 1 at 2-118II.

80 *Arthur Wishart Act (Franchise Disclosure), 2000*, S.O. 2000, c. 3 [Ontario Act].

81 S.G.M. Grange, *Report of the Minister's Committee on Referral Sales, Multi-Level Sales and Franchises*, Ontario Ministry of Financial and Commercial Affairs (1971).

82 *887574 Ontario Inc. v. Pizza Pizza Ltd.* (1995), 23 B.L.R (2d) 259 (Ont. Ct. Gen. Div.), leave to appeal refused [1995] O.J. No. 1645 (Ont. C.A.); *887574 Ontario Inc. v. Pizza Pizza Ltd.* (1994), 23 B.L.R. (2d) 239 (Ont. Ct. Gen. Div.); *887574 Ontario Inc. v. Pizza Pizza Ltd.* (1995), 23 B.L.R. (2d) 250 (Ont. Ct. Gen. Div.); J. Lorinc, *Opportunity Knocks: The Truth About Canada's Franchise Industry* (1995) at 169-205; C. French, "Disputes hurt franchising's image", *The Globe and Mail* (November 24, 1994) and Dillon, *supra* note 7 at 4.

recommended that alternate forms of resolving franchise disputes to litigation be explored and adopted, and that the Ontario Government carry out wide consultations and explore how national harmonized regulatory standards might be pursued.[83]

In 1998, the Ontario Government released a Consultation Paper on franchise legislation,[84] and in 1999, a bill was introduced,[85] along with a private member's bill dealing with franchising.[86] Several franchisees, franchisors and commentators made submissions at the public hearings that followed.[87] Among the heavily debated topics were the power imbalance between franchisors and franchisees, the restrictions placed on franchisees for the sourcing of products and services, the need for provisions for alternative dispute resolution, and the issue of good faith and fair dealing.[88]

The Ontario Act is a disclosure statute based largely on the 1995 Alberta Act, and similarly provides for a duty of fair dealing and the right to associate.[89] The Act does not include an alternative dispute resolution mechanism.

3. Uniform Law Conference of Canada Uniform Franchises Act

The Uniform Law Conference of Canada ("the ULCC") had considered the issue of franchise regulation from time to time from the 1980s.[90] In June 2002, the ULCC established a working committee formed of franchise lawyers and industry and government representatives to develop uniform franchise

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83 *Franchise Sector Working Team Report* (August 30, 1995) in Zaid, *supra* note 1 at 2-142J-142Z.4.

84 Ontario Ministry of Consumer and Commercial Relations, *Ontario Franchise Disclosure Legislation – Vision* (Consultation Paper, June 1998), online: <http://web.archive.org/web/20000831070412/http://www.ccr.gov.on.ca/mccr/22c6_40a.htm> (date accessed: May 8, 2007).

85 Bill 33, *Arthur Wishart Act (Franchise Disclosure), 2000*, 37th Legislature, 1st Session, Ontario,1999-2001, background material online: http://www.ontla.on.ca/web/bills/bills_detail.do?locale=en&BillID=740&isCurrent=false&ParlSessionID=37%3A1 (date accessed: May 8, 2007).

86 Bill 35, *Franchises Act*, 37th Legislature, 1st Session, Ontario, 1999-2001, online: http://www.ontla.on.ca/web/bills/bills_detail.do?locale=en&BillID=749&isCurrent=false&ParlSessionID=37%3A1> (date accessed: May 8, 2007).

87 Ontario Legislative Assembly, Standing Committee on Regulations and Private Bills, *Hansard* (March 7-9, 2000: Hearing on Bill 33: *Franchise Disclosure Act,* 1999), online: <http://www.ontla.on.ca/web/bills/bills_detail.do?locale=en&BillID=740%20%20%20%20%20%20&isCurrent=false&detailPage=bills_detail_related> (date accessed: May 8, 2007).

88 *Ibid.*; see also D.F. So, *Canadian Franchise Law Handbook* (2005) at 24-26.

89 See also O.Reg. 581/00 [Ontario regulations].

90 Zaid, *supra* note 5 at 35.

legislation. The committee's work was a component of the Commercial Law Strategy, the aim of which was "to modernize and harmonize commercial law in Canada, with a view to creating a comprehensive framework of commercial statute law that will make it easier to do business in Canada, resulting in direct benefits to Canadians and the economy as a whole."[91]

After examination of the Alberta and Ontario Acts, the Draft Model Franchise Law adopted by the International Institute for the Unification of Private Law ("UNIDROIT")[92] (discussed below) and the United States Federal Trade Commission Franchise Disclosure Rule[93] (discussed below), the committee reported to the ULCC[94] with a draft Model Bill and regulations in August 2005.

The Model Bill and regulations are based primarily on Ontario's *Wishart Act* and regulations. Provisions from the Alberta model were also adopted, along with a mediation process that is mandatory if a party to the franchise agreement initiates it. The committee reported that:

> many items currently contained in the Alberta or Ontario regulations have been substantially enhanced with additional disclosure requirements, definitions, and more clarity in wording. In addition new disclosure items have been included in the Regulations where it was considered appropriate, reasonable, and necessary. In particular, the mediation Regulation is considered by the Committee to represent a significant and positive development in connection with the resolution of franchise disputes, in the interests [of] all stakeholders.[95]

In August 2005, the ULCC adopted the *Uniform Franchises Act* (the Model Bill)[96] and uniform regulations[97] and recommended them to the provinces and territories for enactment.[98]

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91 *Ibid.*

92 International Institute for the Unification of Private Law [UNIDROIT], *Model Franchise Disclosure Law* (September, 2002), online: <http://www.unidroit.org/english/modellaws/2002franchise/2002modellaw-e.pdf> (date accessed: May 9, 2007).

93 U.S. Federal Trade Commission, *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures,* Code of Federal Regulations, 16 CFR 436, online: <http://www.ftc.gov/bcp/franchise/16cfr436.shtm> (date accessed: May 9, 2007).

94 Uniform Law Conference of Canada [ULCC], Uniform Franchises Act Working Group, *Uniform Franchises Act Report of the Working Group* (August 2005), online: <http://www.chlc.ca/en/poam2/Uniform_Franchises_Act_Rep_En.pdf> (date accessed: May 9, 2007); see also ULCC *Proceedings of Annual Meetings, Civil Section* (August 10-14, 2003), online: <http://www.ulcc.ca/en/poam2/Civil-Minutes-2003-En.pdf> (date accessed: May 9, 2007).

95 ULCC Uniform Franchises Act Working Group, *supra* note 23 at 10.

96 ULCC, *Uniform Franchises Act* [the Model Bill], online: <http://www.ulcc.ca/en/us/Uniform_Franchises_Act_En.pdf> (date accessed: May 9, 2007).

4. Prince Edward Island Franchises Act

A group of Prince Edward Island franchisees, the Islanders for Fair Franchise Law, advocated for franchise legislation in PEI in the 1990s. The group prepared a draft Bill, which was tabled in the Legislative Assembly in May 2001 and referred to the Standing Committee on Community Affairs and Economic Development.[99]

The Standing Committee reported to the House in November 2001.[100] The Committee recommended against the enactment of legislation based on the tabled bill, but commented that "legitimate concerns were expressed to your Committee during the conduct of hearings that are worthy of further consideration".[101] The Committee recommended that the Office of the Attorney General prepare a draft Legislative Proposal using the Ontario and Alberta statutes as reference documents, but not limited to those models. The Committee suggested that the draft should require disclosure in sufficient detail to ensure that franchisees have enough information to make business decisions, and be "as consistent as possible with other Canadian jurisdictions to ensure that Franchisors are not confronted with a different set of rules in each province in which they wish to establish business."[102]

Prince Edward Island enacted the *Franchises Act,*[103] modeled primarily on the ULCC Model Bill, in June 2005. The province also released a Discussion Paper on draft franchise regulations in October 2005,[104] and made the *Franchises Act Regulations* in April 2006.[105] Several substantive provisions of the Act (for

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97 ULCC, *Disclosure Documents Regulation*, online: <http://www.ulcc.ca/en/us/UFA_Disclosure_Documents_Reg_En.pdf> (date accessed: May 9, 2007); ULCC, *Mediation Regulation*, online: <http://www.ulcc.ca/en/us/UFA_Mediation_Reg_En.pdf> (date accessed: May 9, 2007).

98 ULCC, *Report of the Commercial Law Strategy (*August 21-25, 2005), online: <http://www.ulcc.ca/en/poam2/index.cfm?sec=2005&sub=2005f >.

99 Prince Edward Island Legislative Assembly, *Hansard* (May 10, 2001) at 2044 and 2046, online: <http://www.assembly.pe.ca/sittings/2001spring/hansard/2001-05-10-hansard.pdf> (date accessed: May 9, 2007).

100 Prince Edward Island Legislative Assembly, *Hansard* (November 29, 2001) at 328-329, online: <http://www.assembly.pe.ca/sittings/2001fall/hansard/2001-11-29-hansard.pdf> (date accessed: May 9, 2007).

101 *Ibid.*

102 *Ibid.* at 329.

103 *Franchises Act*, R.S.P.E.I. 1988, F-14.1 [PEI Act].

104 P.E.I. Office of the Attorney General, *Franchises Act Regulations Discussion Paper* (October 19, 2005), online: <http://www.gov.pe.ca/photos/original/oag_franchiseac.pdf> (date accessed: May 9, 2007).

105 P.E.I. Reg. EC232/06 [PEI regulations].

example, the duty to deal in good faith and the freedom of franchisees to associate) and part of the regulations came into force 1 July 2006, while the disclosure obligations and other provisions came into force on 1 January 2007.[106]

The PEI Act and regulations closely follow the ULCC Model Bill, but the regulations differ in areas dealing with specific franchisor disclosure document requirements and exemptions.[107] According to the PEI Government, this is because:

> The ULCC model regulations were developed on the assumption that there would be highly harmonized franchise law in place throughout the jurisdictions of Canada before the law would come into force. This is very different from the situation in which Prince Edward Island finds itself as it moves to bring into force its new legislation. In Canada, franchise law is only in force in two of the largest provinces, Alberta and Ontario. The draft PEI regulations take this into account.[108]

As a result, PEI chose to follow the approach of the existing Alberta and Ontario Acts in some respects, rather than the Model Bill.

5. New Brunswick Bill 32: Franchises Act

The New Brunswick Government introduced Bill 6, the *Franchises Act*,[109] in December 2005, following the earlier introduction of a Private Member's Bill in June 2005.[110] Bill 6 died on the Order Paper when the Legislature dissolved in 2006.

In a press release on December 7, 2005, the Minister of Justice said:

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106 *Prince Edward Island Royal Gazette* Vol. CXXXII – No. 18 (May 6, 2006) at 409 and Part II - 140, online: <http://www.gov.pe.ca/royalgazette/pdf/20060506.pdf> (date accessed: May 9, 2007); F. Zaid and D. Mochrie, *P.E.I. and New Brunswick On Board With Franchise-Specific Legislation*, Osler, Hoskin & Harcourt LLP (July 7, 2006), online: <http://www.osler.com/resources.aspx?id=11154> (date accessed: May 9, 2007).

107 For example, the PEI regulations allow a franchisor to use a disclosure document that meets the requirements of another jurisdiction, if a 'wrap-around' document is attached to include any additional material necessary in PEI. The regulations also exempt large franchisors from the requirement to provide financial statements, provide that there is no right of rescission if a disclosure document is substantially complete, allow disclosure documents to be delivered electronically and limit the disclosure of current and former franchisee information to regional franchises.

108 P.E.I. Office of the Attorney General, *supra* note 33 at 1.

109 Bill 6, *Franchises Act*, 55th Legislature, 3rd Session, New Brunswick, 2005-2006, online: <http://www.gnb.ca/legis/bill/pdf/55/3/Bill-06.pdf> (date accessed: May 9, 2007).

110 Bill 81, *Franchise Act*, 55th Legislature, 2nd Session, New Brunswick, 2004-2005, online: <http://www.gnb.ca/legis/bill/pdf/55/2/Bill-81.pdf> (date accessed: May 9, 2007).

> This bill will ensure fairness in the relationship between small business people in New Brunswick and franchisors, while protecting our province's competitive position in attracting new business investment.[111]

Bill 32, the *Franchises Act*, was introduced in the New Brunswick Legislative Assembly on February 23, 2007.[112] The bill has not yet received second reading. Like the former Bill 6, Bill 32 is a disclosure statute based closely on the ULCC Model Bill, and similarly includes a mediation process that is mandatory if initiated by one of the parties to a franchise agreement.

C. Agreement on Internal Trade

Canada's *Agreement on Internal Trade* came into force on July 1, 1995.[113] The Agreement was signed by all provinces and territories and the federal government, with the purpose of reducing and eliminating, to the extent possible, barriers to the free movement of persons, goods, services, and investment within Canada and to establish an open, efficient, and stable domestic market.[114]

The parties agreed to six general rules, including ensuring that government policies and practices do not create obstacles to trade, ensuring that non-trade objectives that may cause some deviation from the guidelines have a minimal adverse impact on interprovincial trade, and eliminating trade barriers caused by differences in standards and regulations across Canada. As one measure, governments are to focus on reconciling their consumer protection requirements that act as non-tariff barriers to allow Canadian firms to capitalize on economies of scale by servicing larger markets.[115]

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111 Hon. B. Green, New Brunswick Minister of Justice, *Press Release* (December 7, 2005), quoted in J.S. MacKenzie and M.D. Wennberg, "Franchise Law: Prince Edward Island and New Brunswick Updates", 7:1 *Atlantic Business Counsel*, Stewart Mckelvey Stirling Scales (January, 2006), online: <http://www.smss.com/site-smss/media/Parent/atlanticbusinesscounsel.pdf> (date accessed: May 9, 2007).

112 Bill 32, *Franchises Act*, 56th Legislature, 1st Session, New Brunswick [New Brunswick Bill], online: <http://www.gnb.ca/legis/bill/pdf/56/1/Bill-32.pdf> (date accessed: May 9, 2007).

113 *Agreement on Internal Trade* (September 1994), online: <http://www.ait-aci.ca/index_en/ait.htm> (date accessed: May 9, 2007).

114 Internal Trade Secretariat, *Overview of the Agreement on Internal Trade*, online: <http://www.ait-aci.ca/index_en/ait.htm> (date accessed: May 9, 2007).

115 *Ibid.*

CHAPTER 4: ELEMENTS OF CANADIAN LEGISLATION

A. Overview

As noted, the Canadian Acts and the ULCC Model Bill are primarily disclosure statutes, as is the legislation in several other countries. While the parties are free to negotiate the terms of their agreements, the statutes require franchisors to provide prospective franchisees with full disclosure of all material information before the signing of an agreement. A franchisee has the right to rescind the agreement and receive compensation if disclosure is not provided and a right of action for damages if the franchisee suffers a loss as a result of a misrepresentation or a failure to comply with disclosure. The statutes also provide that the rights conferred by the Acts are in addition to and do not derogate from any other right or remedy that a party to a franchise agreement may have at common law.

The Acts include some elements governing the franchise relationship: they impose a duty of fair dealing; protect the right of franchisees to form or join an association of franchisees; and in some cases provide a process for the mediation of disputes. Many of the details, such as the contents and form of financial statements and other disclosure documents, are set out by regulation.

B. What Is A Franchise?

The Acts[116] incorporate a broad definition of 'franchise'. Under all Acts except Alberta's, a franchise is defined as:

> [A] right to engage in a business where the franchisee is required to make a payment or continuing payments to the franchisor in the course of operating the business or as a condition of acquiring the franchise or commencing operations and
>
> (i) in which the franchisor grants to the franchisee the right to sell goods or services that are substantially associated with the franchisor's trade-mark, trade name, logo or advertising or other commercial symbol, and the franchisor exercises significant control over, or offers significant assistance in the method of operation, or
>
> (ii) in which the franchisor grants the franchisee representational or distribution rights to sell goods or services supplied by the franchisor or the franchisor's designate and the franchisor provides location assistance to the franchisee.

The definition is similar to that of the U.S. Federal Trade Commission Franchise Rule (discussed below).[117]

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[116] In this discussion, references to 'the Acts' include New Brunswick Bill 32 and the ULCC Model Bill.

[117] U.S. Federal Trade Commission, *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures,* Code of Federal Regulations, 16 CFR 436, online: <http://www.ftc.gov/bcp/franchise/16cfr436.shtm> (date accessed: May 9, 2007).

The Ontario Act differs slightly in that it refers to a 'service mark' as well as a trade-mark,[118] and the Alberta Act is slightly narrower in scope. According to the ULCC Uniform Franchises Act Working Group, "an inclusive definition of franchise was chosen in order to capture a wide range of relationships subject to requirements such as fair dealing but also to exempt certain others (*i.e.* business opportunities or multilevel marketing) from the disclosure requirements."[119]

All Acts except Alberta's exclude cooperative organizations from the application of the Act; the Model Bill, the PEI Act, and the New Brunswick bill also exclude arrangements for the purchase and sale of a reasonable amount of goods and services at reasonable wholesale prices.

C. Pre-Sale Disclosure

Pre-sale disclosure is a key principle of the franchise statutes. Under each of the Acts, franchisors are required to deliver a disclosure document to a prospective franchisee at least 14 days before the franchisee enters into an agreement or pays any money toward the franchise (in Alberta, franchisors may take a refundable good faith deposit before providing disclosure). The franchisor must also provide written statements of any material changes that occur before the agreement is signed or any money paid.

The Acts set out the required contents of the disclosure documents, but most of the details are to be set out regulation. The Acts require:

- the franchisor's financial statements as prescribed by regulation,
- copies of all proposed agreements,
- statements as prescribed by regulation to assist the prospective franchisee to make an informed investment decision, and
- other information and documents as prescribed by regulation.

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118 It has been suggested that, since there is no concept of a 'service mark' in the *Trade-marks Act*, R.S., 1985, c. T-13, the presence of this term "is an indicator of the degree [of] American influence in the drafting of the Canadian statutes", P.D. Jones and D.F. So, "Houdini's Franchise Law: Exclusions and Exemptions to Disclosure in Canada" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006) at 20.

119 ULCC Uniform Franchises Act Working Group, *Uniform Franchises Act with Commentary* at 2, online: <http://www.ulcc.ca/en/poam2/CLS2004_Uniform_Franchise_Act_and_Commentary_En.pdf > (date accessed: May 9, 2007). The definition may capture organizations that did not previously identify themselves as a 'franchise': see P.M. Dillon, "Ontario Franchise Developments in 2004: Has the Pendulum Finished Swinging Yet?" Siskinds Collection of Franchise Law Articles (FRAN/RP-016, June 15, 2005), QL and R. Glass, P. Dillon and M. Robinson, "Accidental Franchises: If It Walks Like a Duck and Quacks Like a Duck…" Siskinds Collection of Franchise Law Articles (FRAN/RP-014, December 15, 2004), QL.

The disclosure must be in a single document, delivered as one document at one time, and include the information required under the regulations. The document must contain all material facts[120] (in Ontario and PEI, including all material facts 'as prescribed') and must be accurately, clearly and concisely set out. 'Material fact' is defined to include any information about the business and operations of the franchise that would reasonably be expected to have a significant effect on the value or price of the franchise or the decision to acquire the franchise.

The information required to be disclosed under the regulations made under the various Acts includes, in part:[121]

- the background of the franchisor (business name and details, length of time in business and number of franchises sold in the preceding five years);
- the background of the officers and directors of the franchisor (prior relevant experience, length of time in business and principal occupation during the preceding five years);
- the litigation history of the franchisor (convictions within the 10 preceding years for fraud, unfair or deceptive business practices or violations or pending charges relating to franchise or business laws, administrative orders or penalties or pending administrative actions, findings of liability and pending civil actions relating to business practices);
- the details of a bankruptcy or insolvency proceeding within the preceding six years;
- the most recently completed financial statements audited or reviewed in accordance with generally accepted standards that are at least equivalent to those in the Canadian Institute of Chartered Accountants Handbook (the accounting standards of other jurisdictions are acceptable so long as they meet the standards);
- the costs of establishing the franchise and, if operating costs are provided, the supporting assumptions and information;

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[120] In Alberta the requirement to disclose all material facts is set out by defining a 'misrepresentation' as an untrue statement of or an omission to state a material fact.

[121] In some cases, the time periods for which information must be provided are fiscal years rather than calendar years. See also R.D. Leblanc and P.M. Dillon, "Franchise Disclosure in Canada in 2007 and Beyond" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006) for a comprehensive comparison of the disclosure requirements.

- if the franchisor includes earnings projections, supporting assumptions and information for the projections (the PEI requirements are the most extensive);
- contact information for current and former franchisees and a description of all franchises that ceased to operate in the previous three years;
- restrictions on suppliers, products or markets, a description of any volume rebates received by the franchisor, policies and practices respecting exclusive territories and restrictions in the franchise agreement on renewal, termination or transfer of the franchise; and
- information about available financing, mandatory and optional training and advertising fund requirements.

A number of categories of information that may be material to the prospective franchisee are not specifically set out in regulation and as a result, may not be disclosed by the franchisor in some cases.[122] These include background and risk factors relating to the nature of the business, settled litigation, and terms of settlements, information about ongoing or concluded arbitration proceedings, the amounts of any volume rebates received by the

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[122] Leblanc and Dillon, *supra* note 6 at 19. Leblanc and Dillon note their view that "[t]he scope of what might constitute a "material fact" pursuant to this definition is limitless and there exists an ongoing debate between certain commentators as to the standard of disclosure required…The Ontario Act introduces confusion by deeming as material facts the prescribed disclosures required in the regulation, effectively requiring their disclosure whether actually material or not. The reaction of franchisors and the franchise bar to this wording has been in some cases to interpret the regulation as definitive of the standard of disclosure in similarity with the rules-based UFOC Guidelines in the U.S. On this basis, many franchisors do not purport to make disclosures of any information which is not specifically requested in the regulation. At the other end of the spectrum exists the school of thought that all facts howsoever vaguely material should be disclosed…," at 11. On the other hand, Trebilcock argues persuasively that the scope of disclosure required is broad: A. J. Trebilcock, "Disclosure – The Advanced Course: Tricky Disclosure Issues and Some Drafting Tips" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006). Levitt agrees, noting that "[t]he conservative advice is to disclose any fact that could possibly be construed as material": E. Levitt, "Annual Legislative Update" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006) at 21. This could include trends in the industry, anticipated new regulations, local market conditions and supply issues and more: E.N. Levitt, "The Arthur Wishart Act (Franchise Disclosure), 2000: Critical Compliance Issues", <http://www.gowlings.com/resources/publications.asp?pubid=1146. (date accessed: May 9, 2007). Zaid notes that "[t]he absence of a specific disclosure item from the Regulation does not mean that there is no obligation to disclose it, but only that the franchisor must determine whether the item is a material fact relevant to the prospective franchisee": F. Zaid, "A Review of Franchise Disclosure Laws in Canada" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006), at 12.

franchisor, and methods and resources for franchise support. However, in *1518628 Ontario Inc. v. Tutor Time Learning Centres LLC*,[123] it was held that information about serious problems with the accounts, billings and financial arrangements and the overall management of the franchise, although not necessarily falling within the statutory definition, constituted "material facts" that should have been disclosed. A task force of the Ontario Bar Association Joint Subcommittee on Franchising has made recommendations for amendments to the Ontario scheme to specifically require the disclosure of several of these matters.[124]

The PEI Office of the Attorney General commented on the difference in approach in relation to material fact disclosure in its Discussion Paper addressing the PEI regulations:

> The ULCC regulations have been drafted to require extensive disclosure in all the listed areas whether or not the matter would be "material" to the franchisee in making the decision to sign the franchise agreement. The extensive list gives comfort to a franchisor that if they complete the document fully and honestly they have almost certainly met the material fact disclosure requirement even though much of the disclosed information might not be material in a given situation. The PEI regulations have not fully adopted this approach. The PEI regulations have been drafted with an eye to the minimum standards which exist at present in the Canadian marketplace, i.e. the laws of Ontario and Alberta. Generally, matters which are not required to be disclosed or not required to be disclosed in the detail required by the ULCC regulations have not been included in the PEI regulations. These matters would only need to be included if they are "material." At the same time, there is nothing in the PEI regulations which would restrict a franchisor from providing the full disclosure in the form of the ULCC regulations if they choose to do so.125

The Ontario, PEI and Model Bill regulations also require a form of risk warning to be presented at the beginning of the document; this includes a statement that prospective franchisees are encouraged to seek information on the franchisor and independent legal and financial advice, and to contact current and previous franchisees.

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123 [2006] O.J. No. 3011 (S.C.J.) at paragraph. 63; leave to appeal granted [2006] O.J. No. 4992 (S.C.J. Div. Ct.). See J. Dolman and A. Frith, "Ontario's Franchise Legislation – What Have We Learned" 26:3 *Franchise Law Journal* (Winter 2007), online: <http://www.osler.com/uploadedFiles/Resources/Publications/OslerHoskinHarcourtLLP_FranchiseLaw-DolmanFrith.pdf. (date accessed: May 9, 2007).

124 Leblanc and Dillon, *supra* note 6 at 26.

125 P.E.I. Office of the Attorney General, *Franchises Act Regulations Discussion Paper* (October 19, 2005) at 1-2, online: <http://www.gov.pe.ca/photos/original/oag_franchiseac.pdf> (date accessed: May 9, 2007). Zaid cautions, however, that "over-disclosure may be irrelevant, misleading or misrepresentative" so that if an international disclosure document is to be used, extraneous or irrelevant information should be deleted or modified: Zaid, *supra* note 7 at 13.

There are several exemptions to the disclosure requirements; for example, disclosure is not required when a franchise is granted to an officer or director of the franchisor or an additional franchise is granted to an existing franchisee.

As well, all Acts except Ontario's exempt confidentiality and site selection agreements from the disclosure requirement. This means that franchisors may enter into a location agreement or require prospective franchisees to sign a confidentiality agreement before providing disclosure. The Alberta Act also exempts fully refundable deposits, so that a franchisor may require a refundable deposit before providing disclosure. In Ontario, these actions would violate the Act; the site selection or confidentiality agreement would likely be an agreement relating to the franchise (for which disclosure is required).[126] As a result,

> In the absence of the ability to secure some form of initial financial commitment or confidentiality covenant from prospective franchisees, the Ontario franchisor must be more wary of "tire kickers" or potential competitors who wish to collect information and documents without serious intentions to proceed.[127]

The Alberta and PEI regulations provide that a disclosure document complies with the Act if it is substantially complete,[128] and allow franchisors to use disclosure documents that comply with the franchise laws of another jurisdiction with a 'wrap-around' addendum to bring the documents into compliance with the Act.[129] The PEI regulations also provide for electronic delivery of disclosure documents.

D. Remedies

The remedies available to franchisees under the Acts are a right of rescission and a right of action for damages. Remedies otherwise available to the parties are also preserved; the rights under the Acts are in addition to any other right or remedy a party to a franchise agreement may have at law.

All Acts provide that the franchisee may rescind the franchise agreement within 60 days if the franchisor failed to provide the disclosure documents within the time required, or, under all Acts except Alberta's, if the contents of the documents did not meet the statutory requirements. The time allowed for rescission increases to two years if the franchisor provided no disclosure

126 Levitt, *supra* note 7 at 46.

127 Leblanc and Dillon, *supra* note 6 at 8.

128 Franchise lawyer Peter Dillon has criticized the Ontario Act's failure to provide for substantial compliance, among other points, arguing that Ontario is "the toughest jurisdiction in the world in which to franchise"; Dillon, *supra* note 4 at paragraph 1.

129 A wrap around addendum sets out any additional material that is necessary for the disclosure document of one province to comply with the disclosure requirements of another province.

document. Upon rescission, the franchisor must compensate the franchisee for any net losses that the franchisee has incurred in acquiring, setting up and operating the business. All Acts except Alberta's also specifically require the franchisor to refund money received from the franchisee and to buy back any remaining supplies, equipment, and inventory sold to the franchisee at a price equal to the purchase price paid by the franchisee.

The issue of incomplete disclosure has been considered by the courts. In *1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd.*,[130] the franchisor had provided 70% of the information required, in several documents presented at different times. The Ontario Court of Appeal found that, rather than constituting incomplete disclosure, information provided at multiple times in multiple documents constituted "no disclosure" under the Act, and the franchisee was entitled to a two year period in which to rescind the contract. Similarly, the provision of a U.S. UFOC disclosure document (discussed below) rather than the document required under the Act has been found to be "no disclosure."[131]

The Acts also provides a right of action for damages, if a franchisee suffers a loss because of a misrepresentation in the disclosure document or statement of material change, or because of the franchisor's failure to comply with the disclosure requirements. In Alberta, the right of action is against the franchisor and every person who signed the disclosure document or statement. The other Acts add to this list the franchisor's broker and the franchisor's associate (Ontario also adds the 'franchisor's agent').[132]

The franchisee is not required to show reliance on the information. The franchisee is deemed to have relied on the misrepresentation, or, where the franchisor has failed to provide a statement of material change, on the information in the disclosure document.

A person will not be liable if he or she proves that the franchisee acquired the franchise with knowledge of the misrepresentation or material change. As

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130 (2005), 256 D.L.R. (4th) 451 (Ont. C.A.).

131 *1518628 Ontario Inc. et. al. v. Tutor Time Learning Centres, LLC*, *supra* note 8.

132 ULCC Uniform Franchises Act Working Group, *supra* note 4 at 18; see also ULCC, Uniform Franchises Act Working Group, *Uniform Franchises Act Report of the Working Committee* (August 11, 2003) at 34, online: <http://www.ulcc.ca/en/poam2/Uniform_Franchises_Act_En.pdf> (date accessed: May 9, 2007). The term "franchisor's agent" in Ontario was originally not defined, which created some interpretation problems and was thought to expose third party advisors to liability. Under amendments to the Ontario regulations made in 2004, a franchisor's agent is now defined as "a sales agent of the franchisor who is engaged by the franchisor's broker and who is directly involved in the granting of a franchise"; O.Reg. 581/00, s.0.1 as amended by O.Reg. 69/04, s.1.

well, a franchisor's broker, associate or agent or a person other than the franchisor who signed the document or statement has various other grounds of defence; for example, that he or she did not know that the document was given to the franchisee and gave written notice to the franchisee promptly on becoming aware that it had been given.

The Ontario Court of Appeal has held that a franchisee's right to rescind is not conditional on his or her conduct as a franchisee, although a franchisor may have a separate right to pursue an action under the common law principles preserved by the Act.[133] A purchaser of a franchise in a transaction that has not yet closed has also been held to be a 'franchisee', and entitled to rescission for non-disclosure under the Ontario Act.[134] The Ontario Court of Appeal has also held that a franchisee may receive both the remedy of rescission and an award of damages.[135] As well, in *Khachikian v. Williams*, an award of punitive damages was made, to reflect the "court's denunciation of what the defendant did and [to] serve as a deterrent to others who might also be inclined to use the concept of franchising as a means of taking undue and improper advantage of another person".[136]

E. Duty of Fair Dealing (Good Faith)

The Ontario and Alberta Acts deem that a franchise agreement imposes on each party a duty of fair dealing in the performance and enforcement of the agreement. The Model Bill, the PEI Act, and the New Brunswick Bill each have a similar provision, but also provide that the duty applies to the exercise of a right under the agreement. As a result, parties must consider the duty of good faith even if exercising a discretionary right or an option provided for by the agreement.[137] None of the Acts impose a duty of fair dealing in the negotiation of an agreement.

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133 *Personal Service Coffee Corp. v. Beer* (2005), 256 D.L.R. (4th) 466 (Ont. C.A.).

134 *Bekah v. Three For One Pizza* (2003), 67 O.R. (3d) 305 (S.C.J.); see also *1368741 Ontario Inc. v. Triple Pizza (Holdings) Inc.*, [2004] A.C.W.S.J. 10256 (Ont. C.A.), aff'g [2003] O.J. No. 2097 (S.C.J.).

135 *1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd.* (2004), 256 D.L.R. (4th) 451 (Ont. C.A.). This decision and other aspects of the Ontario Act have been criticized by the lawyer who represented the franchisor in *Dig This Garden*: see N. Fraser, "Opinion split on act's protection of franchisees" *Law Times* (March 6, 2006) at 13, online: <http://siskinds.com/pdfs/Mar_6_06_reprint_Law_Times.pdf> (date accessed: May 11, 2007). See also S. Graham, "Statutory Rescission: Where's The Equity?" Siskinds Collection of Franchise Law Articles (FRAN/RP-022, May 15, 2006) QL.

136 [2003] O.J. No. 5876 (S.C.J.) at paragraph. 23.

137 F. Zaid and D. Mochrie, *P.E.I. and New Brunswick On Board With Franchise-Specific Legislation*, Osler, Hoskin & Harcourt LLP (July 7, 2006), online:

All Acts except Alberta's provide that a party has a right of action for damages against another party who breaches the duty of fair dealing, and that the duty of fair dealing includes the duty to act in good faith and in accordance with reasonable commercial standards. All Acts also provide that the duty of fair dealing applies retroactively to franchise agreements entered into before the legislation came into force.

The good faith requirement in the Acts has been considered by the courts. The Ontario Supreme Court of Justice has held that a franchisor was entitled to favour one feuding co-franchisee in a buyout of the other co-franchisee in the interests of the overall franchise,[138] and that the duty of good faith applies to the franchisee as well as to the franchisor.[139] In *Personal Service Coffee Corp.,* the Ontario Court of Appeal held that the statutory duty of fair dealing does not apply once the franchisee has rescinded the agreement, since the duty only applies to the performance and enforcement of an agreement that is still in effect (however, remedies may be available at common law).[140] In *Sobeys*,[141] the Ontario Supreme Court of Justice held that the duty under the Ontario Act extended only to the performance and enforcement of existing agreements; it did not require the franchisor to renew an expiring agreement that it considered to be commercially unreasonable. Instead the franchisor was entitled to secure the lease for itself. On the other hand, another franchisor breached its duty of good faith when it failed to award a new competing franchise location to an existing franchisee who was in good standing and whose location was no longer viable, although the franchisor's action was not barred by the franchise agreement.[142] There appears to be no duty to inform the other party of its obligations; a

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<http://www.osler.com/resources.aspx?id=11154> (date accessed: May 9, 2007). According to the ULCC Uniform Franchises Act Working Group, the addition of the words 'including in the exercise of a right' was necessary "because the duty of fair dealing incorporating the duty of good faith and commercial reasonable standards in the Ontario Act does not extend to express contractual provisions granting the franchisor discretionary authority over rights to be exercised during the term of the contract that may be carried out without regard to fair dealing": ULCC Uniform Franchises Act Working Group, *supra* note 4 at 9.

138 *Country Style Food Services Inc. v. Hotoyan*, [2001] O.J. No. 2889 (S.C.J.); see also *Mr. Submarine Limited. v. Sowdaey*, [2002] O.J. No. 4401 (S.C.J.) (the duty of good faith does not require a franchisor to put the franchisee's interests ahead of its own).

139 See *Gerami v. Double Double Pizza Chicken Ltd.*, [2005] O.J. No. 5252 (S.C.J.).

140 *Personal Service Coffee Corp., supra* note 18.

141 *530888 Ontario Ltd. v. Sobeys Inc.* (2001), 12 B.L.R. (3d) 267 (Ont. S.C.J.).

142 *Katotikidis v. Mr. Submarine Ltd.* (2002), 26 B.L.R. (3d) 140 and 29 B.L.R. (3d) 258 (Ont. S.C.J.) the Court found that the Ontario Act duty did not apply to events that occurred before the Act came into force, but awarded damages, including punitive damages, based on the common law duty of good faith.

franchisee who was aware of the franchisor's obligations to provide disclosure and who failed to inform the franchisor was held not to have breached the duty of good faith.[143]

F. Right to Associate

Each Act provides that a franchisee may associate with other franchisees and may form or join an organization of franchisees. A franchisor may not prohibit, restrict, directly or indirectly penalize a franchisee from doing so (or, except in Alberta, interfere with a franchisee). All statutes except Alberta's provide that a provision in an agreement purporting to restrict a franchisee from exercising this right is void, and that a franchisee has a right of action for damages against a franchisor that contravenes this provision.

All Acts provide that the right to associate applies retroactively to franchise agreements entered into before the legislation came into force.

G. Waiver of Rights

All Acts provide that any waiver or release by a franchisee of a right or requirement under the Act or regulations is void. The PEI Act, the Model Bill, and the New Brunswick Bill extend this provision to specifically include prospective franchisees. Under all Acts except Alberta's, this applies retroactively to franchise agreements entered into before the legislation came into force.

H. Dispute Resolution

The Model Bill and the New Brunswick Bill provide for a confidential dispute resolution process, which is mandatory once initiated by a party to a franchise agreement. A party may deliver a notice of dispute to another party setting out the nature of the dispute and the desired outcome. The parties must attempt to resolve the dispute within 15 days after delivery of the notice. If they fail to resolve it, a party may deliver a notice to mediate to all other parties to the agreement. The parties must then follow the rules set out in the regulations respecting mediation.

I. Exemptions

In Alberta, regulations may be made exempting persons, franchises, or sales of franchises from any or all provisions of the Act or regulations. The New

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[143] Even assuming that the duty of good faith existed before the execution of the franchise agreement: *Payne Environmental Inc. v. Lord and Partners Ltd.* (2006), 14 B.L.R. (4th) 117 (Ont. S.C.J.).

Brunswick Bill also provides broad authority for regulations to be made respecting exemptions from any requirement or provision of the Act or regulations. The Ontario and PEI Acts are more specific, authorizing regulations to be made exempting certain franchisors from the requirement to include financial statements in a disclosure document.

Alberta, Ontario, and PEI have made regulations to provide exemptions from the requirement to include financial statements.

> This financial disclosure is a very sensitive topic – most franchisors are wary to disclose sensitive financial information in the form of financial statements required to be provided as part of the disclosure document. To avoid disclosing the financial statements of their operating companies, many franchisors incorporate sparsely detailed separate companies solely to act as the "franchisor" in a franchise relationship.[144]

The Alberta, Ontario, and PEI regulations exempt 'mature' franchisors, which presumably have a solid business foundation, from the requirement to include financial statements. In Alberta and Ontario, the exemptions apply if the net worth of the franchisor is at least $5 million (or $1 million if controlled by a corporation with a net worth of $5 million), it has at least 25 franchisees operating for the preceding five years in Canada (or in Ontario, in another single jurisdiction), and it has engaged in the franchise's line of business continuously for not less than the preceding five years. Ontario has added the requirement that the franchisor, its associates, directors, general partners, or officers must not have had a judgment against them in the preceding five years relating to fraud, unfair or deceptive trade practices, or a law regulating franchises.

The PEI regulations set the same requirements as those in Ontario, except that the $5 million net worth requirement has been lowered to $2 million. The exemptions in all jurisdictions are made by self-assessment; an application to government is not required. However, the PEI Act has an additional provision allowing any franchisor to apply to the minister for an exemption from the requirement to include financial statements in the disclosure document. The minister may exempt the franchisor, subject to any terms and conditions, if satisfied that to do so would not be prejudicial to the public interest.

J. Jurisdiction

All Acts provide that any provision in a franchise agreement that purports to restrict the application of the law of the province or to restrict jurisdiction or venue to a forum outside the province is void with respect to a claim otherwise enforceable under the Act in the province.

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144 Jones and So, *supra* note 3 at 34.

CHAPTER 5: INTERNATIONAL FRANCHISE REGULATION

A. United States

1. FTC Franchise Disclosure Rule and UFOC Guidelines

Franchising in the United States is regulated by the federal government and by several state governments.[145] Federally, the sale of franchises is regulated by the Federal Trade Commission Franchise Disclosure Rule, made under the *Federal Trade Commission Act*.[146] Under the FTC Rule:

> [A] franchise exists in a commercial arrangement between a buyer and seller when the following three elements are present: (i) a grant of the right to use the seller's trademark to offer, sell or distribute goods or services; (ii) the seller offers significant assistance to the buyer in its operations or reserves the right to control its operations; and (iii) the payment of a fee ($500 or more within the first six months of operations). The FTC Rule is interpreted liberally to further its primary goal of investor protection.[147]

The FTC Rule requires franchisors to make detailed disclosures to prospective franchisees. The Rule deals only with franchisor disclosure; there is no express duty of good faith or fair dealing and franchise relationship issues are governed by state contract law.[148] There is no filing or registration requirement

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145 As of 2002, fifteen state governments required pre-sale disclosure of franchise information: U.S. Federal Trade Commission, "The Franchise Rule" (Statement before the U.S. House of Representatives Committee on Energy and Commerce, Subcommittee on Commerce, Trade and Consumer Protection, June 25, 2002), online: <http://www.ftc.gov/os/2002/06/020625bealesfranruletest.htm > (date accessed: May 7, 2007);

146 U.S. Federal Trade Commission, *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures,* Code of Federal Regulations, 16 CFR 436 [FTC Rule], online: <http://www.ftc.gov/bcp/franchise/16cfr436.shtm> (date accessed: May 9, 2007); *Federal Trade Commission Act*, 15 U.S.C. §§ 41-58 [FTC Act], online: <http://www.ftc.gov./ogc/ftcact/shtm> (date accessed: May 12, 2007). See also U.S. Federal Trade Commission, *Guide to the FTC Franchise Rule Table of Contents*, online: <http://www.ftc.gov/bcp/franchise/netrule.shtm> (date accessed: May 12, 2007).

147 L. S. Stadfeld, *Basic Franchise Law Considerations in Supply Relationships,* Weston, Patrick, Willard & Redding, P.A., Boston, MA, online: <http://www.franchise-counsel.com/Relationships.shtml> (date accessed: May 12, 2007); see 16 CFR 436. 2. State law definitions are similar to the FTC definition, except that instead of the 'assistance and control' element, they require a marketing plan prescribed substantially by the franchisor or a community of interest between the parties with respect to the business.

148 U.S. Federal Trade Commission, *supra* note 1. The FTC stated that while franchisee advocates have asserted that "the underlying relationship between franchisor and franchisee is often unfair, with the franchisor dictating the terms under which the franchisee will conduct business, often allegedly resulting in significant financial losses", the FTC has not received a large number of complaints about relationship issues and it was "unaware of any evidence that relationship issues are prevalent throughout franchising", at Part III. Although the FTC

and the FTC does not review disclosures. There is also no private right of action to enforce the FTC Rule; only the FTC can enforce it.[149] The FTC has a broad range of remedies that it may seek for violations, including injunctions, civil penalties and orders for the refund of money to franchise purchasers.

The FTC Rule:

> requires franchisors to make material disclosures in five categories: (1) the nature of the franchisor and the franchise system; (2) the franchisor's financial viability; (3) the costs involved in purchasing and operating a franchised outlet; (4) the terms and conditions that govern the franchise relationship; and (5) the names and addresses of current franchisees who can share their experiences within the franchise system, thus helping the prospective franchisee to verify independently the franchisor's claims. In addition, franchisors must have a reasonable basis and substantiation for any earnings claims made to prospective franchisees, as well as disclose the basis and assumptions underlying any such earnings claims.[150]

Several states have franchisor registration requirements modeled after securities legislation; franchisors must register with a state regulatory agency and obtain approval before they can offer their franchises to prospective franchisees.[151] Unlike the FTC Rule, some state laws provide a private right of action to franchisees.[152] As well, several states have enacted franchise relationship legislation to govern the relationship between the parties after the franchise agreement is signed. All of these statutes have provisions governing termination of the franchise agreement; other matters include contract renewal and transfer, territory encroachment, the purchase of goods and services from designated sources of supply, franchisees' right to associate and forum selection.[153]

Franchise Rule does not govern relationship issues, the FTC does enforce section 5 of the *FTC Act*, which declares unlawful unfair or deceptive practices in or affecting commerce, when specific criteria are met. However, the unfairness authority criteria generally do not apply to franchise relationship issues. See also U.S. General Accounting Office, *Federal Trade Commission: Enforcement of the Franchise Rule* (Report to Congressional Requesters, July 2001) at 7-9 and 40-45, online: <http://www.gao.gov/new.items/d01776.pdf> (date accessed: May 12, 2007).

149 U.S. Federal Trade Commission, *supra* note 1; U.S. Federal Trade Commission, *Guide to the FTC Franchise Rule Table of Contents, supra* note 2.

150 U.S. Federal Trade Commission, *supra* note 1 at Part IA.

151 Stadfield, *supra* note 3. There are additional state laws that may apply; for example, state 'business opportunity' statutes designed to encompass distribution arrangements accompanied by representations or promises, such as vending machine routes.

152 Stadfield, *supra* note 3.

153 U.S. General Accounting Office, *supra* note 4 at 9 and 43-45. The GAO identified 17 states that have enacted franchise relationship legislation; Iowa's is recognized as being the most comprehensive.

The FTC Rule and state laws require the franchisor to provide the disclosure document at least ten business days before the franchisee pays any consideration or signs a contract. A copy of the franchise agreement with all terms completed and all related agreements must be delivered at least five business days before signing.

Currently, most U.S. franchisors use a uniform disclosure format called the Uniform Franchise Offering Circular ("UFOC"), produced by the North American Securities Administrators Association ("NASAA").[154] The UFOC has been accepted by the FTC and by state regulators.[155] The UFOC and the FTC Rule require similar disclosures, including a description of: (1) the franchisor and its business; (2) prior litigation and bankruptcies relating to the franchisor; (3) initial and ongoing fees; (4) obligations of the parties and other terms of the contract; (5) restrictions on sales; and (6) rights to renew and terminate the franchise. Both formats also require substantiation of any earnings claims, statistics on existing franchisees, contact information for franchisees, and audited financial statements.[156]

The UFOC Guidelines also contain disclosure provisions in addition to those required under the FTC Rule, including information about regulations specific to the franchise industry, litigation or bankruptcy involving a franchisor's predecessor, computer system requirements and contact information for former franchisees.[157] As well, under amendments made in 1993, the disclosure must be

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154 North American Securities Administrators Association [NASAA], *Uniform Franchise Offering Circular Guidelines*, online: <http://www.nasaa.org/Industry___Regulatory_Resources/Uniform_Forms/3697.cfm> (date accessed: May 12, 2007). According to Stadfeld, "the states refused to follow the FTC's disclosure format largely because they sought more comprehensive regulation… these states promulgated a more rigorous disclosure format" – the UFOC: L.S. Stadfeld, *Federal Franchise Sales Law Updated for First Time Since 1978,* Weston, Patrick, Willard & Redding, P.A., Boston, MA, online: <http://www.franchise-counsel.com/New-FTCLaw.shtml> (date accessed: May 12, 2007)

155 The FTC authorized franchisors to use the UFOC Guidelines to comply with the FTC Rule's disclosure requirements because the Guidelines, in their entirety, provided consumer protection equal to or greater than the Rule: U.S. Federal Trade Commission, *16 CFR Parts 436 and 437: Disclosure Requirements and Prohibitions Concerning Franchising; Disclosure Requirements and Prohibitions Concerning Business Opportunities* (2007), online: <http://www.ftc.gov/us/2007/01/R511003FranchiseRuleFRNotice.pdf> (date accessed: May 12, 2007).

156 U.S. Federal Trade Commission, *supra* note 1. The FTC Format is not accepted by state regulators in states with registration requirements: Stadfeld, *supra* note 3.

157 *Ibid.* at note 9.

written in 'plain English'. In many states, the UFOC includes an addendum to set out the specific requirements of that state.[158]

Under the FTC Rule and the UFOC Guidelines, a franchisor must comply with certain requirements if it makes an earnings claim. For example, under the UFOC, the claim must have a 'reasonable basis' and include the factual basis for the claim (such as economic and market conditions, costs of goods sold and operating expenses), state the material assumptions underlying the claim and the precise basis for it (for example, the percentage of franchisees that have achieved it), include a conspicuous statement that a franchisee's results are likely to differ and offer to provide substantiation upon request.

2. FTC Rule Amendments

Beginning on 1 July 2008, the requirements of U.S. franchisors under the FTC Rule will change significantly. Following a lengthy review and consultation process,[159] the FTC has substantially revised and modernized the Franchise Rule.[160] Compliance with the new Rule is voluntary as of 1 July2007 and mandatory on 1 July 2008. Permission to use the UFOC Guidelines will be withdrawn effective 1 July 2008,[161] and franchisors will be required to use the new FTC Franchise Disclosure Document, which adopts the UFOC format (and plain English requirement) but supplements it with additional disclosure requirements.[162]

New disclosure requirements under the revised FTC Rule include:

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158 R.D. Leblanc and P.M. Dillon, "Franchise Disclosure in Canada in 2007 and Beyond" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006).

159 See L. Fisher, "FTC Rule Change: The Question Of When" *FranchiseLawNews.Com* (November 2005), online: <http://www.franchiselawnews.com/article/2005/11/08/1/> (date accessed: May 12, 2007).

160 The FTC has released the revised Rule and a Statement of Business and Purpose that provides a rationale for and an explanation of the changes. The new Rule separates the requirements relating to franchises from those relating to business opportunities, and the FTC has initiated a separate review process for the business opportunity requirements: U.S. Federal Trade Commission, *supra* note 11 at 3.

161 This is because the UFOC Guidelines will no longer provide equal or greater protection to prospective franchisees: U.S. Federal Trade Commission, *supra* note 11 at 13, note 46.

162 D.J. Kaufmann, "It's official: FTC revamps federal Franchise Rule" *Franchise Times* (March 2007), online: <http://www.franchisetimes.com/content/story.php?article=00256> (date accessed: May 12, 2007). The new Rule is narrower than the existing UFOC Guidelines in some respects. For example, it eliminates some disclosures relating to brokers and to detailed computer equipment requirements: U.S. Federal Trade Commission, *supra* note 11.

- a summary of all material litigation commenced by franchisors against their franchisees during the preceding year (currently only litigation by franchisees must be disclosed);
- identification of the officers, directors or managers of a franchisor's corporate parent who will exercising management responsibility relating to the franchise;
- all government litigation against a franchisor affiliate that sold franchises within the previous ten years;
- a statement as to whether any officer of the franchisor has an interest in any required supplier;
- information as to how the franchisor or an affiliate may compete with franchisees through distribution channels such as the internet, catalogue sales, telemarketing, co-branding or the establishment of units at 'nontraditional locations';
- expanded disclosure with respect to franchisee territories, including the conditions under which a franchisor will approve franchisee relocation and the establishment of additional outlets, any present plans of the franchisor to operate a competing franchise system, the limits on franchisee solicitations outside assigned territories and a warning of possible adverse consequences if the franchisee will not have exclusive territorial rights;
- an explanation of the franchisor's renewal policies, including any obligation to sign a new franchise agreement on different terms at renewal;
- a statement that franchisors are permitted to make financial performance representations in the disclosure documents, and, if none appear in the documents, franchisees should disregard other representations and report them to government agencies;
- information as to whether a franchise unit has been the subject of repeated sales to different franchisees;
- contact information for each affiliated trademark-specific franchisee association; and
- information as to whether any current or former franchisees are restricted from speaking freely due to a confidentiality agreement.[163]

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[163] *Ibid*; Stadfeld, *supra* note 10; P. Reap, *FTC Issues New Franchise, Business Opportunity Rules*, Wolters Kluwer Law & Business (2007), online: <http://business.cch.com/franlaw/news/02-23b-07.asp> (date accessed: May 12, 2007); A. Marks and K. Klein, "FTC Franchise Rule 2.0" 14:1 *Consumer Protection Update* (Spring 2007), online: <http://www.bryancave.com/FILES/tbl_s7Publications%5CDetails33%5C1474%5CFTCFranchiseRuleArticle4-07.pdf> (date accessed: May 12, 2007).

The Rule also allows franchisors to disclose exclusively in electronic form, and franchisee receipts may also be executed and returned electronically.[164] Franchisors must continually monitor for material changes to financial performance representations and amend the disclosure documents.[165]

Franchisors will be able to provide stand-alone franchise cost or operating expense information even if no financial performance representations are included in the disclosure document, with a warning that this information does not constitute a financial performance representation. Start-up franchisors may phase in audited financial statements over a three year period. The Rule also includes new 'sophisticated investor' exemptions from disclosure where prospective franchisees meet certain net worth, investment or experience criteria.[166]

The new FTC Rule does not incorporate new provisions to govern the franchise relationship. This was an area of significant concern raised with the FTC during the review process:

> [M]any franchisees and their advocates criticized the Rule for not going far enough. They urged the Commission to address in this rulemaking a variety of post-sale franchise contract or "relationship" issues, including prohibiting or limiting the use of post-contract covenants not to compete, encroachment of franchisees' market territory, and restrictions on the sources of products or services. Indeed, some franchisees asserted that if the Rule cannot address post-sale relationship issues, then the Commission should abolish the Rule.[167]

However, the FTC notes that its ability to address relationship issues is restricted by the terms of its governing legislation.

> The FTC Act defines an unfair act or practice as one that is "likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition." The Act also requires that, to justify an industry-wide rule, such practice be prevalent. This proceeding did not yield adequate evidence to support a finding of prevalent acts or practices that meet each of the three prerequisites for unfairness as articulated in Section 45(n) of the FTC Act.[168]

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164 Kaufmann, *supra* note 18.

165 Marks and Klein, *supra* note 19.

166 Stadfeld, *supra* note 10; Kaufmann, *supra* note 18; Marks and Klein, *supra* note 19; U.S. Federal Trade Commission, *supra* note 11 at 219-240.

167 U.S. Federal Trade Commission, *supra* note 11 at 10. See S.P. Kezios, American Franchisee Association, Correspondence to the Federal Trade Commission (April 30, 1997), online: <http://www.ftc.gov/bcp/franchise/comments/kezios62.htm> (date accessed: May 15, 2007).

168 U.S. Federal Trade Commission, *supra* note 11 at 10.

According to the FTC, while it received evidence of injury to franchisees that may be ascribable to acts of franchisors, it is an open question whether the practices are prevalent and the injuries substantial when viewed from the standpoint of the franchising industry as a whole, rather than of a single franchise system. As well, since the purchase of a franchise is voluntary, the FTC could not conclude that prospective franchisees who receive full disclosure could not reasonably avoid the harm. Finally, advocates asserting injury to franchisees did not provide evidence that the injury outweighs potential countervailing benefits to the public at large or to competition. As a result, the FTC declined to impose provisions governing the substantive terms of franchise contracts that would apply to the entire franchise industry.[169] On the other hand, as noted above, the FTC did include additional disclosure provisions, concluding that more disclosure was "warranted to ensure that prospective franchisees are not deceived about the quality of the franchise relationship"[170] before they commit to a franchise.

B. Australia

Australia has a substantial franchising sector relative to its population, with a total of 70 250 franchise units in 2006 and a growth rate from 2004 to 2006 of approximately 15%.[171] The total sales turnover of all business format franchise units in 2005 was estimated at $128 billion, or 14% of Australia's gross domestic product.[172]

The Australian Government's first intervention in the franchising field was a voluntary *Franchising Code of Practice,* developed in 1993.[173] The *Code* set

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169 *Ibid.* at 10-12. The FTC also noted that it has previously voiced concerns with respect to government-mandated contractual terms, stating that terms that are driven by market forces and private parties acting in their own self-interest are most likely to result in products reaching market quickly and efficiently. FTC staff members have filed advocacy comments in relation to state bills that would limit manufacturers' ability to manage their distribution systems, by requiring exclusive territories, burdening wholesaler terminations or limiting responses to changing competitive conditions: *ibid.* at 12, note 45.

170 *Ibid.* at 12.

171 L. Frazer, S. Weaven and O. Wright, *Franchising Australia 2006* (Report prepared for the Franchise Council of Australia, 2006) at 9, online: <http://www.franchise.org.au/content/?action=getfile&id=450> (date accessed: May 12, 2007). This figure includes 5,660 company owned units and 8,390 fuel and motor vehicle retail outlets; the growth rate also includes company owned units.

172 *Ibid.*

173 Office of Small Business, Department of Employment, Workplace Relations and Small Business, Commonwealth of Australia, *Review of the Franchising Code of Conduct* (Discussion Paper, December 1999) at 4, online:

standards of franchisor disclosure, implemented franchisee cooling-off periods and provided access to dispute resolution mechanisms. However, a 1995 review found that only about 50% to 60% of franchisors had chosen to register.[174] The *Code* was widely viewed to be ineffective, and was allowed to lapse in 1996.[175]

In 1998, regulations implementing a mandatory Franchising Code of Conduct[176] were made under the *Trade Practices Act 1974*.[177] The key features of the Code are the requirement that franchisors provide the appropriate disclosure document and a copy of the Code at least 14 days before an agreement is signed or a non-refundable payment is made, a cooling-off period (a franchisee may terminate an agreement within seven days of signing it or of making a payment), mandatory mediation for dispute resolution and mandatory disclosure of information by a vendor franchisee to a prospective purchaser of the franchisee's business.[178] A franchisor must provide a new disclosure document to franchisees every year upon request. As well, a franchisor must not enter into, renew or extend a franchise agreement or receive a non-refundable payment unless the franchisee has provided a written statement that the franchisee has received, read and had a reasonable opportunity to understand the disclosure document.

In the case of a new franchise agreement, the franchisor must also receive signed statements from the franchisee that the franchisee has been given advice by an independent legal or business advisor or an accountant or has been told that that kind of advice should be sought but has decided not to seek it. A franchisor may not induce a franchisee not to associate with other franchisees,

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<http://www.industry.gov.au/assets/documents/itrinternet/ReviewFCoCdiscPaper1.pdf> (date accessed: May 12, 2007).

174 *Ibid.* Key franchising sectors, including the motor vehicle and real estate franchise industries, chose not to be covered by the Code, and non-compliance with the Code was an issue even among those franchisors who had registered.

175 *Ibid.*

176 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, SR 1998 No. 162 [Franchising Regulations] online: <http://www.comlaw.gov.au/ComLaw/Legislation/LegislativeInstrumentCompilation1.nsf/all/search/4FA9F21A9489DC27CA256F71004E4CCB> (date accessed: May 12, 2007).

177 *Trade Practices Act 1974* , No. 51, 1974, amended to No. 92, 2006, online: <http://www.comlaw.gov.au/ComLaw/Management.nsf/current/bytitle/1EA2ECBAF7F8CDFFCA256F710006F07D?OpenDocument&VIEW=compilations> (date accessed: May 12, 2007).

178 Franchising Policy Council, *Review of the Franchising Code of Conduct: Report of the Franchising Policy Council* (Report to the Minister of Employment, Workplace Relations and Small Business, Australia, May 2000) at 16, online: <http://www.industry.gov.au/assets/documents/itrinternet/ReviewofFCoC.pdf> (date accessed: May 12, 2007); *Trade Practices (Industry Codes – Franchising) Regulations 1998*, *supra* note 32, s. 10.

and franchise agreement must not contain a general release of the franchisor from liability. A franchisor must give a franchisee a reasonable time to remedy a breach before it can terminate an agreement, and franchise agreements must provide for a dispute mediation procedure that complies with the Code.[179]

Apart from the dispute resolution process, a party to a franchise agreement must seek compensation for damages through litigation. However, the Code is a mandatory industry code under the *Trade Practices Act, 1974*, and the Australian Competition and Consumer Commission also carries out a role in educating the public about the Code, and in investigating and bringing proceedings against those suspected of breaching the Code. The Commission can also apply for injunctions and for compensatory orders on behalf of individuals who have suffered loss as a consequence of another person's breach.[180]

The Franchising Policy Council conducted a review of the 1998 Code in 2000. The Council made a number of recommendations for amendments,[181] but concluded that overall, the Code had been a successful initiative and that the benefits to the industry outweigh the costs of compliance with the Code.[182]

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179 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, *supra* note 32.

180 Franchising Code Review Committee, *Review of the Disclosure Provisions of the Franchising Code of Conduct* (Report to the Minister for Small Business and Tourism, Australia, October 2006) at 26, online: <http://www.industry.gov.au/assets/documents/itrinternet/Franchising_Code_Review_Report_2006_FINAL_06120720070205134250.pdf> (date accessed: May 12, 2007); franchisees may also have remedies at common law (at 29). See also J. Martin, Australian Competition and Consumer Commission, "The Health Of Franchising From The Viewpoint Of Its Regulator" (Paper for the Franchise Council of Australia Adelaide Conference, October 23, 2001), online: <http://www.accc.gov.au/content/index.phtml/itemId/179406>.

181 Franchising Policy Council, *supra* note 34. These included a recommendation that a short form disclosure document be used for franchises with an annual turnover of less than $50,000 annually, that international franchisors be exempt from the disclosure requirements where an Australian master franchisor has been appointed to make the disclosures, and that the Government consider expanding the functions of the ACCC to enable the Commission to more closely monitor compliance with the Code. The Council noted options such as requiring disclosure documents to be registered with the ACCC, at 56. The regulations were amended in 2001 to implement the short form disclosure document for small franchises, to clarify that both a franchisor and master franchisee must disclose information to a sub franchisee (a joint form is permitted) and to require franchisors to maintain current disclosure documents: *Trade Practices (Industry Codes – Franchising) Amendment Regulations 2001 (No. 1)*, SR 2001 No. 165, online: <http://www.comlaw.gov.au/ComLaw/Legislation/LegislativeInstrument1.nsf/0/2041FFDD2B1C8D51CA256F700080DA4B?OpenDocument> (date accessed: May 12, 2007).

182 Franchising Policy Council, *supra* note 34 at 56.

In 2006, a survey of franchising in Australia found that the most common causes of franchisor-franchisee disputes were related to system compliance, communication problems, and claims of misrepresentation. Mediation was used as a means of resolving disputes more than twice as often as litigation.[183]

The Franchising Code of Conduct was again reviewed in 2006 by the Franchising Code Review Committee, established by the Australian Government following concerns raised about whether the disclosure provisions of the Code were working effectively and about the enforcement of the Code by the ACCC.[184] The Committee made a number of recommendations, including the following:

- the franchisor should be required to provide all agreements, in the form in which they are intended to be executed, at the same time as the disclosure documents. The Committee had found that franchisees were in some cases given complete contracts only at the time of signing, and that the contracts presented for signing sometimes differed from earlier drafts;
- financial disclosure requirements should be extended to any consolidated entity to which the franchisor belongs;
- the franchisor should be required to provide a risk statement identifying known significant risks that could have a material impact on the franchise;
- marketing fund annual financial statements should be required to be audited;
- the requirement to disclose financial benefits from the supply of goods or services to franchisees should include the amount or method of calculation of the rebate or benefit;
- the ACCC should collect information respecting the auditing of financial statements and determine whether the lack of audited statements is causing unsatisfactory outcomes;
- where consent is obtained, the contact details of past franchisees should be included in the disclosure documents (along with the number of past franchisees who declined to give consent);
- the business experience of all who may have management responsibilities with the franchisor should be disclosed;
- franchisor directors should be included among those required to provide disclosure, and the scope of disclosure should be extended to criminal convictions for non-serious offences;

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183 Frazer, Weaven and Wright, *supra* note 27 at 11.

184 Franchising Code Review Committee, *supra* note 36 at 22.

- the exemption for international franchisors with only one franchise or master franchise in Australia should be deleted;
- consideration should be given to prohibiting unilateral material changes by franchisors and removing or modifying the right of a franchisor to unilaterally terminate a franchise agreement. If the right is maintained, adequate franchisee compensation should be required;
- franchisors should be prohibited from inducing prospective franchisees not to associate or communicate with current or past franchisees (the current prohibition applies to current franchisees associating with other franchisees);
- franchisors should be required to register with and submit annual disclosure documents to the ACCC and the ACCC should undertake sample audits of disclosure documents;
- the Government should apprise the ACCC of franchisee concerns respecting the level of enforcement action;
- the Code should include a requirement of good faith and fair dealing.[185]

The Australian Government announced in February 2007 that it accepted most of the recommendations of the Review Committee, and would consult with the franchising industry on their implementation. The government declined to implement the recommendations for inclusion of a duty of good faith, mandatory risk statements, the mandatory registration of franchisors with the ACCC and ACCC disclosure document audits.[186] The recommendation respecting the right of franchisors to unilaterally change franchise agreements will be addressed through amendments to the *Trade Practices Act 1974*.[187]

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185 Franchising Code Review Committee, *supra* note 36.

186 Hon. F. Bailey, Minister of Industry, Tourism and Resources, *Reform of Franchising Code of Conduct* (Media Release, February 6, 2007), online: <http://minister.industry.gov.au/index.cfm?event=object.showContent&objectID=94295C17-EA1C-0051-28ED423358DDEC21> (date accessed: May 12, 2007); Hon. F. Bailey, Minister of Industry, Tourism and Resources, *Consultation with the Franchising Industry Underway* (Media Release, February 21, 2007), online: <http://minister.industry.gov.au/index.cfm?event=object.showContent&objectID=E163FC5D-F7BC-D911-8050F99B577F2429> (date accessed: May 12, 2007); S. Giles, *Franchising code amendment announcement*, Deacons (February 2007), online: <http://www.deacons.com.au/UploadedContent/NewsPDFs/LU-060207-Franchising_code_amendment_announcement.pdf> (date accessed: May 12, 2007); *Australia: Franchising Code Review*, DLA Phillips Fox (February 26, 2007), online: <http://www.mondaq.com/article.asp?articleid=46498&lastestnews=1> (date accessed: May 12, 2007).

187 Hon. F. Bailey, Minister of Industry, Tourism and Resources, *Reform of Franchising Code of Conduct, supra* note 42.

C. Europe and Asia

The most important European Union law affecting franchising is Article 81 of the European Community Treaty.[188] It prohibits agreements distorting competition and a number of practices that may be found in franchising, such as the sharing of markets or sources of supply, although there are exemptions where competition is not eliminated.[189]Specific franchising laws vary among the countries. Several countries, including the U.K., Ireland, Germany, Denmark, the Netherlands and Portugal have no franchise-specific statute.[190] Legislation in Spain requires franchisors to register in the Franchisors' Registry and provide disclosure to prospective franchisees 21 days before signing an agreement or accepting a payment.[191] France and Italy have disclosure legislation requiring franchisors to provide disclosure 30 days before the execution of an agreement.[192] Other countries that have adopted franchise regulatory legislation include Sweden,[193] Mexico, Belgium, Belarus, Lithuania, and Estonia.[194]

As well, the European Franchise Federation has adopted a European Code of Ethics for Franchising. National franchise associations that are members of the Federation must require their member franchisors to accept and comply with the Code, and operate an accreditation scheme with checks to ensure that its voting franchisor members are complying. The Code obliges parties to a franchise to

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188 *Treaty Establishing the European Community*, Official Journal C 325, 24 December 2002, Article 81, online: <http://www.europa.eu.int/eur-lex/lex/en/treaties/dat/12002E/htm/12002E.html> (date accessed: May 12, 2007).

189 *Ibid.* See also J.M. LaPierre, *European Union: A Survey of Franchising in the European Union*, U.S. Department of Commerce (December 12, 2005), online: <http://commercecan.ic.gc.ca/scdt/bizmap/interface2.nsf/vDownload/ISA_4091/$file/X_2559958.DOC> (date accessed: May 12, 2007).

190 *Franchising in the EU Member States*, Field Fisher Waterhouse LLP, London, England, online: <http://www.europeanfranchising.com/franchisingineu/intro.aspx> (date accessed: May 12, 2007).

191 *Ibid.* See also UNIDROIT, *Legislation and Regulations Relevant to Franchising*, online: <http://www.unidroit.org/english/guides/1998franchising/annex.htm> (date accessed: May 12, 2007).

192 *Ibid.*

193 See UNIDROIT, *Legislation and Regulations Relevant to Franchising – Sweden* (January 2007), online: <http://www.unidroit.org/english/guides/1998franchising/country/sweden.htm> (date accessed: May 12, 2007).

194 For a brief explanation of developments in these countries, see E. Levitt, "Annual Legislative Update" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006) at 7-16. See also *F#: FFW's International Franchise Update*, Field Fisher Waterhouse LLP, London, England, online: <http://www.europeanfranchising.com/PDFs/FSharpSpring2006.pdf> (date accessed: May 12, 2007).

exercise fairness in their dealings with each other and lists essential terms that a franchise agreement must cover.[195]

Work has also been underway on a model European Civil Code, which would include measures to regulate franchising. The Study Group on a European Civil Code, a network of academics from across the EU, aims to produce principles for private law rules to apply across Europe. A draft chapter on franchising contains pre-contractual disclosure provisions, as well as a number of provisions to regulate the franchise relationship throughout the term of the agreement.[196]

D. UNIDROIT

The International Institute for the Unification of Private Law ("UNIDROIT") is an independent intergovernmental organization of 60 Member States instituted to "study needs and methods for modernising, harmonising and co-ordinating private and, in particular, commercial law as between States and groups of States".[197]

In 1985, the Canadian member of the Governing Council of UNIDROIT proposed that the organization consider the preparation of uniform rules on franchising.[198] At that time, franchising was a new development in Europe and was rare in other countries, with the exception of North America. However, franchisors' representatives opposed the concept of an international instrument,

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195 See European Franchise Federation, *European Code of Ethics for Franchising*, online: <http://www.eff-franchise.com/selfregulation.html> (date accessed: May 12, 2007).

196 "An Uncivil Code?" *F#: FFW's International Franchise Update*, *supra* note 50. Draft relationship provisions include requirements imposed on the franchisor to provide ongoing assistance necessary to operate the business without charge, make reasonable efforts to promote and maintain the reputation of the franchise network and provide the franchisee ongoing information about matters such as market conditions and advertising campaigns. Franchisee obligations include the requirement to make reasonable efforts to operate the business according to the franchisor's business method, follow reasonable instructions, take reasonable care not to harm the network and allow reasonable access to the franchisor for checks and audits.

197 UNIDROIT, *About Unidroit*, online: <http://www.unidroit.org/english/presentation/main.htm> (date accessed: May 12, 2007). It was first established in 1926 as an auxiliary of the League of Nations, and re-established in 1940 by multilateral agreement between 60 member States.

198 UNIDROIT, *Model Franchise Disclosure Law*, September 2002, online: <http://www.unidroit.org/english/modellaws/2002franchise/2002modellaw-e.pdf> (date accessed: May 12, 2007). The Explanatory Report notes that there had been "a number of instances of sharp practices within Canada that it was feared might spread also to other countries with the international expansion of franchising," at 11.

and UNIDROIT agreed to monitor franchising developments.[199] Over time, interest in the development of an international franchise instrument grew, and in 1993 UNIDROIT established a Study Group on Franchising.[200] The new interest "was largely due to the increased attention devoted to franchising by legislators and the consequent proliferation of franchise laws, not all of which had, in the view of the members of the Study Group, given sufficient consideration to the specific nature and characteristics of franchising, thereby unintentionally putting the future development of franchising in the country concerned at risk".[201]

The Franchising Study Group prepared a *Guide to International Master Franchise Arrangements*,[202] published in February 1998, and a *Model Franchise Disclosure Law*,[203] submitted to the Governing Council in September 2002.

The UNIDROIT Model Law deals only with the disclosure obligations of franchisors; it does not address the relationship between the parties.[204] The Group considered approaches that included relationship provisions, such as "for example, whether the franchisee has a statutory right to renew the agreement, and whether the franchisee has a right to cure when he/she breaches the contract",[205] noting that the additional requirement for registration in some jurisdictions "considerably increased the burden that was placed on the franchisor".[206] However, the Group concluded that the experience of States with relationship legislation had been negative, and that while it was feasible to reach agreement on disclosure provisions, and therefore to attain a degree of uniformity, "it was far more problematic to devise common norms for relationship issues in view of the great variety of relationships that existed within the context of franchising".[207] As a result, the Group concluded that regulation at the international level should deal only with disclosure.

Under the Model Law, a franchisor must give a prospective franchisee a disclosure document at least 14 days before the signing of any agreement or the payment of a non-refundable deposit, other than a confidentiality agreement or a

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199 *Ibid.* at 11-12.

200 *Ibid.* at 12.

201 *Ibid.* at 14.

202 UNIDROIT, *Guide to International Master Franchise Arrangements* (1998).

203 UNIDROIT, *supra* note 54.

204 *Ibid.*

205 *Ibid,* at 14. The relationship provisions identified by the Group are more far-reaching than those included to date in Canadian franchise statutes.

206 *Ibid.*

207 *Ibid.* at 3-4.

security deposit for a confidentiality agreement. The Model Law sets out a list of information that must be included in the disclosure document, but any format may be used.[208]

If the disclosure document or notice of material changes is not delivered within the 14 day period or contains a misrepresentation or omission of a material fact, the franchisee may terminate the franchise agreement and/or claim damages, unless the franchisee had the information through other means, did not rely on the misrepresentation, or termination is a disproportionate remedy in the circumstances. Any waiver by a franchisee of a right under the Act is void.[209]

CHAPTER 6: ISSUES FOR CONSULTATION

Franchising has become prevalent in Canada and in other countries, and there is a trend toward regulation through franchise legislation, primarily with the aim of protecting franchisees. As noted, the Canadian laws are primarily disclosure statutes; franchisors must provide prospective franchisees information about a number of specific matters before the franchisee signs a franchise agreement or pays any money to the franchisor. There are also some provisions governing the franchise relationship, imposing a duty of fair dealing and protecting the right of franchisees to associate with other franchisees.

The previous chapters have provided a brief explanation of franchising and an overview of current regulatory schemes. Our preliminary review has identified a number of issues for discussion. However, we invite the reader not only to comment on the issues that we raise, but also to identify any additional issues of interest.

The discussion in this paper should also not be interpreted as an indication of our stance on these matters. Rather they are put forward as a starting point for discussion.

A. Is Franchise Legislation Needed In Manitoba?

The principal argument against legislating to regulate franchising is that it may tend to have a chilling effect on the attractiveness of Manitoba as a business location. Any increased regulation imposes an additional cost and administrative burden on franchisors that becomes a disincentive to conducting business in the province.

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208 *Ibid.* at 4-8.

209 *Ibid.* at 8-9.

There is a contrasting argument that the requirements of Canadian legislation to date are not particularly onerous in relation to responsible franchisors, whose conduct would likely meet the minimum standards in the absence of regulation. Franchisors that are based in Alberta or Ontario, where legislation has been in place for some time, will already be familiar with the requirements of those jurisdictions, and franchisors in other provinces with aspirations to expand will need to meet those requirements if they wish to access larger markets. Further, franchisors entering Canada from the U.S. do so from an environment of regulatory restrictions. As a result, the argument that regulation has a chilling effect in relation to prospective franchisors is growing less persuasive.

In fact, the requirements of franchise legislation in other Canadian jurisdictions may impose little more than good business practices, and some commentators advise franchisors to use one of the disclosure models even when operating in a non-regulated province, "in order to build the goodwill of their brand in that jurisdiction and more importantly to embrace practices which will reduce unnecessary exposure to litigation for misrepresentation".[210]

Finally, with its smaller population base, Manitoba may be more likely - for the time being at least - to be a 'franchisee' rather than a 'franchisor' province, and franchisees are typically at a disadvantage in the business relationship. A choice not to regulate may risk the development of a reputation for Manitoba as a haven for incompetent or disreputable franchisors.

The Franchising Policy Council of Australia has noted the Australian experience:

> Mandatory regulation of an industry can involve a compliance burden and a cost. The consensus of the franchising industry was that such a burden and cost was worthwhile if the benefit was an informed and responsible industry. The franchising industry was prepared to seek protective statutory mechanisms to combat the small number of unscrupulous operators who had the potential to tarnish the image of the whole industry.[211]

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210 R.D. Leblanc and P.M. Dillon, "Franchise Disclosure in Canada in 2007 and Beyond" (Paper presented to The Domino Effect: 6th Annual Franchising Conference, Ontario Bar Association, November 16, 2006) at 7-8. The Canadian Franchise Association also requires its members to provide a minimum level of disclosure: see Canadian Franchise Association, *CFA Disclosure Rules*, online: <http://www.cfa.ca/Page.aspx?URL=CFADisclosureRules.html> (date accessed: May 15, 2007).

211 Franchising Policy Council, *Review of the Franchising Code of Conduct: Report of the Franchising Policy Council* (Report to the Minister of Employment, Workplace Relations and Small Business, Australia, May 2000) at 14-15, online: <http://www.industry.gov.au/assets/documents/itrinternet/ReviewofFCoC.pdf> (date accessed: May 12, 2007).

The Council concluded that "the costs are worthwhile considering the benefits that the … Code provides to the franchising industry."[212]

Another commentator suggests:

> Although there are compliance costs, it is arguable that this creates an appropriate barrier to entry. If franchisors cannot afford the relatively modest cost of preparation of a franchise agreement and disclosure document, they ought not to be attempting to franchise.[213]

It should also be noted that Manitoba does currently regulate certain ongoing commercial relationships; legislation amending *The Farm Machinery and Equipment Act* to govern farm equipment dealerships was enacted in May 2000.[214] The amendments prohibit the practice of 'dealer purity', so that a farm equipment manufacturer may not prevent a dealer from carrying competing equipment lines and products. A manufacturer may also not discriminate among similarly situated dealers or terminate a dealership agreement without cause. In most cases a court order is also required. The Act also provides for the court to appoint a mediator to mediate disputes on the request of one of the parties to the dealership agreement and requires the parties to participate in good faith.[215]

B. If Legislation Is Desirable, What Elements Should Be Included?

If Manitoba legislates to regulate franchising, a degree of uniformity with the franchise legislation of other provinces will no doubt be desired. The trend toward harmonized franchising legislation in Canada is consistent with the principles of the *Agreement on Internal Trade* and can be expected to contribute clarity and certainty to the commercial franchise environment. If regulatory requirements are consistent across provincial boundaries, barriers to the movement of goods, services and investment may be reduced, and franchisors will have little non-market incentive to choose to conduct business in one province over another.

The existing Canadian statutes are relatively consistent in their approach to regulation, and focus primarily on requiring pre-contractual disclosure. However,

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212 *Ibid.* at 56.

213 *FCA and the Franchising Code of Conduct* (May 17, 2006), Franchisebusiness.com, online: <http://www.franchisebusiness.com.au/articles/B1/0C0403B1.aspx> (date accessed: May 12, 2007).

214 *The Farm Machinery and Equipment Act*, C.C.S.M. c. F40.

215 Some dealership arrangements may fall within the definition of 'franchise' used in Canadian franchise legislation. If franchise legislation is enacted in Manitoba, it will be necessary to consider the effect of any inconsistency between the farm equipment dealership provisions and the franchise provisions.

there are areas of difference among the Acts. As well, in the years since Canadian franchise legislation was first enacted, various suggestions have been made for improvements to the regulatory scheme. Some call for amendments to address specific problems that have been encountered,[216] and others represent more significant structural changes.

1. Disclosure Elements

As noted, there are areas of difference among the Canadian statutes; many of these relate to specific franchisor disclosure requirements. The Commission is interested in comments from the public with respect to disclosure matters, including:

(a) Scope of disclosure of material facts

- Should the ULCC approach to disclosure of 'material facts' be followed (setting out an extensive list of matters that must be disclosed whether or not the information is material in a situation) or the approach under current provincial regulations (which provides less detail)? The provincial approach may be less likely to result in irrelevant material being included, and there is still a general requirement to include information about a matter that is not listed but meets the definition of 'material fact'. It is also the current Canadian standard. However, there is a risk that a franchisor may exclude relevant information.
- Whether the more comprehensive or less comprehensive approach is chosen, are there categories of disclosure not currently included in provincial legislation that should be specifically required? For example, information respecting:
    - settled litigation and terms of settlement;
    - arbitration and/or mediation proceedings;
    - confidentiality agreements signed by current and former franchisees;
    - background, market conditions and risk factors relating to the nature of the business;
    - information as to how the franchisor may compete with franchisees through alternate distribution channels, such as the internet or catalogue sales;

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216 In Ontario, for example, franchise lawyer Peter Dillon has criticized the *Wishart Act*, arguing that Ontario is "the toughest jurisdiction in the world in which to franchise"; P. M. Dillon, "Ontario Franchise Developments in 2004: Has the Pendulum Finished Swinging Yet?" Siskinds Collection of Franchise Law Articles (FRAN/RP-016, June 15, 2005), QL at paragraph. 1; see also P.M. Dillon, "Will Franchising Survive As a Business Model Under Canadian laws and Regulations?" *Franchise Law Journal* (Summer 2006).

- information respecting the parents, predecessors, affiliates and associates of the franchisor;
- bankruptcy and insolvency proceedings relating to officers, directors and partners with management responsibilities;
- franchisee support resources and methods;
- policies respecting security interests and guarantees;
- gross-up provisions to compensate foreign franchisors for the cost of royalty withholding tax;
- repeated sales of the same franchised outlet;
- where the franchisor receives a rebate or benefit from a required supplier, the source of the benefit and how the benefit is calculated;
- whether the franchisor or any officer of the franchisor has an interest in a required supplier.

(b) Wrap around disclosure document and substantial compliance. Alberta and PEI allow franchisors to use disclosure documents that are acceptable in other jurisdictions with 'wrap around' material to comply with the province's requirements. These jurisdictions also provide that a disclosure document complies with the legislation if it is 'substantially complete'.

(c) Exceptions for confidentiality, site selection or refundable deposit agreements.

Disclosure documents must be delivered to a prospective franchisee 14 days before the signing of an agreement relating to the franchise or the payment of consideration relating to the franchise. All Acts except Ontario's exempt confidentiality and site selection agreements from the disclosure requirement; the Alberta Act also exempts fully refundable deposits. Should franchisors be able to require a refundable deposit or enter into a confidentiality or site selection agreement with a franchisee before providing disclosure?

2. Exemptions

In Alberta and under the New Brunswick Bill, regulations may be made to provide for exemptions from any or all provisions of the Act or regulations. The Ontario and PEI Acts authorize regulations to be made exempting certain franchisors from the requirement to include financial statements in a disclosure statement. As well, under the PEI Act, any franchisor may apply to the Minister for an exemption from the requirement to disclose financial statements. The Minister may exempt the franchisor, subject to any terms and conditions, if satisfied that to do so would not be prejudicial to the public interest.

Regulations have been made in Alberta, Ontario, and PEI to exempt 'mature franchisors' from the requirement to include financial statements in a disclosure statement. Mature franchisors may be expected to provide more stable business opportunities, and to be reluctant to reveal sensitive information to their competitors. On the other hand, long established businesses can encounter financial difficulties, and it is arguable that all information relevant to the purchase of a franchise should be fully disclosed to prospective franchisees.

Is the ability to exempt certain franchisors from the requirement to provide financial statements or to implement for other exemptions from the requirements of legislation or regulations appropriate?

3. Franchise Relationship Regulation

In addition to the disclosure requirements and franchisee remedies for non-disclosure, Canadian franchise legislation includes certain provisions that regulate the relationship between the parties to a franchise agreement. The provisions impose a duty of fair dealing on the parties to a franchise agreement and restrict the enforceability of certain terms that a franchisor might otherwise include in the agreement (for example, a franchisor cannot restrict the franchisee's freedom to associate, and cannot enforce a clause under which a franchisee purports to waive his or her rights under the Act).

Given the power imbalance between the parties to the franchise contract, the 'take it or leave it' nature of most agreements, and the ability of a franchisor under many agreements to unilaterally make fundamental changes to the operation of the franchise during the term of the contract and at its renewal, some jurisdictions place additional restrictions on the terms that a franchisor may include in an agreement or the changes that it may impose.[217] In the U.S., bills have been introduced in Congress, but not enacted, proposing additional regulation; for example:

> [T]he Small Business Franchise Act of 1999 (H.R. 3308), proposed, among other things, a comprehensive scheme for regulating the franchise relationship and included provisions on contract terminations, and transfers; encroachment; the purchase of goods or services from designated sources of supply; and franchisee's rights to associate with other franchisees.[218]

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217 An Australian review of the efficacy of disclosure provisions in franchise regulation concluded that the long term nature of the franchise contract is inconsistent with the use of disclosure as the primary regulatory tool. Franchise contracts were analyzed in relation to goals such as balance of power, certainty and fairness of contract terms, and did not appear to be consistent with those goals: E.C. Spencer, "The Efficacy of Disclosure in the Regulation of the Franchise Sector in Australia" (Paper presented to the Third Meeting of the European Network on the Economics of the Firm (ENEF), September 7-9, 2006), online: <http://www.enef.group.shef.ac.uk/2006%20workshop%20papers/SPENCER.pdf> (date accessed: May 12, 2007).

218 U.S. General Accounting Office, *Federal Trade Commission: Enforcement of the Franchise Rule* (Report to Congressional Requesters, July 2001) at 40, online:

As well, several U.S. states have enacted laws addressing matters such as the termination, renewal and transfer of the franchise, territory encroachment, and requirements for the purchase of goods and services from designated sources.[219] Iowa's legislation is recognized as being the most comprehensive, and among other things, prohibits franchisors from terminating or refusing to renew a franchise without good cause (or, in the case of renewal, unless certain circumstances exist, such as the franchisor's withdrawal from that market). It also prohibits franchisors from requiring franchisees to purchase goods or services exclusively from the franchisor or designated sources when comparable goods and supplies are available from other sources. Franchisees also have a cause of action for damages if a franchisor allows encroachment that adversely affects the franchisee's sales.[220] In Australia, the Franchising Code Review Committee recently recommended that consideration be given to prohibiting unilateral changes by franchisors and removing or modifying the right of a franchisor to unilaterally terminate a franchise agreement. The Committee added that if the right is maintained, adequate franchisee compensation should be required.[221]

The ability of the franchisor to impose unilateral changes to business operations was also identified as a concern by the American Franchisee Association, which has advocated for federal franchise relationship provisions.[222]

> [A] prospective franchisee may do his or her due diligence, investigate the system, talk to franchisees, and be comfortable in signing the current franchise agreement. ...[but] some of the unilateral changes to franchise relationships involve issues that no franchisee could have anticipated upon the initial signing of the contract. In other words… a franchisee may be bound by changes to the relationship that, had they known, they never would have signed the agreement in the first place.[223]

<http://www.gao.gov/new.items/d01776.pdf> (date accessed: May 12, 2007).

219 *Ibid.* at 43-44.

220 *Ibid.* at 44; Iowa Code §§ 523H.1-523H.17.

221 The Australian Government has indicated that this recommendation will be addressed in the context of amendments to the *Trade Practices Act, 1974*: Hon. F. Bailey, Minister of Industry, Tourism and Resources, *Reform of Franchising Code of Conduct* (Media Release, February 6, 2007), online: <http://minister.industry.gov.au/index.cfm?event=object.showContent&objectID=94295C17-EA1C-0051-28ED423358DDEC21> (date accessed: May 12, 2007).

222 The American Franchisee Association proposed a *Model Responsible Franchise Practices Act* in 1996; see The American Franchisee Association, *Who Are We?,* online: <http://www.franchisee.org/history.htm> (date accessed: May 12, 2007). As well, the American Association of Franchisees and Dealers developed voluntary standards for fair franchising, which would enable franchisors to display a "Fair Franchising Seal": see The American Association of Franchisees and Dealers, Fair Franchising Standards (revised August 2002), online: <http://aafd.org/images/logo/Standards.pdf> (date accessed: May 12, 2007).

223 U.S. General Accounting Office, *supra* note 9 at 70-71.

One specific suggestion made to the Commission relates to the sale of a franchise by a franchisee. Typically, if a franchisee sells his or her franchise and assigns the agreement and/or sub-lease to the purchaser, the original franchisee remains liable for all obligations contained in the agreements. This is a typical provision of commercial leases. However, some franchise agreements also provide that if the purchaser subsequently renews the agreements for a further term, the original franchisee continues to be liable for all obligations of the purchaser under the renewed agreements, despite having had no input into their terms. It was suggested that Manitoba franchise legislation provide that, in this situation, the obligations of the franchisee do not extend beyond the term of his or her original agreements and any renewals signed by that franchisee.[224]

A contrary view to suggestions for additional restrictive provisions is that disclosure legislation reflects the right balance in the franchise relationship, and the freedom of the franchisor to exercise control over the operation of the business on an ongoing basis is necessary for the creation and maintenance of the business brand. Franchisor control and flexibility creates and adds value to the franchise identity, which is why franchisees invest in the franchise in the first place, and there is no 'one size fits all' solution for disputes involving companies operating in a wide range of industries. As well, many obligations contained in franchise relationship regulatory proposals are ambiguous, creating uncertainty and potentially leading to increased litigation and increased costs. Comprehensive pre-sale disclosure and the ability to contact present and former franchisees ensure that the prospective franchisee is able to obtain the information necessary to determine the likelihood of disputes occurring within a specific franchise relationship.[225]

As well, unlike federal regulation in the U.S. and Australia, Canadian jurisdictions have incorporated a standard of conduct—the duty of fair dealing—in their legislation.[226] In fact, it has been suggested that existing Canadian

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224 Correspondence from A.L. Weinberg, Q.C. (January 2, 2007).

225 See U.S. General Accounting Office, *supra* note 9 at 72-74, outlining the views of the U.S. International Franchise Association, which has opposed federal franchise relationship legislation. The IFA also opposed proposed 'minimum standards of fair conduct', which included a duty of good faith, a duty of due care (or competency) and a fiduciary duty for franchisors in relation to accounting and advertising programs.

226 There is also no private right of action for franchisees under the U.S. FTC Franchise Disclosure Rule, and the American Franchisee Association has advocated for franchisee access to the courts: see J. Chun, "Separate but equal? Two associations seek franchise reform through different means – American Franchisee Association, AFA, and the American Association of Franchisees & Dealers - AAFD" *Entrepreneur* (September 1996), online: <http://findarticles.com/p/articles/mi_m0DTI/is_n9_v24/ai_18648850> (date accessed: May 15, 2007).

legislation already goes too far, and that Canada should have adopted the UNIDROIT 'less is more' approach to franchise regulation:

> Because of the strong presence of lawyers with extensive experience on behalf of franchisors operating internationally, the frequent and well-intentioned efforts to inject more and more protections on behalf of the franchisee were tempered by the larger consideration that in the final analysis legislators could end up protecting the franchisees right out of a livelihood by introducing overly burdensome laws. Even worse, legislation might protect the economy right out of the jobs and wealth that franchising produces. Although the debate among franchisor and franchisee counsel and lobbyists continues about the legitimacy of the claim, Alberta's 1971 act and Iowa's present relationship law are cited as examples of the macroeconomic harm that over-burdensome regulation produces. In business, fear – no matter how irrational – is a deterrent.[227]

4. Franchise Regulatory Body

In Ontario, it has been suggested that new legislation is needed to create a franchising regulatory body. The regulator's functions might include reviewing the quality of disclosure given to franchisees, providing a less expensive system for resolving disputes in comparison to litigation, and imposing penalties for contraventions of franchise legislation and regulations.[228] The regulatory concept could also require some franchisors to post a bond, so that franchisees who suffer damage will be compensated.[229]

It is argued that the existing Canadian legislation does not provide adequate protection for franchisees:

> Some franchisors are not giving adequate disclosure, and franchisees who have already invested a life's savings at the age of 40 or 50 are having to spend $50,000 to $100,000 to enforce their rights under franchise law to rescind their contracts and recover payments… "When a franchisee files a notice of rescission, the franchisor says: 'Sue me'…If the franchisor is bad enough not to give you a disclosure document to begin with, most likely he will not refund the money…People should not be forced to locate a franchise lawyer and litigate this, but should have the benefit of a regulatory body, given that franchising plays such an important role in our economy and more and more people are choosing to buy a franchise instead of set up their own business".[230]

The concept of a governing body with the power to impose substantial penalties, including cease trade orders, had been supported by franchisee

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227 P.M. Dillon, "Will Franchising Survive As a Business Model Under Canadian laws and Regulations?" *supra* note 7: the author served as the Canadian consultant on the project (at note 5).

228 J. Daw, "Government regulator could help both sides in a franchise: Province awaiting report from committee" *Toronto Star* (March 16, 2006).

229 *Ibid.*

230 *Ibid.* quoting B. Hanuka, Chair, Ontario Bar Association Joint Subcommittee on Franchising.

representatives on the Franchise Sector Working Team that made recommendations for franchise legislation in Ontario in 1995.[231]

Others have objected to this suggestion, arguing that it would add an unnecessary layer of administration that would "dissuade honest franchisors from conducting business [in Ontario] and increase the cost of doing business for franchisors and franchisees, thereby hurting us all".[232] The Canadian Franchise Association does not support the proposal, noting that it used to be a function of Alberta's securities commission to review franchise disclosure documents, but the scheme was repealed.[233]

A regulatory office could be structured in a number of ways. In the U.S. for example, the Federal Trade Commission conducts investigations of violations of the FTC Franchise Rule, and may seek a variety of remedies to enforce the Rule, including injunctions, monetary penalties, and orders for refunds to franchisees. The FTC may initiate an investigation as a result of a complaint or on its own initiative (for example, following media reports).[234] Unlike the scheme established by the early franchise legislation in Alberta, however, franchisors are not required to register with the FTC and the FTC does not review or approve initial disclosure documents. Similarly, in Australia, the Australian Competition and Consumer Commission investigates and brings proceedings against franchisors suspected of breaching the Code of Conduct. The Commission can also apply for injunctions and for compensatory orders on behalf of individuals who have suffered loss as a consequence of another person's breach.[235] Franchisors are not required to register with the ACCC.[236]

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231 *Franchise Sector Working Team Report* (August 30, 1995) in F. Zaid, *Canadian Franchise Guide*, loose-leaf (1993) at 2-142J-142Z.4.

232 Daw, *supra* note 19, quoting lawyer J. Adler.

233 *Ibid.* quoting R. Cunningham, President of the Canadian Franchise Association.

234 U.S. General Accounting Office, *supra* note 9 at 46-48; however, due to limited resources, the FTC focuses on complaints that exhibit a pattern or practice of violations nationwide.

235 Franchising Code Review Committee, *Review of the Disclosure Provisions of the Franchising Code of Conduct* (Report to the Minister for Small Business and Tourism, Australia, October 2006) at 26-17, online: <http://www.industry.gov.au/assets/documents/itrinternet/Franchising_Code_Review_Report_2006_FINAL_06120720070205134250.pdf> (date accessed: May 12, 2007). See also J. Martin, Australian Competition and Consumer Commission, *The Health of Franchising from the Viewpoint of its Regulator* (Paper for the Franchise Council of Australia Adelaide Conference, October 23, 2001), online: <http://www.accc.gov.au/content/index.phtml/itemId/179406> (date accessed: May 12 ,2007)..

236 While franchisor registration was recently recommended by the Franchising Code Review Committee, the Australian Government has declined to implement this recommendation: S. Giles, *Franchising code amendment announcement*, Deacons (February 2007), online:

5. Alternative Dispute Resolution

The use of alternative dispute resolution mechanisms is growing in popularity in the franchise industry; in part, it is said, because of the legislated requirements for franchisors to disclose to franchisees the details of concluded or pending litigation. Some franchisors have inserted mandatory binding arbitration or other alternative dispute resolution provisions in their franchise agreements.[237] Alternatively, franchisors and franchisees may agree to voluntary mediation or other alternative dispute resolution processes.

Alternative dispute resolution methods have benefits over litigation in that they generally are cheaper and can be more private and less combative than the court process. ADR is often considered to be particularly appropriate in the context of ongoing business relationships, often enabling the business relationship to be preserved.[238] The Ontario Franchise Sector Working Team recommended that alternative dispute resolution methods be explored and adopted,[239] and the concept was raised at the public hearings on the Ontario Act. On the other hand, the American Franchisee Association has noted that mandatory arbitration provisions can be a disadvantage to franchisees, in that arbitration is private and does not result in useful precedents.[240] As well, in the most flagrant fact situations, a contract providing for mandatory arbitration may prohibit any award of punitive damages that might otherwise be available.

In the U.S., a national franchising mediation program was developed in 1993 by a steering committee of franchisor companies who were growing increasingly concerned about media reports of unfair treatment of franchisees by some franchisors.[241] The program operates through the Center for Public

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<http://www.deacons.com.au/UploadedContent/NewsPDFs/LU-060207-Franchising_code_amendment_announcement.pdf> (date accessed: May 12, 2007); *Australia: Franchising Code Review*, DLA Phillips Fox (February 26, 2007), online: <http://www.mondaq.com/article.asp?articleid=46498&lastestnews=1> (date accessed: May 12, 2007).

237 D.F. So, *Canadian Franchise Law Handbook* (2005) at 266.

238 *Ibid.* at 264.

239 *Franchise Sector Working Team Report supra* note 22 at 2-142J-142Z.4.

240 *The Twelve Worst Franchise Agreement Provisions*, American Franchisee Association, online: <http://www.franchisee.org/Buying%20a%20Franchise.htm> (date accessed: May 12, 2007).

241 M. Aronson, "National Franchise Mediation Program: Where Do We Go From Here?" 29:3 *Franchising World* (May/June 1997); P. Philipps, "The National Franchise Mediation Program: A Business-like Alternative to Suing Your Business Partner" 33:1 *Franchising World* (Jan/Feb 2001).

Resources Institute for Dispute Resolution[242] and is non-binding and voluntary, although franchisors are asked to join for a minimum two year period.

The Ontario and PEI regulations require a franchisor's disclosure document to describe any alternative dispute process used or imposed by the franchisor. In Ontario, the document must also include a statement that any party may propose an alternative dispute resolution process, which may be used if agreed to by all parties. The ULCC Model Bill and the New Brunswick Bill contain provisions allowing one party to a franchise agreement to deliver a notice to the other party requiring the mediation of a dispute. According to the ULCC Working Group,

> The Committee considered at great length whether franchise disputes would be resolved more advantageously through a form of alternative dispute resolution. Recognizing that in certain provinces the rules of practice in civil proceedings mandate a form of pre-trial mediation, and recognizing that the Ontario Act contains a mandatory disclosure statement that mediation is a form of dispute resolution, the Committee determined that it would be beneficial to provide for mediation to be invoked by any party to a franchise agreement.
>
> The Committee believes based on its own experiences and those brought to the attention of the Committee that party initiated mediation will be of significant benefit to resolve franchise disputes prior to the commencement of, as well as after the commencement of, litigation proceedings.

The mediation rules are to be set out by regulation. The mediation procedure does not preclude subsequent proceedings in relation to the dispute before a court, tribunal, or arbitrator.

CONCLUSION

Franchising is an important and growing component of the Canadian economy, and Manitoba is no exception. The franchise concept is appealing to many prospective business owners, offering a model for business success accompanied by ongoing support. However, franchising is not risk-free, and there is a trend in other jurisdictions toward regulating franchising, to require franchisors to provide significant disclosure to prospective franchisees, and in some cases, to regulate more extensively the ongoing relationship.

This paper has provided an overview of franchising regulation, and the Manitoba Law Reform Commission invites your comments on the issues and

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242 See the Center for Public Resources website at <http://www.cpradr.org/CMS_disp.asp?page=frn_whatis&M=7.12> (date accessed: May 12, 2007). The CPR reports a success rate of approximately 80% in cases in which the franchisee agreed to participate, and in which a mediator was needed. Additional disputes were resolved before requiring a mediator.

questions raised, together with any additional suggestions or ideas for addressing franchise law reform.