<u>OBA 6th ANNUAL FRANCHISE LAW CONFERENCE</u>

HOUDINI'S FRANCHISE LAW: EXCLUSIONS AND EXEMPTIONS TO DISCLOSURE IN CANADA

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November 16, 2006

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"My brain is the key that sets me free."

"I make the most money, I think, in Russia and Paris, for the people of those countries are so willing to be amused, so eager to see something new and out of the ordinary."

"The greatest escape that I ever made was when I left Appleton, Wisconsin."

Erik Weisz (a.k.a. Harry Houdini) 1874-1926

1. Introduction

Often lawyers experienced in franchising are approached by businessmen proposing some sort of commercial arrangement that they do not wish to have called a "franchise". The reasons for wishing to escape the application of the franchise laws vary. In some cases they do not wish to bear the expense of preparing a disclosure document. In other cases they genuinely do not consider their business arrangement to be comparable to, say a hamburger stand.

Whatever their motivation they usually ask counsel to advise them on whether their proposed arrangement is caught within the definition of a "franchise," and if so, what can be changed to escape being designated as a "franchise."

To assist franchise counsel caught in these delicate situations this paper reviews the exclusions and exemptions to the definition of a "franchise" and the obligation to disclose so that they may advise such persons on the chances of success for their "great escape."

In reality the answer may be less a matter of law and more about the businessman's appetite for risk or certainty. Many of the exclusions in the Canadian franchise legislation are too specific, such as for employment relationships or for Crown grants, to be of much assistance. The few that may have wider application have a lack of clarity that gives judges significant room to exercise their discretion, depending upon how they view the facts.

The elements of the definition of a "franchise" are then briefly discussed. This a large topic and a full treatment cannot be given in this paper. Here again there is room for significant variations in interpretation, both by counsel and by others such as judges. Finally the paper discusses the exemptions from disclosure for franchisors in particular types of sales.

Harry Houdini, although born in Hungary, grew up in Appleton, Wisconsin, just north of Lake Winnebago (now equally famous for its motor homes), on Highway 41 between the better known towns of Oshkosh and Green Bay. Houdini considered leaving Appleton his greatest escape. The rest were all entertainment and illusion.

So it may be for some those wishing to escape the application of the franchise laws. The definitions and exclusions are difficult to apply with great certainty, and often leave open the possibility that and judge will later grant an application by an aggrieved purchaser complaining that he or she should have received a disclosure document.

2. Exclusions

One of the problems faced in drafting franchise legislation is how to ensure that only the types of arrangements giving rise to the contractual problems discussed above are caught by the disclosure requirements. The development of the definition of a "franchise" is still ongoing. In the United States there are two competing model definitions used by the various states in their statutes to define what is a "franchise."

As a supplement to the formal definition of what is a "franchise" in the statute as a way to restrict the application of the franchise law, the draftsperson also has the option of specifically excluding certain specified types of commercial arrangements. The franchise laws are thus excluded from applying to these arrangements *ab initio*. While this may appear to be an easy solution to problems in the definition of what is a "franchise," in practice the effectiveness of these exclusions often depends on the existing understanding of the terms used to describe the excluded commercial arrangement.

The concept of a "partnership" has a long history in law that generally includes an element of joint risk sharing that is quite uncharacteristic of a franchise system. In contrast what is meant to be excluded by the term "single license" is subject of much conjecture and in fact may well become a trap for the unwary lawyer when advising a commercial client that does not want to comply with the franchise legislation.

Some of the persons responsible for drafting Canada's franchise statutes have been strongly influenced by the franchise legislation used in the United States, and in particular by the Federal Trade Commission (FTC) Franchise Rule[1], a regulation enacted

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[1] "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," in effect October 21, 1979, 16 C.F.R. Part 436.

under the *Federal Trade Commission Act*.[2] Section 436.2 contains the definitions and a number of exemptions and exclusions. Subsection (4) is titled "Exclusions and provides as follows:

> (4) Exclusions. The term *franchise* shall not be deemed to include any continuing commercial relationship created solely by:
>
> (i) The relationship between an employer and an employee, or among general business partners; or
>
> (ii) Membership in a bona fide "cooperative association"; or
>
> (iii) An agreement for the use of a trademark, service mark, trade name, seal, advertising, or other commercial symbol designating a person who offers on a general basis, for a fee or otherwise, a bona fide service for the evaluation, testing, or certification of goods, commodities, or services;
>
> (iv) An agreement between a licensor and a single licensee to license a trademark, trade name, service mark, advertising or other commercial symbol where such license is the only one of its general nature and type to be granted by the licensor with respect to that trademark, trade name, service mark, advertising, or other commercial symbol.

Other sections deal with "fractional franchises," unwritten arrangements, retail "kiosks" and where the total payments before or within 6 months of commencing operations are less than $500.00.

To varying degrees these exclusions have been transposed into Canada, and further exclusions have been developed. These will now be discussed in turn.

(a) Employer-Employee Relationships

Section 2(3) of Ontario's *Arthur Wishart Act (Franchise Disclosure), 2000*[3] (the "Ontario Act") provides simply that the Ontario Act does not apply to a "employer-employer relationship" with out further guidance as to the definition of such a relationship. Ontario was the second province to enact franchise disclosure legislation.

[2] 15 U.S.C. §§ 41-58, as amended.
[3] S.O. 2000, Ch. 3, as amended by S.O. 2001, Ch. 9, Schedule D, sec. 1.

Alberta first enacted franchise disclosure legislation in 1971,[4] based on the first American franchise statue that was adopted in California.[5] The original law contained a definition of a "franchisee" but did not contain any exclusions such as now are found in the FTC Franchise Rule.

When Alberta replaced its previous legislation with a new *Franchises Act*[6] (the "Alberta Act") that no longer required the registration of a disclosure document with the Alberta Securities Commission no specific section on exclusions was included. At that time the Alberta Government did have the option of considering the exclusions in the FTC Franchise Rule and their possible usefulness in Alberta.

In this regard the Uniform Law Conference of Canada Working Group on a Uniform Franchises Act chose to use the Ontario Act as their model in general.[7] Accordingly the Uniform Franchise Act[8] (the ULCC Act") that they produced has sub-section entitled "Non-application" which simply states that the Act does not apply to "an employer-employee relationship. The exclusions are not discussed in the Report of the Working Group.

Even before the ULCC adopted the Report of the Working Group the Government of Prince Edward Island introduced a bill in the legislature based on the proposed ULCC Act.[9] Section 2(3) of the Bill had a list of continuing commercial relationships to which the proposed law would not apply. The first was the "employer-employee relationship." The Bill was quickly passed by the Legislature on June 7, 2005 (the "PEI Act").[10] Again there is no definition of the relationship.

Finally just before its recent general election[11] New Brunswick was in the process of considering a bill based on the ULCC Act (the "New Brunswick Bill").[12] Section 2(4)(a) proposed that the Act not apply to "employer-employee relationships."

We are not aware of any cases where a business has defended a claim that it failed to provide an individual with a disclosure document in reliance on this exclusion. It appears axiomatic that for an employer-employee relationship to exist, the 'prospective franchisee' would have to be an individual. The standard tests for an employment

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[4] *Franchise Act,* R.S.A. 1980, Ch. F-17.
[5] *Franchise Investment Law,* Cal. Corp. Code §§ 31000-31516, in effect January 1, 1971.
[6] R.S.A. 2000, Ch. F-23, in effect November 1, 1995.
[7] Uniform Law Conference of Canada, Proceedings of the 2004 Annual Meeting, Civil Section Minutes, Commercial Law Strategy, Report of the *Uniform Franchise Act* Working Group; and Uniform Law Conference of Canada, Civil Section, Uniform Franchise Act, Report of the Working Group, August 2005.
[8] Available at http://www.ulcc.ca/en/us/Uniform_Franchises_Act_En.pdf .
[9] Bill No. 43, *Franchises Act,* 2nd Session, 62nd General Assembly, First Reading May 12, 2005.
[10] *Franchises Act,* R.S.P.E.I., Ch. F. 14.1.
[11] The election was September 18, 2006.
[12] Bill No. 7, *Franchises Act,* 3rd Session, 55th Legislature, First Reading December 7 2005.

relationship in Canada are based on the degree of control that the employer has over the employee,[13] particularly if control is broadly defined to include economic dependence.

In this regard many franchise systems place the risk of loss and chance of profit entirely on the franchisee. In some systems however the franchisee may own only the inventory while the building and equipment are controlled or owned by the franchisor. But in these cases the franchisor generally complies with the franchise disclosure laws, rendering the exclusion of little meaning.

Prior to the adoption of the Ontario Act a terminated franchisee sought redress on the basis that he was really an employee[14] in order to gain a longer notice period, and thus greater damages in lieu of notice. The judge granted relief for the franchisee on two grounds, one of which was that the degree of control exercised by the franchisor was such that the franchise relationship was really an employment relationship.

It appears that this exclusion is of little practical assistance to businesses wishing to escape the disclosure obligations of the franchise relationship, as the employment relationship is generally considered to have greater obligations.

(b) Partnership

The legal concept of a partnership is one of the oldest business forms in existence. Ontario's *Partnerships Act*[15] defines a partnership as "the relation that subsists between persons carrying on a business in common with a view to profit." One of its most distinctive features is the unlimited liability of the partners for the acts of their members. It was to overcome this obligation that the modern limited liability corporation was developed.

As with the exclusion for the employer-employee relationship, 'partnership' is listed as an excluded relationship in the Ontario Act, the ULCC Act, the PEI Act and the New Brunswick Bill without further definition. And we are not aware of any Canadian cases where a business has defended a claim that it failed to provide a disclosure document in reliance on this exclusion.

While one reason for this state of affairs may be that franchisors would not want the obligation of unlimited liability for the acts of their 'franchisees', there is always the possibility of an unhappy partner seeking to use the franchise disclosure legislation to seek redress for problems with in the partnership. And the franchise disclosure legislation does not specifically exclude limited partnerships from the application of the legislation. Limited partnerships are generally considered to be a species of partnership, so that it is

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[13] See *Regina v. Walker,* (1858) 27 L.J.M.C. 207; *Montreal Locomotive Works Ltd. et al.,* [1947] 1 D.L.R. 161; and *Stevenson Jordan and Harrison, Ltd. v. MacDonald and Evans,* [1952] 1 T.L.R. 101.

[14] *Head v. InterTan Canada Ltd.* (1991), 5 O.R. (3d) 192 (Ont. Sup. Ct. J. – Gen. Div.).

[15] R.S.O. 1990, Ch. P.5, Section 2.

arguable that an exclusion for 'partnerships' would include an exclusion for 'limited partnerships.' A 'franchisor" could theoretically then design a structure with itself as a limited partner to escape liability.

The FTC's interpretation of this exclusion however relies upon the Statement of Basis and Purpose accompanying the FTC Franchise Rule for the proposition that the partners must be *bona fide* general partners.[16]

(c) Co-operatives

Like the word 'partnership,' the word 'co-operative' is often used loosely to describe commercial relationships where the parties work together for a common interest. But it too has a much more precise legal meaning. The co-operative movement traces its roots to the founding of the Rochdale Society of Equitable Pioneers in 1844.[17] In order to ameliorate the Dickensian conditions of the industrial revolution in England the group founded a society to operate a grocery store.

The original rules of the Society became the basis for what are known as the basic co-operative principles. These have evolved over time but are now encoded in various statutes such as Ontario's *Co-operative Corporations Act.*[18] This act defines a co-operative as follows:

> "co-operative" means a corporation carrying on an enterprise on a co-operative basis and to which this Act applies;
>
> "co-operative basis" means organized, operated and administered upon the following principles and methods,
>
> (a) each member or delegate has only one vote,
>
> (b) no member or delegate may vote by proxy,
>
> (c) interest on loan capital and dividends on share capital are limited to a percentage fixed by this Act or the articles of incorporation, and
>
> (d) the enterprise of the corporation is operated as nearly as possible at cost after providing for reasonable reserves and the payment or crediting of interest on loan capital or dividends on share capital; and any surplus funds arising from the business of

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[16] Informal Staff Advisory Opinions 93-3, March 3, 1993, BFG ¶6447; and 93-4 March 3, 1993, BFG ¶6448.
[17] Ontario, *Report on Co-operatives by Select Committee on Company Law,* 1971, 4th Session, 28th Legislature, p. 1; Daniel Ish, *The Law of Canadian Co-operatives* (Toronto; Carswell, 1981) p. 5.
[18] R.S.O., Ch. 35.

> the organization, after providing for such reasonable reserves and interest or dividends, unless used to maintain or improve services of the organization for its members or donated for community welfare or the propagation of co-operative principles, are distributed in whole or in part among the members in proportion to the volume of business they have done with or through the organization;[19]

The *Co-operative Corporations Act* also provides that "No corporation, association, partnership or individual not being a co-operative to which this Act applies shall use in Ontario a name that includes the word "co-operative" or "coopérative" or any abbreviation or derivation thereof whether or not the word, abbreviation or derivation is used in or in connection with the name."[20]

The Ontario Act incorporates this definition by reference. The Act provides that "Membership in a co-operative association, as prescribed" is excluded from the application of the Act.

The regulations[21] prescribe four classes of associations that may be considered co-operatives. Organizations incorporated under Ontario's *Co-operative Corporations Act* or its federal counterpart, the *Canada Cooperatives Act*[22] and "co-operative corporations" as defined in the *Income Tax Act* [23] are excluded from the application of Ontario's franchise disclosure legislation. Also excluded are so-called buying co-operatives, as follows:

> (a) an organization operated on a co-operative basis by and for independent retailers that,
>
> (i) purchases or arranges the purchase of, on a non-exclusive basis, wholesale goods or services primarily for resale by its member retailers, and
>
> (ii) does not grant representational rights or exercise significant operational control over its member retailers;

In the ULCC Act the definitions of an excluded co-operative were moved from the regulations to the legislation itself, but otherwise left much as in Ontario. Accordingly the PEI Act and the New Brunswick Bill have the same co-operative exemption as Ontario, but with the definition is spelled out in the text.

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[19] *Ibid.*, Section 1.
[20] *Ibid.*, Sec. 7(3).
[21] O. Reg. 581/00, Sec. 1.
[22] [1998], Ch. 1.
[23] R.S.C. 1985, Ch. 1 (5th Supp.).

Again we are not aware of any Canadian cases were a business has defended a claim that it failed to provide a disclosure document in reliance on this exclusion. It would appear that the distinctive aspects of operating on a co-operative basis, as based on the original Rules of the Rochdale Pioneers, impose restrictions that are not attractive enough relative to the burden of franchise disclosure.

There is an FTC Staff Advisory Opinion that found a non-profit association of religious bookstores qualified for the exclusion.[24] The organization was owned and controlled on a substantially equal basis by those for whom it was rendering services.

(d) Certification Arrangements

The federal *Trade-marks Act*[25]defines a "certification mark" as:

> "certification mark" means a mark that is used for the purpose of distinguishing or so as to distinguish wares or services that are of a defined standard with respect to
>
> (*a*) the character or quality of the wares or services,
>
> (*b*) the working conditions under which the wares have been produced or the services performed,
>
> (*c*) the class of persons by whom the wares have been produced or the services performed, or
>
> (*d*) the area within which the wares have been produced or the services performed,
>
> from wares or services that are not of that defined standard;

These sorts of arrangements require many of the elements of a franchise but represent a different type of commercial arrangement. There is the offering of goods or services in association with a trade-mark; the payment of a fee, and some degree of control over or assistance in the method of operation.

However Section 23 of the *Trade-marks Act* provides that a certification mark may only be adopted by a person not engaged in the production of the wares or offering of the services with which the mark is associated. While some franchisors make it a practice not to own any units, the use of certification marks instead of trade-marks would preclude the franchisor from owning any units without invalidating its trade-marks.

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[24] Informal Staff Advisory Opinion, July 14, 1980 regarding the Association of Logos Bookstores, Inc., BFG ¶6419.
[25] R.S.C. 1985, Ch. T-13.

Ontario adopted the wording of the certification mark exclusion wholesale from the FTC Franchise Rule, including the use of the term ‘service mark’, a type of trade-mark in the United States that does not exist in the *Trade-marks Act.* The ULCC Act deleted this foreign intrusion but otherwise used the wording in Ontario. Accordingly both the PEI Act and the New Brunswick Bill have the same wording.

While there is at least one franchisor in Canada that has registered certification marks and licensed them to its franchisees, we are not aware of any Canadian cases were a business has defended a claim that it failed to provide a disclosure document in reliance on this exclusion.

(e) Single License

This exclusion appears to have originated in the FTC Franchise Rule and was adopted in its entirety into the Ontario Act. The ULCC Act deleted the reference to ‘service marks’ and added the words “in Canada” after the words “to be granted,” but otherwise left it unchanged. Accordingly the revised exclusion appears in the PEI Act and the New Brunswick Bill.

This exclusion is often considered by franchisors when they are contemplating their first franchise arrangement, and the wording of the exclusion appears to make this option available. However the interpretations given to this exclusion by the FTC suggest that it is not intended to be used by franchisors at all.

The FTC has issued three Staff Advisory Opinions with respect to the possible use of this exemption.[26] These opinions make it clear that the essential difference between the type of single license arrangement intended to be excluded and a franchise is the degree of control. In the United States, as in Canada, a person licensing the use of a trade-mark is required to exercise control over the quality of the goods and services offered by the licensee, failing which the licensed trade-mark may be considered to have lost its distinctiveness, and thus be invalid.[27] An example of the type of license intended to be excluded by this provision is given by the authors of CCH’s Business Franchise Guide as a license by a designer to a manufacturer to produce goods according to the designer’s specification, as is common in the clothing industry.[28]

The FTC has stated that it considers the type of control likely to be exercised in such arrangements to be passive, such as the inspection of goods and testing to insure that

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[26] Informal Staff Advisory Opinion 93-10, January 12, 1994, BFG ¶6454; Informal Staff Advisory Opinion 00-3, March 20, 2000, BFG ¶6507; and Informal Staff Advisory Opinion 05-1, March 2, 2005, BFG ¶6525.
[27] *Trademark Act of 1946* as amended (the “Lanham Act”), Public Law 79-489, Chapter 540, approved July 5, 1946; 60 Stat.427, Section 45, definition of “related company”; and Section 50(1) of Canada’s *Trade-marks Act.*
[28] BFG ¶6217, h. “Single Trademark Licenses.”

quality standards are being met.[29] Franchising on the other hand would require active control over the franchisee's method of operation. This might include control over the location of the business, the hours of operation and the management of the business.

Further the fact that a particular license is the first of what may be a series is insufficient. "To take advantage of the single trademark exclusion, the franchisor must offer the Licensee an exclusive license to use its marks. If the totality of the circumstances suggests that the licensor intends to offer, or reserve the right to offer, more than a single exclusive license, then the exclusion will not apply."[30]

It should be noted that in its most recent Staff Advisory Opinion the FTC opined that the grant of a license to a single salon owner appeared to fall squarely within the exclusion. Apparently franchise type controls were not contemplated, except that the continued employment of a particular manager was required.[31]

It is an open question whether these FTC opinions would be relevant to a judge in a Canadian court when trying to decide upon the breadth of the single license exemption. We are not aware of any Canadian cases were a business has defended a claim that it failed to provide a disclosure document in reliance on this exclusion.

The general practice in fact has been to avoid reliance upon this exemption because of the uncertainty over its interpretation. Some have suggested that the words "to be granted" refer only to licenses granted at the time of the entering to the license agreement. The conditions regarding the degree of control and that the license be exclusive are not present in the wording of the original exclusion in Canada or in the U.S.

This ambiguity would allow a judge an option to further consider the generally perceived fairness of the arrangement. In these circumstances the franchisor is not usually the successful party.

(f) Kiosks or Leased Premises

The FTC Franchise Rule provides an exemption (not an exclusion):

> Where pursuant to a lease, license, or similar agreement, a person offers, sells, or distributes goods, commodities, or services on or about premises occupied by a retailer-grantor primarily for the retailer-grantor's own merchandising activities, which goods, commodities, or services are not purchased from the retailer-grantor or persons whom the lessee is directly or indirectly (A) required to do business with by the retailer-grantor or (B) advised

[29] Informal Staff Advisory Opinion 00-3, *supra* note 26.
[30] *Ibid.*
[31] Informal Staff Advisory Opinion 05-1, *supra* note 26.

> to do business with by the retailer-grantor where such person is affiliated with the retailer-grantor;[32]

In larger retail stores, in particular in department stores, there is a long established practice to allow independent retailers of specialty goods to operate a booth or kiosk. There is usually nothing to indicate that the booth or kiosk is not part of the larger store and the booth or kiosk is often required to use the point of sale system supplied by the larger retailer.

In the Ontario Act the concept became an exclusion and was shortened to read:

> An arrangement arising out of a lease, licence or similar agreement whereby the franchisee leases space in the premises of another retailer and is not required or advised to buy the goods or services it sells from the retailer or an affiliate of the retailer.

The Ontario version appears to represent a loosening of the requirements for the exclusion in that the kiosk operator may purchase goods from the department store owner so long as the kiosk operator is not required or advised to buy goods from the retailer.

In these instances the large retailer is usually only interested in control insofar as there is risk to its trade-mark and goodwill. In addition to passive inspections and testing it will also usually require some control over the handling of customer complaints.

But the large retailer is not interested in how the business is operated, or in suggesting that it has a successful business model for the purchaser. In fact usually the reason that the retailer chooses to license the kiosk operator is because it does not have the expertise to sell the goods using its staff. There may be professional licenses involved, such as with optometrists, or unusual risks in the selection of the goods, such as with butchers or jewelers.

For some reason this exclusion was not included in the ULCC Act, and as a consequence it does not appear in the PEI Act or the New Brunswick Bill.

One problem that has arisen with this exemption is that it does not apply to similar arrangements if the "kiosk" is not located on the retailer's premises. Many larger retailers sell household appliances and other goods that need services that are provided in the home. These are often contracted out. The department store owner is not selling a business concept, rather it is renting out a portion of its customer stream by means of a sort of collateral license. Arguably these arrangements should also be excluded.

(g) Oral Arrangements

[32] § 436.2 (3)(ii).

The FTC Franchise Rule also has an exemption for where there are no documents in writing to evidence any material term of the relationship.[33] In the Ontario Act this has been transformed into an exclusion.

This exclusion was included in the ULCC Act and accordingly is found in the PEI Act and the New Brunswick Bill.

The FTC has issued a Staff Advisory Opinion in which it states that this exemption was intended to be a *de minimis* exemption and that it will be narrowly construed.[34] It went further in the opinion to question whether the requestor had fully thought through its request.

> We question whether any franchisor can reasonably assert that its agreements are and will remain strictly oral in the future, since such a representation would imply an ability to anticipate and prevent the creation of any document recording a material term of the agreement, whether by the franchisor, its advisors, employees or others.[35]

Surprisingly there is a Canadian case were a business has defended a claim that it failed to provide a disclosure document in reliance on this exclusion. However the judge found that because there was a cheque with the annotation "license fee" written on it there was enough to qualify as "writing which evidences any material term or aspect of the relationship."[36]

(h) The Crown

This is a wholly Canadian exclusion first introduced in the Ontario Act. The term 'franchise' is often used to describe arrangements whereby a province or municipality grants a right to deliver utility services such as natural gas. Although the name may be the same, in fact there are few economic similarities between these arrangements and a business format franchise.

This exclusion was not included in the ULCC Act, but the Government of Prince Edward Island added it back in the PEI Act with the terse phrase "This Act does not bind the Crown." The New Brunswick Bill follows the ULCC Act, but then it has not yet completed its journey through the Legislature. Perhaps someone in the new government will notice and add the exclusion if the Bill is re-introduced.

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[33] § 436.2 (3)(iv).

[34] Informal Staff Advisory Opinion July 18, 1980 regarding Contemporary Times, BFG ¶6421.

[35] *Ibid.*

[36] *Narbeh Khachikian and 1521514 Ontario Limited v. Patrice Williams and 1288235 Ontario Limited c.o.b. "Classical Martial Arts Canada Toronto,"* Ontario Superior Court of Justice Court File No. 02-CV-2333261SR, November 24 2003.

(i) Reasonable Wholesale Price Purchases (Distributors)

The issue of whether persons who simply buy products for resale should be subject to the disclosure obligations has been the subject of much discussion. In the original FTC Franchise Rule such distributors of goods were neither specifically included nor excluded. The definition of a "franchise" in the FTC Franchise Rule[37] had three main elements, namely the (i) distribution of goods or services in association with the franchisor's trade-mark, (ii) significant control of, or significant assistance to, the franchisee's method of operation, and (iii) required payments by the franchisee to the franchisor.[38] These will be discussed more fully in the next section.

In 1979 Schwinn Bicycle Co. sought an opinion from the FTC as to whether payments made by Schwinn bicycle dealers to Schwinn Bicyle Co. at *bona fide* wholesale prices for orders of goods in quantities determined solely by the dealer were "required payments" pursuant to the FTC Franchise Rule.[39] The FTC replied that such payments were not "required payments" and that thus FTC Franchise Rule did not apply to Schwinn.[40]

When Alberta adopted its new legislation in 1995 it included a definition of a "franchise fee" that specifically excluded "a purchase of or an agreement to purchase a reasonable amount of goods at a reasonable bona fide wholesale price" and equivalent provisions excluding the purchase of services or the payment of credit or debit card fees in the Alberta Act.[41] While the question of how to prove that the prices charged to the distributor were both "reasonable" and "bona fide wholesale" prices caused some concern amongst practitioners having to advise clients as to whether or not they had to prepare a disclosure document, it was clear that insofar as these elements could be evidenced distributors of goods and services did not have to use a disclosure document.

In 1998 the Government of Ontario published a consultation paper on its proposal to create franchise disclosure legislation (the "Consultation Paper").[42] The Consultation Paper described three broad forms of franchise arrangements, one of which was:

> ***Product distribution*** franchises where the franchisee obtains an exclusive licence from the franchisor to market products in a specific location or area. Unlike business-format franchises, product distribution arrangements allow the franchisee some scope to personalize their business (e.g. "John Smith – Chrysler Scarborough"), with the franchisor generally exerting less control over the format of the franchise than described above. Examples include automotive dealers and soft drink bottlers.[43]

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[37] § 436.2(a).
[38] BFG ¶6204.
[39] §436.2(a)(2).
[40] Informal Staff Advisory Opinion August 3, 1979 regarding Schwinn Bicycle Co., BFG ¶6381.
[41] Section 1(1) "franchise fee."
[42] Ministry of Consumer and Commercial Relations, *Ontario Franchise Disclosure Legislation: A Consultation Paper* (Toronto; June 1998).
[43] *Ibid.,* at p. 2.

It appears therefore that from the beginning of the process the Ontario Government was not prepared to simply exempt all distributors. And when the Ontario Act was adopted there was no definition of a "franchise fee" with exclusions for reasonable *bona fide* wholesale prices such as found in the Alberta Act.

As will be discussed further in the next section of this paper, the Ontario Act also contains a definition of a "franchise" with wording describing the payment of a fee in broader terms than is used in the Alberta Act.

In Alberta a "'franchise fee' means a direct or indirect payment to purchase a franchise or to operate a franchised business,"[44] but in Ontario the fee element of the definition of a "franchise" means that the

> franchisee is required by contract or otherwise to make a payment or continuing payments, whether direct or indirect, or a commitment to make such payment or payments, to the franchisor, or the franchisor's associate, in the course of operating the business or as a condition of acquiring the franchise or commencing operations.[45]

Under this definition would Schwinn be a franchisor? Would the commercial requirement to make some orders of Schwinn bicycles in order to remain a Schwinn distributor be considered a requirement other than by contract? Subject to the discussion below regarding "required payments," ambiguities such as this leave room for judges to decide that a person like Schwinn is a franchisee if they believe that the matter at hand is egregious enough to warrant the application of the remedies found in the Ontario Act.

The Uniform Law Conference of Canada Working Group discussed this issue and apparently came to the opposite conclusion from that of Ontario. Although there is no mention in the Report of the Working Group as to any rationale for the exclusion, the ULCC Act contains an exclusion for:

> (g) an arrangement arising out of an agreement,
>
> > (i) for the purchase and sale of a reasonable amount of goods at a reasonable wholesale price, or
> >
> > (ii) for the purchase of a reasonable amount of services at a reasonable price.[46]

The same wording also appears in the PEI Act and the New Brunswick Bill. However all three of these pieces of legislation use the same wording with respect to fees as is found in the Ontario Act. Note that the words "*bona fide*" which are

[44] *Supra* note 41.
[45] Ontario Act, Sec. 1 "franchise."
[46] Section 2(3)(g).

used in the Alberta Act to modify the words “wholesale price” are absent in these version.

Accordingly for what Ontario called “product distribution franchises” in its Consultation Paper there are now three different tests for deciding whether the relevant franchise legislation applies. Under the ULCC Act and its progeny only the word “reasonable” as applied to both the amount of goods and the price restrains a judge from applying the broad definition of the payment element of the definition of a “franchise” that is found in these Acts.

3. **Definition of a “Franchise”**

Most of the exclusions discussed above offer little assistance to the business person seeking an escape from the confinement of the franchise laws. The more usual route for such persons is to try to organize there affairs so as to not fall within the definition of what is considered a “franchise” in the relevant legislation.

There is a large body of commentary on what should be, or has been, considered a franchise,[47] and the nuances of the definitions will not be fully explored in this paper. It is by far the most common subject of FTC Informal Advisory Opinions, but there are no Canadian cases on the definitions now found in the statutes that we are aware of except for four cases that have not considered the elements of a definition sufficiently to contribute to this discussion.[48]

[47] See for example James R. Sims and Mary Beth Trice, “Hidden Franchises” in *Franchising : The Next Generation – 20th Annual Forum* (Chicago: ABA Forum on Franchising, 1997); James R. Sims and Mary Beth Trice, “The Inadvertent Franchisee and How to Safeguard Against It,” 18 (2) *Franchise Law Journal* 54 (1998); Rochelle B. Spandorf and Mark A. Kirsch, “The Accidental Franchise,” in *Gateway to the Future of Franchising – 24th Annual Forum on Franchising* (Chicago: ABA Forum on Franchising, 2001); Kim I. McCullough and John R.F. Baer, “A View From the Bridge: Structuring and Counseling National Distribution Systems,” in *Lights, Camera Action: Spotlight on Franchising -26th Annual Forum on Franchising* (Chicago: ABA Forum On Franchising, 2003); Michael K. Lindsey and Rochelle B. Spandorf, “When are Distribution or Licensing Agreements Franchise Agreements?” in *International Franchise Association 37th Annual Legal Symposium* (Washington, DC: International Franchise Association, 2004); Andrew L. McIntosh and Kimberley A. Agster, “Walking Like a Duck: Joint Ventures and Franchises,” 26 *Franchise Law Journal* 85 (2006).

[48] *Bekah v. 3 For 1 Pizza & Wings (Canada) Inc.* [2003] O.J. No. 4002; 67 O.R. (3d) 305 (S.C.J.) and *1368741 Ontario Inc. v. Triple Pizza (Holdings) Inc.*, [2003] O.J. No. 2097 (S.C.J.) both regarding whether a purchaser in a transaction that did not close was a franchisee within the meaning of the Ontario Act; *Bezhad Ahmed and Shahzad Khan v. Three For One Pizza & Wings (Canada) Inc., Triple Holdings Limited and 1571817 Ontario Inc.*, Ontario Superior Court of Justice Case No. 03-CV-252778-CM3, released January 9, 2004, as to whether a sub-franchise was a franchise; *Personal Service Coffee Corp. v. Beer*, 2005 CanLII 25180 (Ont. Court of Appeal), where the issue was not plead on appeal.

In the United States two basic types of definitions are used. The more common one is the three element test (payment, trade-mark and assistance or control) as used in the FTC Franchise Rule. But several state franchise and dealership laws define a franchise or dealership as an arrangement having a "community of interest" between the grantor and grantee in either the operation of the business or the marketing of such goods and services.[49] A Wisconsin decision[50] in 1987 is widely cited for setting out ten factors to be considered in determining whether a "community of interest exists."

The factors are (1) the duration of the parties' relationship; (2) the extent and nature of the parties' obligations; (3) the percentage of time or revenue devoted to the grantor's products or services; (4) the percentage of the grantee's gross proceeds or profits derived from the grantor's products or services; (5) the extent and nature of the grantee's territory; (6) the use of the grantor's trademarks or logos; (7) the grantee's financial investment in the inventory, facilities, and goodwill of the alleged dealership; (8) the personnel devoted to the alleged dealership; (9) the amount of money and time spent on advertising and promotions for the supplier's products and services; and (10) the extent of supplemental services provided by the grantee to purchasers of the grantor's products or services.

Canadians searching for policy guidance on the rationale behind the definitions in the legislation may wish to consider some of these factors. In doing so they should have regard to some commercial arrangements that have been, initially unknown to their participants, to be considered to fit the definition of a "franchise" in the U.S.:

1. Trade-mark licenses.
2. Joint ventures, corporate partnering and strategic alliances.
3. Distribution agreements
4. Sweat equity programs.
5. Sales agent agreements.
6. Software and computer licenses.
7. Subcontractor agreements.

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[49] See for example the New Jersey *Franchise Practices Act*, Sec. 56:10-3, BFG ¶4300.03, where a franchise is defined as "a written arrangement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trade mark, service mark, or related characteristics, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise." See also the Wisconsin *Fair Dealership Law*, Sec. 135.02, BFG ¶4490.02, which defines "community of interest" as "a continuing financial interest between the grantor and grantee in either the operation of the dealership business or the marketing of such goods or services."

[50] *Ziegler Co., Inc. v. Rexnord, Inc.*, 1986-1987 BFG ¶8882.

8. Business referral networks.[51]

The various elements of the definitions will now each be discussed.

(a) Is it a "Business"?

All of the Canadian definitions of a "franchise" start with the phrase "a right to engage in a business." The FTC Franchise Rule uses different wording, namely "any continuing commercial relationship." Arguably the term "business" is a narrower term. In Canadian tax law a distinction is made between carrying on a business and simply passively investing, although obviously both are usually conducted in the expectation of a positive return.

Although we are not aware of a Canadian case on this point, there are a number of FTC Informal Advisory Opinions regarding non-profit corporations.[52] Generally where the arrangements do not involve any expectation of profit by the parties the FTC has decided that the FTC Franchise Rule does not apply to the arrangement. Where both parties are properly organized as non-profit corporations and/or charities this is easy to evidence.

Where there is doubt, the FTC has stated that it will "examine the corporation's actual activities on a case-by-case basis."[53] The FTC will assert, and has asserted, jurisdiction where the business is carried on for the profit of either or both of the parties "notwithstanding any attempt to hide for-profit activities under the cloak of a non-profit entity."[54] The sale of goods to "franchisees" at wholesale prices rather than at cost would trigger concern on the part of the FTC. In the past they have challenged a blood bank, a Christian college and a college football association.[55]

The arrangement may also not meet the definition of a "franchise" in Canada if the relationship is not a continuing relationship. A *bona fide* single sale of a business with a temporary license agreement and post –closing training should not be subject to the franchise disclosure laws.

(b) Substantially Associated with a Trade-mark

This is one of the traditional elements of the definition of a "franchise." Although there are slight variations in wording in this branch of the definition in the Canadian franchise legislation, Ontario's wording will serve as a good example. It requires that:

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[51] Sims and Trice, "Hidden Franchises" *supra* note 47.
[52] Opinion 95-3, April 4, 1995 regarding Home Instruction Program for Preschool Youngsters U.S.A., BFG ¶6468; Opinion 99-4, May 13, 1999 regarding Challenger Center For Space Science Education, BFG ¶6501; Opinion 00-4, April 7, 2000 regarding All Kinds of Minds, BFG ¶6508; and Opinion 02-2, April 26, 2002 regarding Project GRAD, ¶6513.
[53] Opinion 99-4, *supra* note 52.
[54] *Ibid.*
[55] *Ibid.*

> the franchisor grants the franchisee the right to sell, offer for sale or distribute goods or services that are substantially associated with the franchisor's, or the franchisor's associate's, trade-mark, service mark, trade name, logo or advertising or other commercial symbol,[56]

The key concept is that there is a grant of right to distribute goods or services that are **substantially associated** the trade-mark. The trade-mark granted does not have to be the primary trade-mark used in the business. It does not have to be the name of the business.

The Canadian *Trade-Marks Act* defines a "trade-mark" as:

> (*a*) a mark that is used by a person for the purpose of distinguishing or so as to distinguish wares or services manufactured, sold, leased, hired or performed by him from those manufactured, sold, leased, hired or performed by others,
>
> (*b*) a certification mark,
>
> (*c*) a distinguishing guise, or
>
> (*d*) a proposed trade-mark;[57]

Note that there is no concept of a "service mark" in the *Trade-marks Act*. It's presence in the definitional section of the franchise statutes is an indicator of the degree American influence in the drafting of the Canadian statutes.

The concept of a trade-mark is quite broad and even a distinguishing guise such as the shape of a soft-drink bottle would qualify as a trade-mark. A trade-mark need not be registered, and arguably association with an unregistered trade-mark would be sufficient to meet the definition of a franchise.

But the language of the definition is broader still, in that an association with an "other commercial symbol" would be sufficient to make an arrangement a franchise. The FTC Franchise Rule contains similar wording and the FTC has considered the meaning of these words in an Informal Advisory Opinion.[58] In this Opinion the FTC advised that usually an express contractual prohibition on the use to the franchisor's trade-marks will be sufficient to avoid having the arrangement defined as "franchise." There are however two exceptions.

One is where the seller's trade-marks are displayed on the products sold. The second is similar in that the presence of a "commercial symbol" would be sufficient to meet the definitional requirements. The Opinion states that the term "commercial symbol" originated in state laws and has been interpreted to include buildings, display racks,

[56] Ontario Act, Sec. 1 "franchise" (a)(i).
[57] R.S., 1985, c. T-13, Sec. 2.
[58] U.S. Marble, Inc., October 9, 1980, BFG ¶6424.

miniature golf course layouts, restaurant buildings "and other items characterized by distinctive shape, size and other features." It is a question of whether such distinctive element comes to the attention of the end purchasers at the time of sale so as to cause them to associate the two businesses in the arrangement.

If this interpretation is followed in Canada then only the sale of generic goods would ensure that the trade-mark element of the definition is not met. Notwithstanding the breadth of this element, in practice the presence or absence of the trade-mark element is usually clearer than the other definitional elements.

(c) Required Payments

The variations in the wording of this definitional requirement in Canada have already been discussed in the earlier section of this paper regarding the exclusion for distributors who purchase goods at a reasonable wholesale price. It is sufficiently similar to the wording in the FTC Franchise Rule that the Informal Interpretative Opinions on this topic assist in the interpretation of this element of the definition.[59]

Firstly, to not be a "required payment" the amount of goods purchased must be either determined by each purchaser in the exercise of its business judgment and discretion,[60] or otherwise not exceed amounts that a reasonable businessman would have in stock to maintain a supply reasonably sufficient to meet anticipated demand.[61]

With respect to prices, the general statement is that *bona fide* wholesale prices will not trigger the "required payment" element of the definition. Where purchasers have a genuine option to purchase the items required by contract or by the practical necessity of opening an outlet but can purchase them from a third party the element will not be triggered. But the choice must be "real, legitimate and practical" in the context of the industry and community in which the purchaser chooses to carry on business.[62] In one opinion the percent of purchasers who had actual chosen to buy from the supplier was looked at.[63]

Contractual obligations can be significant. The FTC has written that contractual provisions for the repurchase of inventory that actually have the effect of making the dealer's inventory investment risk-free would be a persuasive indicator of a *bona fide*

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[59]See for example Opinion regarding Ford Motor Co., August 23, 1979, BFG ¶6386; Opinion regarding Snap-on Tools Corp., August 27, 1979, BFG ¶6388; Opinion regarding Mountain Valley Spring Co., January 25, 1980, BFG ¶6404; Opinion regarding Teledyne Acoustic Research, March 7, 1980, BFG ¶6405; Opinion regarding Marathon Oil Co., September 30, 1980, BFG ¶6425; Opinion regarding Red Wing Shoe Co., January 7, 1983, BFG ¶6435; Opinion 93-6, June, 1, 1993, BFG ¶6450;Opinion 93-7, June 1, 1993, BFG ¶6451; Opinion 94-2, February 14, 1994, BFG ¶6458; and Opinion 96-1, April 12, 1996, BFG ¶6476.
[60] Opinion re Snap-on Tools, *supra*.
[61] Opinion re Ford Motor Co., *supra* note 59.
[62] *Ibid.*
[63] Opinion re Marathon Oil Co., *supra* note 59.

wholesale price.[64] However a contractual requirement to purchase even one unit as a demonstration model may trigger the definition.[65] Discounts by themselves may also be insufficient to avoid the application of the definition.[66]

The purpose of this exercise, in the eyes of the FTC, is to ensure that the term "required payments" captures all sources of hidden fees.[67] But the problem that the franchise laws seek to remedy is the lack of information about the effects of purchasing a franchise, including the degree of economic dependence and risk. This is a much larger question than simply disclosing fee arrangements.

Accordingly the decisions interpreting the community of interest definitions have also looked at a variety of other factors in a comparative context. The wording in the Canadian legislation regarding the "required payment" element allows for such payments to be otherwise required and to be indirect. This leaves considerable scope of a judge to find a technical justification for the application of what is essentially a community of interest definition, should the facts of the case so motivate the judge.

(d) Control or Assistance in the Method of Operation

The last of the three main elements in the definition of a "franchise" is usually the most difficult to determine with any degree of certainty.

The Alberta Act defines this element as being where "goods or services are sold or offered for sale or are distributed under a marketing or business plan prescribed in substantial part by the franchisor or its associate."

Ontario chose not to follow Alberta's lead on this element, and defined this element as occurring where the franchisor:

> exercises significant control over, or offers significant assistance in, the franchisee's method of operation, including building design and furnishings, locations, business organization, marketing techniques or training,[68]

Ontario's broader wording was adopted in the ULCC Act and thus appears in the PEI Act and the New Brunswick Bill. The wording in the FTC Franchise Rule is similar to the Ontario wording. Again the FTC has issued a number of Informal Staff Advisory Opinions that may be useful in interpreting this wording.[69]

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[64] Opinion re Snap-on Tools, *supra* note 59.
[65] Opinion 96-1, *supra* note 59.
[66] Opinion 94-2, *supra* note 59.
[67] Opinion 93-6, *supra* note 59.
[68] Ontario Act, Sec. 1 "franchise" (a)(ii).
[69] Opinion regarding Solar Heating Equipment Industries, Inc., April 25, 1980, BFG ¶6411; Opinion regarding International Consumers Club, May 5, 1980, BFG ¶6413; Opinion regarding Con-Wall Corp., February 17, 1981, BFG ¶6427; Opinion regarding Travelhost Magazine, Inc. March 2, 1989, BFG ¶6444; Opinion 94-7, October 18, 1994, BFG ¶6463; Opinion 95-5, April 4,

There are several interpretation issues that exist in the Ontario definition. What is "significant"? Does the control or assistance have to apply to all of the franchisee's method of operation or just part of the method of operation?
In deciding what is "significant" the FTC has relied upon the Statement of Basis and Purpose for the FTC Franchise Rule. Assistance should be considered "significant" where the franchisee is substantially dependent upon the producer's expertise or ability for making the distributorship profitable.[70] Offers of step-by-step assistance are considered to induce prospects to rely to a significant degree on the expertise and assistance of the seller. In contrast assistance and controls narrowly tailored to ensure the proper sale of a specific product were considered to have at most a marginal effect on the method of operating the entire business, and thus not create a dependency.[71]

However in a dry-cleaning franchise training that is limited to the technical aspects of operating a dry-cleaners were considered to be "significant."[72] The offer of such technical training and expertise was considered to be material to a purchaser's decision to buy.

The FTC addresses the "significant control and assistance" on a case by case basis.[73] The nature of the particular industry, the level of sophistication of the investors as well as the importance of the assistance or control are considered. Reliance is considered to be proportionate to financial risk, and where alternate services are available the financial risk is considered to be lessened.[74]

Sales area restrictions are considered sufficient to be a "significant' control over the method of operation.[75] In contrast in a hotel situation the offer of sales and marketing assistance that the owner could use or not use in his or her discretion did not create sufficient dependence to trigger the operation of the Franchise Rule.[76]

Finally a supplier offering a health travel business to hospitals argued that its offer would not be "significant" to the entire method of operation of the hospitals. The FTC replied that the entire operation of the hospital was the incorrect context for such an evaluation. The correct context for such an evaluation was the total business relationship between the parties.[77]

1995, BFG ¶6470; Opinion 95-8, August 29, 1995, BFG ¶6473; Opinion 97-7, August 18, 1997, BFG ¶6487; Opinion 99-3, April 28, 1999, BFG ¶6500; Opinion 03-4, 2003, BFG ¶6519; and Opinion 04-3, June 7, 2004, BFG ¶6523.

[70] Opinion re International Consumers Club, *supra* note 69.

[71] Opinion 03-4, *supra* note 69, regarding a paint-matching system.

[72] Opinion 95-5, *supra* note 69.

[73] Opinion 99-3, *supra* note 69.

[74] Opinion 04-3, *supra* note 69.

[75] Opinion re Con-Wall Corp., *supra* note 69.

[76] Opinion 95-8, *supra* note 69.

[77] Opinion 97-7, *supra* note 69.

Is there an allowable level of control for trade-mark licenses that should not trigger the definition? In Canada Section 50 of the *Trade-marks Act* requires that the owner of a mark exercise direct or indirect control over the "character or quality of the wares or services" offered in association with the trade-mark otherwise the distinctiveness of the trade-mark will be lost. It would appear that from the discussion of the FTC opinions in this area that whether or not the required minimum controls necessary to preserve the trade-mark would trigger the application of a franchise law would depend on the context in which such controls were exercised. If the product(s) or service(s) are a dominant part of the licensed business then controls over the character or quality may well be significant enough to make the licensee dependent on the licensor, and thus a franchisee. Licensors should note that this is equally likely to happen where the licensee is restricted from selling certain other goods, as it is when assistance is given in the sale of the goods.

(e) Grant of a Franchise

One option used by franchisors and others to develop multiple units in a territory is to grant what are known as "area development rights." There are a variety of forms that such an arrangement may take, but one of the key features is that an area development agreement usually requires the holder to enter into a separate franchise agreement if the holder wishes to actually open a location itself. In other words, area development agreements do not usually grant the right to engage in the business contemplated by the franchise system, but rather in the business of promoting the franchise system itself.

If there is no grant of a right to operate a franchise, is such an agreement a "franchise" agreement? According to a recent paper, the majority of published opinions in the United States hold that an area development agreement does not constitute a "franchise" under the definitions in various state franchise laws.[78] For example a letter agreement that the franchisee would open two stores and sign a separate franchise agreements for each such store was held not to constitute a "franchise agreement" In New Jersey, a state with one of the broader definitions of a franchise.[79]

However the prudent advice is to deliver a disclosure document to the area developer in any event.[80] "If the underlying relationship satisfies the definitional elements of a franchise under the Franchise Rule or applicable state law, then the franchisor will be required to provide the proper disclosure to the prospective area developer.[81]

[78] Jeffery A. Brimer, Charles B. Cannon, and Keith D. Klein, "Area Development Agreements – Law & Practice," in *International Franchise Association 39th Annual Legal Symposium* (Washington, DC: IFA, 2006) at p. 25.
[79] *Postal Depot, Inc. v. Parcel Plus, Inc.,* BFG ¶11,786 (Sup. Ct. N.J., 2000).
[80] *Supra* note 78, at p. 26.
[81] *Ibid.,* see also *Motor City Bagels, L.L.C. v. The American Bagel Co.,* 50 F. Supp. 2d 460, BFG ¶11,654 (D. Md., 1999).

In Alberta the Court of Queen's Bench found that an area development agreement was not a "franchise agreement" within the meaning of the Alberta Act because it did not grant a franchise.[82] The agreement simply provided the area developer with the right to receive a share of the royalties and franchise fees for those franchises that were opened in the area. However the case did not involve disclosure issues, so it is not helpful directly on the issue whether disclosure is required.

4. Exemptions

A franchise relationship not excluded from the application of the Act may nevertheless find itself exempt from certain requirements of the Act. In particular, franchisors otherwise subject to the general disclosure requirement in Canadian provinces with franchise legislation, may nevertheless qualify for an exemption from the production and delivery of a) a disclosure document to prospective franchisees or b) financial statements in conjunction with the production of a disclosure document. This portion of the paper will examine the statutory disclosure exemptions available to franchisors in Ontario, Alberta and Prince Edward Island, as the three provinces with franchise legislation currently in force. Additionally, this portion of the paper will also examine the statutory disclosure exemptions set out in the draft New Brunswick franchise legislation (the enactment of which has been delayed due in no small part to the recent provincial election in New Brunswick in which the party in power at the time of the introduction of the draft legislation has changed), and the model uniform franchise legislation adopted by the Uniform Law Conference of Canada (the "ULCC").

Exemptions from the Franchisor's General Obligation to Disclose

The general policy behind the disclosure requirement is to provide prospective franchisees with information relating to the franchise, the franchise system, and the costs of operating and establishing a franchised business. However, not every sale or grant of a franchise will trigger the general disclosure requirement. Legislation in Ontario, Alberta, Prince Edward Island, New Brunswick and legislation set out by the ULCC each identify very similar situations in which the disclosure requirement is not triggered. They are each considered in detail, below.

<u>Sale by Franchisee, or resale exemption</u> **-** The "grant" (this term is used by ON, PEI, NB and the ULCC) or "sale" (this term used by AB) of a franchise by a franchisee is exempt from the disclosure requirement if a) the franchisee is not the franchisor, an associate of the franchisor, director, employee of franchisor or associate, b) the grant or sale is for the franchisee's own account or benefit, c) in

[82] *711447 Alberta Ltd. v. Sarpinos Enterprises (Canada) Ltd.,* [2000] A.J. No. 1121, 2000 CarswellAlta 1067 (Alta. Q. B.).

the case of a master franchise, in which the entire franchise is granted, and d) the grant or sale is not "effected"[83] by or through the franchisor is exempt from the disclosure requirement. Generally speaking the resale exemption provides that the resale of an existing franchise, by a franchisee to a prospective franchisee is exempt from the disclosure requirement as long as it meets the conditions set out above.[84] For the most part, the first three conditions in relation to this exemption are fairly easy to discern and generally not contentious. However, the fourth condition—whether or not the grant or sale is effected by or through the franchisor—has been the source of some litigation and much questioned interpretation. By way of an attempt to clarify the muddy waters, but which perhaps obfuscates the matter further, the respective Acts state that a sale or grant is not considered to be "effected by or through" the franchisor merely because the franchisor has the right to approve or disapprove of the transfer, or because the franchisor takes a transfer fee (which must be set out in the franchise agreement, or not exceed the reasonable actual costs incurred by the franchisor in processing the grant or transfer). Recent case law has refined what comprises a transfer "effected by or through" the franchisor, which case law will be considered in a later section of this paper.

In addition to the interpretation of a transfer "effected by or through" the franchisor, there are certain other practical challenges to the resale exemption. On one hand, the requirement that a disclosure document be produced by the franchisor in every instance of a franchise resale from an existing franchisee may be unwieldy. Additionally, it is not unconceivable that a departing franchisee may fraudulently report certain aspects about the financial viability or profitability of the franchised business. In those instances, it may be inequitable to hold the franchisor responsible for properly disclosing a transaction that it is only marginally involved with. On the other hand, it is perhaps in these instances that a prospective franchisee most *requires* a disclosure document, and the remedies attached thereto. It can be argued that the risk should follow the reward, and if the franchisor is not "rewarded" by a franchise resale, its assumption of some ongoing risk in association with providing a disclosure document upon resale is unfair.

<u>Sale to Insider</u> – A grant, or sale of a franchise, to an officer or director of the franchisor, who has held that position for at least 6 months (the PEI, NB and ULCC legislation require that the requisite period be the immediately preceding 6

[83] For clarification, a franchisor is *not* considered to have "effected" the grant or sale by a franchisee to a new franchisee if they simply collect a reasonable fee or approve of the new franchisee. (*Arthur Wishart Act (Franchise Disclosure), 2000*, s.5(8) [*Wishart Act*]; *Franchises Act*, Revised Statutes of Alberta 2000, s.5(2) [*FAA*]; *Franchises Act* S.P.E.I., 2005, c.36, s.5(8) [*FAPEI*]; *Uniform Franchise Act* s. 5(10) [*UFA*]; Bill 6, *Franchises Act*, 3d Sess., 55th Leg., New Brunswick, 2005 cl. 5(10) (first reading December 7, 2005) [Bill 6]).

[84] *Wishart Act*, s.5(7)(a); *FAA*, s.5(1)(a); *FAPEI,* s.5(7)(a); *UFA*, s.5(8); Bill 6, cl. 5(8), *supra* note 83.

months), and who purchases the franchise for their own account or benefit, is exempt from the disclosure requirement.[85]

The policy behind this particular exemption is fairly clear—an insider, or officer or director of the franchisor, who has served for a set period of time, will likely have first-hand knowledge of the operation of the franchised business and the information found in a disclosure document and hence, not require the production of a disclosure document. However, to presume that *every* director or officer of a franchisor is privy to all of the information required to make an informed decision about the purchase of a particular franchised business may be faulty. While most directors could be appropriately considered to be in receipt of this information, the exemption equally applies to officers, an undefined term in the Ontario, Prince Edward Island, New Brunswick and ULCC legislation, and depending upon the number of officers in a given franchisor corporation, or the limitation of the tasks and responsibilities of that particular officer, one can imagine an instance where an officer of the franchisor may *not* have the direct and appropriate knowledge required to make an informed purchase decision.

<u>Sale of an Additional Franchisee to an Existing Franchisee</u> – A grant, or sale of a franchise to an existing franchisee is exempt from the disclosure requirement, provided that the additional franchise is substantially the same as the existing franchise operated by the franchisee.[86] Additionally, pursuant to the ON, PEI, NB and ULCC legislation, this exemption only applies if there has been no material change[87] since the existing franchise agreement, renewal or extension, was executed.[88] Practically speaking, it is highly unlikely that no material change, as the term is defined, has occurred within the franchise system over the course of any significant time. Except in situations where a franchisee purchases a second unit very shortly after purchasing the original unit, and in which the parties to the second transaction and the obligations between the parties pursuant to the second transaction remain identical to the first, it is impractical and imprudent to advise a franchisor to rely upon this exemption.

<u>Sale by Executor, Trustee, etc.</u> – The grant, or sale of a franchise, by an executor, administrator, sheriff, receiver, trustee, trustee in bankruptcy or guardian on behalf of person other than franchisor or the estate of franchisor is exempt from the disclosure requirement.[89] This exemption relieves certain third parties, who

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[85] *Wishart Act*, s.5(7)(b); *FAA*, s.5(1)(b); *FAPEI*, s.5(7)(b); *UFA* s. 5(8)(b); Bill 6, cl. 5(8)(b), *supra* note 83.
[86] *Wishart Act*, s.5(7)(c); *FAA*, s.5(1)(c); *FAPEI*, s.5(7)(c); *UFA*, s. 5(8)(c); Bill 6, cl. 5(8)(c), *supra* note 83.
[87] Recall, a "material change" is a change that, if known, would have a significant adverse effect on the value or price of the franchise to be sold, or the decision to purchase the franchise (*Wishart Act*, s.1(1); *FAA*, s.1(1)(o); *FAPEI*, s.1(1)(1)); *UFA*, s. 5(8)(d); Bill 6, cl. 5(8)(d), *supra* note 83.
[88] *Wishart Act*, s.5(7)(c); *FAPEI*, s.5(7)(c); *UFA*,s. 5(8); Bill 6 cl. 5(8), *supra* note 83.
[89] *Wishart Act*, s.5(7)(d); *FAA*, s.5(1)(f); *FAPEI*, s.5(7)(d); *UFA*, s. 5(8)(d); Bill 6, cl. 5(8)(d), *supra* note 83.

are selling the franchise on behalf of the franchisee in instances where the franchisee is precluded by law from disposing of its own property, from the disclosure requirement.

Fractional Franchise Exemption – The grant, or sale of a fractional franchise is exempt from the disclosure requirement. A "fractional franchise" is an arrangement in which an existing business adds a franchised product or service to its other lines of business. For example, if a department store wanted to offer franchised make-up sales and services to its customers within its business, the franchise that would be granted to the department store would be considered a fractional franchise. The fractional franchise exemption only applies if the parties, at the time of entering into the fractional franchise arrangement, anticipate, or ought to have anticipated that the fractional franchise will account for 20% or less of the total sales of the business (additionally, in PEI, NB and the ULCC, the 20% of total sales must not be exceeded during the first year of operation of the franchise).[90] From a practical perspective, the calculation of the total projected sales that may be derived from a particular franchised product or service line can be exceptionally difficult to calculate. Because of the 20% threshold, even if a franchisor is certain that the sale of those goods or services from that franchised line will not exceed 20% of the business' total sales, if the total sales of the business decreases, the franchisor may find themselves in a position where they no longer are eligible for the fractional franchise exemption. This practical problem is compounded by the trend by many franchisors not to provide earnings claims or projections in association with their businesses. Accordingly, it may be very difficult for a business to calculate whether or not the sales derived from a fractional franchise will be 20% or less of the total sales of its business. Again, a prudent franchisor, unless it is certain that sales from the franchised line will be substantially below this threshold, would be warned not to rely upon this exemption.

Renewal or Extension Exemption – The renewal or extension of an existing franchise agreement is exempt from the disclosure requirement. Additionally, ON, PEI, NB and the ULCC require that for this exemption to take effect, the franchised business must have been operating without interruption, and that there has been no material change since entering into the latest franchise agreement, or the latest renewal or extension.[91] While this exemption makes sense—an existing franchisee will likely have valuable first-hand knowledge about the franchise system due to its hands-on experience, in practical terms, this exemption is seldom applied because of the "no material change" requirement. It is exceptionally rare that no material changes occur with respect to the franchised business during the term of an existing franchise agreement—whether the change be a slightly different strategic direction of the franchised system, the

[90] *Wishart Act*, s.5(7)(e); *FAA*, s.5(1)(h); *FAPEI*, s.5(7)(e); *UFA*, s. 5(8)(e); Bill 6, cl. 5(8)(e), *supra* note 83.
[91] *Wishart Act*, s.5(7)(f); *FAA*, s.5(1)(d); *FAPEI*, s.5(7)(f); *UFA*, s. 5(8)(f); Bill 6, cl. 5(8)(f), *supra* note 83.

implementation of new sales techniques, or the introduction of new or modified goods or services to react to different markets, and as a result, most prudent franchisors will provide disclosure at renewals or extensions, reasonably assuming that a material change will have taken place in their system during the term in order to ensure compliance with the respective legislation. As a risk prevention measure, if a franchisor does wish to rely upon this exemption, it should at the very least obtain an acknowledgement from the franchisee stating that both parties anticipate, based upon reasonable and independent estimates, that the gross sales attributable to the fractional franchise will not exceed the prescribed amount. While this may not ameliorate a situation in which the threshold is exceeded, it will at least establish the anticipated figures contemplated by the parties at the time the acknowledgement is executed.

De Minimus Sales – A grant or sale of a franchise where the total annual investment required is less than a certain amount is exempt from the disclosure requirement.[92] (In Alberta and Ontario, this amount prescribed is $5,000. Regulations for PEI, NB and the ULCC dealing with *de minimus* sales exemptions, when promulgated, will set out the amount relevant to that province or jurisdiction). Some franchisors may consider themselves exempt from the disclosure requirement if they simply set their franchise fee lower than the prescribed amount. However, they will soon find that the total annual investment contemplated in this exemption includes not only the franchise fee, but any cost to a franchisee to "acquire and operate" the franchised business, and as a result, the actual cost to acquire and operate the franchised business may quickly and substantially exceed the prescribed amount, resulting in the franchisor being ineligible to rely upon this disclosure exemption, and exposing the franchisor to liability for failure to provide proper disclosure. A conservative application of this section will require that a franchisor ensure that the total cost to acquire and operate their franchised business, including all franchise fees, royalty fees, inventory purchases, rent payments, or payments to other third party suppliers, be under the prescribed amount.

Short-Term Franchises – Ontario, PEI, NB and the ULCC have a specific exemption that exempts a franchisor from the disclosure requirement if the franchise agreement does not extend past one year, and if the franchise agreement does not involve or require the payment of a non-refundable franchise fee. Additionally, in Prince Edward Island, New Brunswick and pursuant to the ULCC, this exemption is only available if location assistance is provided to the franchisee by the franchisor or its associate.[93] There are certain challenges to this exemption—in particular, it is unclear if a series of renewal terms that would extend past the one year franchise term would prevent a franchisor from utilizing this exemption. Additionally, although the inclusion of the "no payment of a non-refundable franchise fee" is certainly beneficial, a franchisee may find themselves

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[92] *Wishart Act*, s.5(7)(g)(i); *FAA*, s.5(1)(e); *FAPEI*, s.5(7)(g); *UFA*, s. 5(8)(g); Bill 6 cl. 5(8)(g), *supra* note 83.
[93] *Wishart Act*, s.5(7)(g)(ii); *FAPEI*, s.5(7)(h); *UFA*, s. 5(8)(h); Bill 6, cl. 5(8)(h), *supra* note 83.

(itself?him/herself?) spending an inordinate amount of money in their franchised business, regardless of whether or not there was a non-refundable franchise fee charged initially. Lastly, although missing from the ON Act, the inclusion of the additional location assistance requirement in the PEI, NB and ULCC legislation is likely tied to the typical or standard vending machine arrangement and as such, it appears likely that this exemption, in those jurisdictions, is only appropriate in those types of arrangements.

Multi-Level Marketing – In Ontario, Prince Edward Island, New Brunswick and pursuant to the ULCC legislation, a franchisor who finds themselves governed by the "multi-level marketing plan"[94] provisions of the *Competition Act* (Canada), is also exempt from the disclosure requirement. As parties who operate multi-level marketing plans are subject to their own disclosure requirements which require that any claims relating to compensation be based upon fair and reasonable information pursuant to the *Competition Act*,[95] they are exempt from the franchise legislation disclosure requirement.[96]

Large Investment Exemption – Ontario is alone in providing what is essentially a sophisticated investor exemption. In Ontario, the grant of a franchise where the prospective franchisee will be investing over $5,000,000 in the acquisition and operation of the franchise over the course of one year, is exempt from the disclosure requirement.[97] Presumably, this exemption exists because a prospective franchisee who seeks to invest such a large sum of money within one year to acquire and operate the franchise opportunity will have access to funds, professionals to review and negotiate contracts, and information about the franchise that may not be accessible to a smaller-scale franchise purchaser. It is somewhat telling that the PEI, NB and ULCC legislation, all of which were prepared after the Ontario legislation, have not included this particular exemption. While the justification behind providing an exemption to those who would invest a significant amount of money in a set period of time is reasonable—a prospective franchisee in Ontario that is going to spend $5,000,000 or more within the course of one year, is likely able to retain legal, accounting and business advisors, and to discharge its due diligence requirements accordingly, the information that may be salient or important to the purchaser may nevertheless be unavailable or difficult to establish. Additionally, it has been considered somewhat unfair that a franchisee that is investing such a significant amount of money in a franchise is not afforded the statutory protections relating to the disclosure document pursuant to the Ontario Act, such as the deemed reliance and misrepresentation provisions (regardless of the exemption, all franchisees, unless their franchisor is excluded

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[94] A "multi-level marketing plan"is a plan for the supply of a product whereby a participant in the plan receives compensation for the supply of the product to another participant in the plan who, in turn, receives compensation for the supply of the same or another product to other participants in the plan. (*Competition Act*, R.S. 1985, c.C-34, s.55(1).).

[95] *Competition Act*, R.S. 1985, c.C-45, s.55(2.1).

[96] *Wishart Act*, s.5(7)(g)(iii); *FAPEI*, s.5(7)(i); *UFA* s. 5(8)(i); Bill 6, cl. 5(8)(i), *supra* note 83.

[97] *Wishart Act*, s.5(7)(g)(iii), *supra* note 83; O. Reg 581/00, s.10.

from the Act, are afforded all of the statutory protections in the Ontario Act relating to the relationship, and other, provisions).

In all instances, the party seeking to rely upon the exemption must meet the burden of proving that it complied with the respective Act. Practically speaking, the onus is then on the franchisor to establish that if the Act applies to it, that it properly provided disclosure, unless it can prove that it qualified for one of the disclosure exemptions listed above.

In summary, in all three provinces, a general obligation exists for a franchisor to provide a prospective franchisee with a disclosure document, absent the application of one of the above noted exemptions. Some of these exemptions have been tested and clarified by recent case law, an analysis of which follows.

Case Law Update Relating to Disclosure Exemptions

There are surprisingly few cases that have dealt with the statutory disclosure exemptions to date. Perhaps franchisors, erring on the side of conservative action, are disclosing in borderline instances, or situations where an exemption is not absolutely applicable. An additional consideration could simply be that most of the exemptions are clear and not contentious, and as a result, whether or not a disclosure exemption would apply in a particular instant case would be easily discernable. A recently decided case focuses on the resale exemption and the interpretation of what is "effected by or through".

1518628 Ontario Inc., Nancy Van Dorp and Dean McCoy v. Tutor Time Learning Centres, LLC, William D. Davis and Frank Jerneycic, ("**Tutor Time**") – In this case, a motion was brought by the plaintiffs for partial summary judgment. The corporate plaintiff had purchased the shares of a corporate franchisee of the Tutor Time franchise system operating in Burlington. The parties to this transaction obtained the consent of the Franchisor, Tutor Time Learning Centres ("TTLC"). As a prerequisite for its consent, TTLC required the plaintiffs to comply with a number of conditions, most of which were found in the franchise agreement section dealing with the pre-conditions to transfer, but some of which were not, and which included the requirement of the Mr. McCoy (the spouse of the principal of the corporate plaintiff) to provide a personal guaranty. [98]

Generally speaking, the Ontario resale exemption states that a transfer "effected by or through" the franchisor is not eligible for the resale exemption, but further states that a sale or grant is not effected by or through the franchisor merely because a) the franchisor has a right, exercisable on reasonable grounds, to approve or disapprove of the grant; or takes a transfer fee which does not exceed the reasonable actual costs incurred by the franchisor to process the grant.

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[98] *1518628 Ontario Inc., Nancy Van Dorp and Dean McCoy v. Tutor Time Learning Centres, LLC, William C. Davis and Frank Jerneycic*, [2006] O.J. No. 3011 (S.C.J.).

The plaintiffs complied with all of the transfer conditions of TTLC and later brought an action claiming rescission on the basis that no disclosure was given. TTLC responded with their position stating that disclosure was not required, as this transaction fell within the resale exemption, and that the conditions imposed upon the plaintiffs, were simply instances of "right(s), exercisable on reasonable grounds" and if disclosure was in fact required, then the provision of the TTLC UFOC utilized in the United States to the plaintiffs constituted proper disclosure. Cumming J., disagreed. He found that a "right, exercisable on reasonable grounds" was distinguishable from a "power". In his view, a "right" meant a condition in the franchise agreement, that is, "an express contractual right between franchisor and franchisee".[99] Cumming J. held that the requirement on Mr. McCoy to provide a personal guaranty rendered him an additional transferee under the franchise agreement, and accordingly,

> a franchisor who exercises the power, albeit on reasonable grounds and pursuant to its usual practice, to require a non-officer, non-shareholder spouse (Mr. McCoy) to in effect become a co-franchisee is not merely engaging in the relatively passive act of approval of the transfer of the franchise…rather the grant is being effected by or through the franchisor.[100]

Accordingly, the franchisor TTLC was ineligible to rely upon the resale exemption and was thus obliged to provide disclosure to the plaintiffs. (Cumming J. went on to state that the use of the TTLC UFOC did not constitute proper disclosure and as such, the plaintiffs would be eligible for the rescission remedy. The motion ultimately failed for the plaintiffs however, because of the fact that they had signed an agreement releasing the defendants from liability, with full knowledge of TTLC's breach and their rights and remedies resultant.)

MAA Diners Inc. v. 3 for 1 Pizza & Wings (Canada) Inc. [2003] O.J. No. 430, 30 B.L.R. (3d) 279, (S.C.J.) ("**3 for 1**") – In this case, MAA Diners Inc. together with the individual plaintiffs, claimed rescission against the purchase of a 3 for 1 Pizza franchise. The admitted franchisor, 3 for 1 Pizza & Wings (Canada) Inc. alleged that the corporate parties from whom the franchise was purchased were unrelated to the franchisor and accordingly, they relied upon the resale exemption found in the Ontario Act. Speigel J. disagreed. In his judgment, Speigel J. stated that the party from whom the plaintiffs purchased the franchise was in fact to be considered as one and the same together with the franchisor. Evidence was adduced at trial in which the individual plaintiff asked about the corporate relationship between the vendor and the franchisor, and was told that they were "the same company". Additionally, at trial, it was found that an officer for the admitted franchisor prepared all of the contractual documents between the plaintiffs and the vendors, including the bill of sale and sublease, and admitted to "facilitat(ing) or manag(ing) the transaction with the plaintiffs. Accordingly, Speigel J. had no difficulty in stating that the transaction was effected by or

[99] *Ibid*. at para 44.
[100] *Ibid*. at para 49.

through the franchisor and as such, there was no exemption applicable to the transaction to provide disclosure to the franchisees. [101]

An Alberta case, *917246 Alberta Ltd. v. Panda Flowers (1999) Ltd.* (2004), 44 B.L.R. (3d) 117, 2004 ABQB 234, ("**Panda Flowers**") visited the resale exemption issue as well. In this case, the plaintiffs brought an action claiming misrepresentation, breach of promise and rescission of the franchise agreement.[102] Similar to the Tutor Time case, the Panda Flowers case hinged on the application and interpretation of the fourth subsection in the resale provision—whether the grant or sale was effected by or through the franchisor. The plaintiffs pointed to three factors which they claimed took the involvement of the franchisor beyond simply approving or disapproving of the corporate plaintiff as the new franchisee: a) that the franchisor encouraged the corporate plaintiff to commit to an offer (the franchisor said that the transaction was "a steal of a deal"), b) that the franchisor changed a material term of the franchise agreement relating to the franchisee's identity (the franchisor required that the individual plaintiff be bound together with the corporate plaintiff to a non-competition clause), and c) that the franchisor changed a material term of the franchise agreement in not permitting the individual plaintiff to work in the franchised store in question during the period prior to the closing of the transaction (which the franchisor admitted, claiming that to permit her to work prior to closing would expose the proprietary information of the system to a certain amount of risk). Mr. Justice Kenny dismissed each of these three factors claimed by the plaintiffs in his judgment stating:

> The facts…confirm a reasoned and diligent investigation by the plaintiffs in looking to purchase the franchise. The deal was reviewed in advance by her accountant and her lawyer. The sale purchase agreement was drafted by her counsel. She had the opportunity to walk away from the transaction at any time prior to signing the agreement…in addition, at no time prior to February 23, 2003 (which time was two years after she had purchased the franchise), did the plaintiff request a copy of the disclosure document.[103]

Ultimately, the court did not allow the action and found that the sale of the franchise to the plaintiff was not effected by or through the franchisor and therefore there was no requirement of the defendants to provide a disclosure document. Curiously, Mr. Justice Kenny relied in no small part in coming to this decision, upon the plaintiff's "freedom" to decide whether or not to proceed with the franchise transaction in the face of the three enumerated factors. Given the finding in Tutor Time, the Panda Flowers discussion on freedom to proceed may be less persuasive than before in Ontario courts.

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[101] *MAA Diners Inc. v. 3 for 1 Pizza and Wings (Canada) Inc.*, [2003] O.J. No. 430, 30 B.L.R. (3d) 279 [*3 for 1*].
[102] *917246 Alberta Ltd. v. Panda Flowers (1999) Ltd*. 2004 ABQB 235, 44 B.L.R. (3d) 117 [*Panda Flowers*].
[103] *Ibid*. at para 18.

In *Walden v. 887985 Alberta Ltd.* [2005] O.J. No. 257, 2005 CarswellOnt 251 (S.C.J.) ("AG Connexions"), the courts were tasked with the application of the "sale to an existing franchisee" exemption. In the AG Connexions case, one of the individual plaintiffs operated an AG Connexion franchise within Bruce County. Several months later, the individual plaintiff contacted the franchisor and it was agreed that his territory would be changed to an area closer to his home. Accordingly, his promissory note for Bruce County was cancelled, and a second franchise agreement was executed, with his wife as an additional franchisee, whereas she had only signed as a witness on the original franchise agreement. The franchisor did not provide a new disclosure document to the franchisees with respect to the second franchise agreement. Less than two years later, the plaintiffs gave notice of their intention to rescind the contract and claim damages. The court, in finding for the franchisee, held that the franchisor was not entitled to rely upon the "sale to an existing franchisee" exemption from disclosure as the second agreement essentially replaced the first agreement, and was not simply a "grant of an additional franchise" as it replaced the original territory for an entirely new territory. Lastly, there was no evidence adduced at trial that established that Mrs. Walden received any disclosure document prior to signing the second franchise agreement as an additional franchisee.[104]

Just as certain transactions in the franchise relationship do not attract the requirement to provide a disclosure document, there exist certain situations in which a franchisor which otherwise has to provide a disclosure document, shall not be required to provide financial statement information as part of their disclosure document. These situations are covered below.

Exemption from Franchisor's General Obligation to Disclose Financial Statements

Generally speaking the regimes set out by Alberta, Ontario, Prince Edward Island, New Brunswick and by the ULCC require the production and disclosure of the franchisor's 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.

The general requirement to disclose financial information about the franchisor is to inform the prospective franchisee of the financial health and success of their prospective franchisor. However, franchise legislation in Alberta, Ontario and Prince Edward Island provides certain franchisors with an exemption from having to provide specified financial disclosure to prospective franchisees. This exemption is intended to provide mature, established and financial viable franchisors that have a consistent record of good relations with franchisees and

[104] *Walden v. 887985 Alberta Ltd.*, [2005] O.J. No. 257 (S.C.J.).

who comply with the law from having to disclose specified financial information to prospective franchisees, or where to so exempt the franchisor would not prejudice the public interest.

Alberta's Financial Disclosure Exemption

In order to qualify for Alberta's financial disclosure exemption, a franchisor must satisfy this two part test:

- The franchisor has a net worth on a consolidated basis based on its most recent audited or review engagement financial statements of not less than $5,000,000 or $1,000,000 if it is controlled by a corporation that has a net worth of not less than $5,000,000; **and**

- The franchisor has had at least 25 franchisees operating in Canada during the 5 year period prior to the disclosure document, or the franchisor has conducted business continuously for not less than the 5 years prior to the disclosure document, or it is controlled by a corporation that satisfies one of these requirements.[105]

Ontario's Financial Disclosure Exemption

Ontario's financial disclosure exemption is similar to Alberta's. However, until July 1, 2005, a franchisor seeking exemption from financial disclosure was required to make application Ministry of Consumer and Business Services with evidence that it satisfied the below tests in order to receive the exemption. Since July 1, 2005, Ontario has taken a path more similar to Alberta, in that a franchisor is no longer required to make application to the Ministry for the financial exemption, it must simply satisfy the tests below in a self-declaratory process. In order to qualify for Ontario's financial disclosure exemption, a franchisor must establish that it satisfies this three part test:

- The franchisor has a net worth on a consolidated basis based on its most recent audited or review engagement financial statements of not less than $5,000,000 or $1,000,000 if it is controlled by a corporation that has a net worth of not less than $5,000,000; **and**

- The franchisor has had at least 25 franchisees operating in Canada or in a single jurisdiction other than Canada during the 5 year period prior to the disclosure document, or it is controlled by a corporation that satisfies this requirement.; **and**

- The franchisor, its associates, officers, directors, or general partners have not had any judgment, order or award made in Canada (or the other jurisdiction, if relied upon in the section above) against them relating to fraud, unfair or deceptive business practices, or a law regulating

[105] *Franchises Act*, Revised Statutes of Alberta 2000, Alberta Regulation 312/2000s.1

franchises, including the *Arthur Wishart (Franchise Dicslosure), 2000 Act* in the five years prior to the date of the disclosure document.[106]

Prince Edward Island's Financial Disclosure Exemption
Unlike both Alberta and Ontario, Prince Edward Island requires approval from an authority—in this case, the Attorney General of Prince Edward Island, in order for a franchisor to avoid financial disclosure otherwise required by Prince Edward Island's *Franchises Act*. Section 8 of that act states that any franchisor may apply to the Minister (defined in the Act as the Attorney General), who may, if satisfied that to grant such an exemption would not be prejudicial to the public interest, exempt that franchisor from including the prescribed financial statements in its disclosure document, subject to the terms set out in the Minister's exempting order. The payment of a $250 fee is also required in order for the franchisor's application for exemption to be considered.

New Brunswick and ULCC Financial Disclosure Exemption
Section 5(9) of both the New Brunswick's draft Franchises Act and the ULCC Uniform Franchises Act exempt the Crown from the financial disclosure requirements otherwise applicable in a franchise relationship.[107] Additionally, section 14(1)(j) of the New Brunswick Act reserves the right of the Lieutenant-Governor in Council to make regulations exempting a franchisor from any requirement of the Act.[108] Section 14(1)(h) of the Uniform Franchises Act is not as specific, but permits the Lieutenant-Governor in Council to make regulations respecting any matter that they consider necessary or advisable to carry out effectively the intent and purpose of the Act.[109] It can be reasonably expected that the regulations for the NB Act, once promulgated and the ULCC Uniform Franchises Act, if adopted, will incorporate some form of financial disclosure exemption similar to those available in Alberta, Ontario and Prince Edward Island. Whether New Brunswick or the ULCC will follow the self-declaratory regime found in Alberta and Ontario, or require official approval from a regulatory authority as in Prince Edward Island, remains to be seen.

5. Conclusion

All of the Canadian franchise laws have a provision that "In any proceeding under this Act, the burden of proving an exemption or an exclusion from a requirement or provision is on the person claiming it." [110] This should always be kept in mind when considering the use of an exemption or exclusion under franchise legislation. If the client still wishes to proceed without disclosure the reasons for claiming such exemption or exclusion should be carefully documented.

[106] *Wishart Act*, s.5(7)(g)(iii), *supra* note 83; O. Reg 581/00, s.11.
[107] *UFA*, s. 5(9); Bill 6 cl. 5(9), *supra* note 83.
[108] Bill 6, cl. 14(1)(j), *supra* note 83.
[109] *UFA*, s. 14(1)(h), *supra* note 83.
[110] Alberta Act, Sec. 19; Ontario Act, Sec. 12; PEI Act, Sec. 13; New Brunswick Bill, Sec. 13; ULCC Act, Sec. 13.

This review of the exclusions and exemptions available suggests that there are significant difficulties in using many of them with certainty. In the U. S. the rule of practice is stated as “If in doubt, disclose.” Firstly at the time that a decision is made as to whether to use the exemption or exclusion, it is rarely possible to envisage the nature of the claims that the purchasers of the system may make. If the claims are particularly egregious a judge may be tempted by the latitude afforded by the definition of the exemption or exclusion to try to remedy the perceived harm that the led to the adoption of the franchise law.

Secondly in many cases although the cost of compliance with the disclosure requirements may be significant, the cost of a court later finding that a system is in fact a “franchise” system and that each franchise who purchased within the limitation period therefore has a right of action against the franchisor may be even more significant.

Still where the exemptions and exclusions are truly warranted, and carefully evidenced, they can be used to avoid the cost of disclosure.