Franchising Business and Law Alert 2008

Canadians try to figure out what is a disclosure document, and other franchise mysteries

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In Canada FDDs are not reviewed by any government agency. It is up to the franchisor to prepare and deliver the document correctly failing which the franchisee can, for a limited period of time, send in a rescission notice.

The limitation period for a complete failure to deliver a disclosure document is two years. But the limitation period for the delivery of an incomplete disclosure document is only 60 days. Most franchisees do not sour on the deal in the first 60 days. But most franchisors deliver some form of disclosure document, making the two year rescission period unavailable. That is unless the disclosure document delivered is not a disclosure document!

Two recent cases in Alberta and Ontario have considered the issue of whether a failure to sign the certificate required in Canada is fatal to the disclosure document. They came to opposite conclusions.

Alberta – Holiday Inn case – Court of Appeal

The trial decision in Hi Hotel Limited Partnership v. Holiday Hospitality Franchising 2007 ABQB 686 http://www.canlii.org/en/ab/abqb/doc/2007/2007abqb686/2007abqb686.html was released in January of this year. The decision in favor of the franchisee was unsuccessfully appealed as reported in August: http://www.canlii.org/en/ab/abca/doc/2008/2008abca276/2008abca276.html

In this case the question was whether a failure to provide the signed Certificate required under Alberta's *Franchises Act* is fatal to an otherwise complete disclosure. It should be noted that this was a case of third party buying from a franchisee, that the new franchisee had tried to reach agreement with the franchisor on cancellation of the franchise agreement, and the franchisor had counterclaimed for what the Court of Appeal described as "enormous" penalties.

The Court of Appeal took the question very seriously and thoroughly discussed other disclosure cases from across Canada and comparable securities law provisions. One interesting quote is:

> Clearly the Legislature thought that relief against misstated facts was not enough. Silence by the franchisor is not enough. *Caveat emptor* is repealed. Someone soliciting such an investment or the fees for a franchise must put into the investor's or franchisee's hands accurate complete written information.

In other words all material facts must be disclosed.

The court stated that "The similar securities legislation requiring a signed certificate on a prospectus is enacted "to encourage director oversight, due diligence and care in the prospectus process"." Legislation calling for a signature is neither mere busy work nor cosmetic. For these reasons the Court held that the absence of a signed certificate made the existence or non-existence of other flaws academic. There was no disclosure document delivered. The franchisee was able to claim rescission.

Ontario - 6792341 Canada Inc. v. Dollar It Limited – June 18, 2008 - unreported

An Ontario franchisee applied to the Ontario Superior Court of Justice in Ottawa for rescission of the franchise agreement on the grounds that the franchise document was so devoid of particulars that it was void for non-compliance; in other words that it was not a disclosure document. The franchisee relied upon the trial decision in the Holiday Inn case discussed above, as the appeal decision had not been released at that time. Ontario cases were also cited but were characterized by the judge as all being cases where there was no disclosure in a single document.

Counsel for the franchisees has advised that the missing items included financial statements of the franchisor, the fact that the landlord was an associate of the franchisor, the required statement on the expenditure of advertising funds, a copy of the lease or sub-lease, mention of a volume rebate policy, and on top of that the document was not signed.

In an extremely brief judgment the judge held that because in this case disclosure was given in one document the deficient disclosure document was not void *ab initio* as required by Section 6(2). The judge held that the 60 day limitation period should apply to deficient disclosure documents, and in this case it was too late. The franchisee's remedy therefore lay in a claim under Section 7 for misrepresentation and damages.

The judge seemed uninterested in the fact that the disclosure document was not signed. But now Ontario law directly contradicts that of Alberta on this point. An appeal is being considered.

Ontario – 4287975 Canada Inc. v. Imvescor - No Rescission but with Reasons

In this case http://www.canlii.org/en/on/onsc/doc/2008/2008canlii41163/2008canlii41163.html the Ontario Superior Court of Justice was asked by a noted franchise litigator how to interpret the rescission provisions of Ontario's disclosure law when the franchise agreement was signed more than 60 days after the disclosure document was delivered.

For the purposes of the question it was assumed that the disclosure document was complete. The rescission for incompleteness is to be exercised within 60 days of the receipt of the disclosure document. By waiting more than 60 days to sign the disclosure document did the franchisee lose its right to rescission for incompleteness?

The court said yes. The purpose of the Act is to ensure that franchisees have adequate information on which to make a decision. In this case the franchisee had six months to review the document. It also had the option of not entering into the franchise agreement if it considered the disclosure document to be incomplete.

A problem with this analysis that the judge did not deal with was that a $15,000.00 deposit was asked for and given before disclosure. This is a breach of the Act and tends to lock franchisees in, even if they can sue to get the money back.

Ontario – Other Mysteries - System Changes and Fair Dealing:
Fairview Donut v. The TDL Group

Also in June there were press reports that a group of Tim Hortons' franchisees had launched a class action regarding the system's conversion from selling donuts baked fresh everyday in the store to selling frozen products purchased from a plant in which the franchisor has a half interest, and finishing the cooking process in a microwave, among other things.

Notwithstanding the fact that the franchise agreements contain a clause permitting the franchisor to change the system, the franchisees allege that this change has among other things breached the duty of fair dealing in instituting this change because it resulted in a transfer of revenues from the franchisees (who were paid for their baking) to the franchisor (who is now paid a mark-up by the franchisees for the "par-baked" product).

Although still unproven, this is similar to the successful claim made by the franchisees in the decision of the Cour d'appel du Québec in Provigo Distribution Inc. c. Supermarche A.R.G. (now finally available in English):
http://www.canlii.org/en/qc/qcca/doc/1997/1997canlii10209/1997canlii10209.html

The Cour d'appel considered what should be the response of the franchisor to changing market conditions. In found liability on the franchisor because:

> Faced with this new state of affairs, the appellant, bound by an obligation of good faith and loyalty toward the respondents, had the duty to work with its franchisee and provide it with the necessary tools at least to minimize the impact of any economic prejudice that could be caused, if not to prevent it altogether. Between doing absolutely nothing and maintaining the status quo, which might have cost it its place in the market, and exercising its right to compete freely with third parties, there is a middle ground. The appellant could not neglect its franchisees and reclaim the vulnerable segment of its order centre through the activities of its own Héritage stores. It should have worked with the franchisees to establish an adequate marketing response that would have enabled them to minimize their losses and reposition themselves in an evolving market. (unofficial translation by CanLII)

The Provigo case was previously used by Dunkin Donuts franchisees in Québec to make a claim for lack of support, but the case was not well known in the rest of Canada because it was previously only available in French, which many lawyers in English Canada do not read. That hurdle now seems to have been overcome in Ontario.