

**26th Annual IFA/IBA Joint Conference
May 2010
Legislative Update
News from Around the World**

Canada

Legislative Update

New Brunswick

While the New Brunswick *Franchises Act* was passed by the provincial legislature on June 26th, 2007 the statute has yet to be proclaimed into force pending adoption of the accompanying regulations. The Province consulted widely on the regulations in early 2009 and went out for a more limited consultation later in the year. It is expected that the regulations will be adopted in early summer of 2010 with an effective date of most likely January 1, 2011.

Manitoba

The movement towards franchise regulation in Canada is continuing with the Province of Manitoba introducing its own franchise Bill in its legislature on April 6th, 2010. The Bill adopts the harmonization approach recommended by the Uniform Law Conference

of Canada (*Uniform Franchises Act*) which had already been adopted by Prince Edward Island and New Brunswick and follows closely the Ontario statute and somewhat less closely the Alberta statute predating it. The Manitoba Bill follows the Manitoba Law Reform Commission's issuance of a Consultation Paper on Franchise Law in 2007 resulting in a one day conference bringing together academics, legislators, lawyers and franchise leaders from across the country. After the conference, the Manitoba Law Reform Commission released its report recommending that the Manitoba legislature enact franchise legislation. The report can be found at:

<http://www.manitoba.ca/justice/mlrc/reports/116.pdf>

The Manitoba Bill provides for:

- disclosure consistent with that of the other provinces;
- a statutory duty of fair dealing which includes the duty of good faith;
- a statutory right to associate;
- a right of rescission for non-compliance with the disclosure obligations;
- a right to sue for misrepresentation without the common law requirement to prove reliance;
- unlike franchise legislation in Ontario and Prince Edward Island, the Manitoba Bill is intended to bind the Crown;

- contemplates that unlike the other provinces, the disclosure document may be delivered in tranches over a period of time and provides that the limitation periods do not begin to run until the delivery of the last tranche;
- if a franchise agreement contains a dispute resolution mechanism, the disclosure document must describe the procedure to be followed;
- there is no large franchisor exemption from disclosure; and finally
- there is a provision for substantial compliance in disclosure requirements as opposed to strict compliance;

Other notable features of the Manitoba Bill are that confidentiality and location agreements do not constitute franchise agreements if their sole purpose is to retain confidential information or assign a territory; a fully refundable deposit is not consideration for the purposes of the Act; and the Crown does not have to include financial statements in its disclosure document but large franchisors must provide financial disclosure.

Legal Update

- 1. When is a disclosure document not a disclosure document?**
 - a. Some confusion / more clarity, the Court of Appeal speaks.**

Franchisees have a two year right of rescission from the time they sign a franchise agreement under Section 6 (2) of the *Arthur Wishart Act* if no disclosure document is

given rather than a more limited 60 day right of rescission contained in Section 6 (1) of the Act for defective disclosure.

The Ontario Court of Appeal dealt with this very situation in the case of *6792341 Canada Inc. v. Dollar It*,¹ which involved an appeal by a franchisee from a decision which dismissed its application for rescission of the franchise agreement based on the two-year rescission period. At the appeal level, the franchisor admitted that its disclosure document was deficient and the Court identified some of these deficiencies.²

The Court of Appeal seemed to have no hesitancy in allowing the franchisee's appeal and held that the document which the franchisor had delivered to the franchisee was not sufficient to enable the franchisee to make an informed decision whether or not to acquire the franchise and therefore did not qualify as a disclosure document prescribed by the Act. As clearly stated by the Court of Appeal, this was equivalent to the

¹ [2009] O.J. No. 1881 (C.A.)

² The deficiencies in the disclosure document were:

1. It did not contain a signed and dated certificate of disclosure.
2. The franchisor's financial statements or opening balance sheet was not included.
3. The head lease was not produced nor were details of it provided.
4. The documentation lacked information about the sub landlord who was a franchisor's associate within the meaning of the Act.
5. Certain prescribed statements pertaining to the advertising fund were missing.
6. A description of the territory to be granted wasn't included.
7. The franchisor's policy on the proximity between the franchisees was not included.
8. Other descriptions of licenses, registrations, authorizations and permissions required to be obtained were not included and lastly there was no disclosure regarding volume rebates as prescribed by the regulation.

franchisee not having received the disclosure document at all and consequently the two year rescission period under Section 6(2) of the Act was available to the franchisee. The Court of Appeal reaffirmed its own previous statements from *Personal Coffee Service v. Beer*³ which held that “the focus of the Act was on protecting the interests of franchisees. The mechanism for doing so is the imposition of rigorous disclosure requirements and strict penalties for non-compliance. For that reason, any suggestion that these disclosure requirements or the penalties imposed should be narrowly constructed, must be met with skepticism.” The Court of Appeal in *Dollar It* further noted that the failure to provide the required certificate of disclosure in and of itself would be enough for the court to conclude that the purported disclosure document was not a disclosure document as required by the Act. The Court was also critical of the franchisor’s document which referred the reader to relevant information found in the attached documents rather than responding by directly disclosing the required information.

This case was consistent with the earlier decision of the Ontario Superior Court of Justice in *Sovereignty Investment Holdings, Inc. v. 9127-6907 Quebec Inc.*⁴ The Court in *Sovereignty* identified four deficiencies which the Court said, each on its own, was sufficient to support a finding that the disclosure document was not a disclosure document for the purposes of the Act. These four fatal deficiencies were: a failure to

³ (2005), 256 D.L.R. (4th) 466 (Ont. C.A.)

⁴ [2008] O.J. No. 4450 (S.C.J.)

include the required financial statements; that there was no reasonable basis for the earnings projection; that the disclosure was not given as a single document delivered as such at one time; and that there was a failure to include the signed and dated certificate. What *Sovereignty* held and the Court of Appeal in *Dollar It* seems to support is that Section 6(2) is directed to the situation in which the franchisee is unable to make an informed decision at all because of fundamental deficiencies in the disclosure provided to it. Section 6(1) is directed to the situation in which the franchisee is unable to make a fully informed decision as a result of inadequate disclosure of material facts.

In my view, these cases provide a great deal of clarity, firstly, to confirm that the delivery of something called a “disclosure document” in and of itself will not mean that a disclosure document will be found to have been delivered as required by the Act. Secondly, the courts have been very helpful in identifying fatal deficiencies. Thirdly, the courts have been helpful in trying to define a test which is based on the ability of a franchisee to make an informed decision given the deficiencies.

2. Franchise class actions. Alive but how well?

What is important to note is that in certifying a number of cases over the last 10 years, our courts have demonstrated that class actions in the franchising context in Canada are

clearly viable, particularly where the evidence can be developed that the issues facing the franchisees are systemic. This may not reflect what would appear to be the experience arising from many of the cases coming out of the United States.

There were two decisions in this area (*Quiznos*⁵ and *Midas*⁶) that account for recent developments and with the *Quiznos*' decision currently in reserve at the Ontario Court of Appeal.

One issue the Court of the Appeal did not have to consider when it heard the *Quiznos* appeal was whether the class action waiver provision contained in the franchise agreement would be enforced. At first instance and as part of the certification decision, the trial judge found that the class action waiver provision contained in its form of franchise agreement was unenforceable because the provision was in conflict with the public policy factors that underlie class proceedings, which are access to justice, judicial economy, and the behaviour modification of civil wrongdoers. The court found that enforcing the class action waiver provision would not be in the public interest.

⁵ 2038724 *Ontario Ltd v. Quiznos Canada Restaurant Corp.*, [2009] O.J. No. 1874 (Div. Ct.)

⁶ *Landsbridge Auto Corp. v. Midas Canada Inc.*, [2009] O.J. No. 1279 (S.C.J.)

The battle line in the *Quiznos* appeal, which is the fundamental question affecting the viability of franchise class actions, concerns the significance of the individual franchisee's claims and issues and whether those claims and issues will outweigh the preferability of proceeding by way of a class action. The trial judge at first instance found that the whole case was really about damages and that the franchisees' damages claims were individualistic and that the individual inquiries far outweighed the issues that were common. Therefore, he dismissed the motion for certification. The Divisional Court found that the trial judge made errors in principle when he unduly focused on the issue of damages. Instead, the Divisional Court applied an analysis to the certification test which was consistent with the approach to be taken to certification from the various Court of Appeal decisions in Ontario when it certified *Quiznos* as a class action.

It is worth understanding the factual matrix of the *Quiznos* case. *Quiznos* franchisees are complaining that they pay too much for product which they are required by *Quiznos* to buy from designated distributors where an affiliate of *Quiznos* makes a substantial amount of money every year from that distribution scheme. The franchisees say this constitutes a breach of contract and breaches the duty of good faith and also that the arrangements between *Quiznos* and its distributor offend the price maintenance prohibition contained in Section 61 of the *Competition Act* prior to its recent

amendments. Section 61 effectively says that one party, ie. Quiznos, cannot tell another party, ie. the distributor, what prices the distributor is to charge its customers, ie. the Quiznos franchisees, for product. This is effectively what occurs in the Quiznos distribution scheme.

The Divisional Court in *Quiznos* certified all the common issues which the franchisees were seeking to be certified. The decision may be found in CanLii.⁷

The Ontario Superior Court of Justice also certified the *Midas* case as a class action based on a complaint of the franchisees which was said to be systemic. The *Midas* case revolved around changes that Midas made to its system in 2003 which Midas says it was authorized to make under its franchise agreement but which the franchisees complained were neither authorized nor permitted by the statutory duties of good faith and fair dealing.

The facts in *Midas* are relatively straightforward. In 1981, Midas sought to change its franchise agreement to increase royalties from 5% to 10%. Midas renegotiated its franchise agreements with its franchisees to make this change. The clear evidence was

⁷ <http://www.canlii.org/en/on/onscdc/doc/2009/2009canlii23374/2009canlii23374.html>

that Midas advised the franchisees that they would receive a 14½% discount off the products that Midas manufactured and distributed to them as a quid pro quo for this change. The problem, however, was that the 14½% discount did not find its way into the new franchise agreement. Nevertheless, Midas provided the 14½% discount for a period of 20 years to its franchisees. In 2003, Midas decided to get out of the manufacturing and distribution businesses. From that point forward, Midas negotiated an agreement with a third party supplier to provide Midas brand products to the franchise system. What occurred at that point was that Midas' fortunes improved greatly but the franchisees' fortunes suffered as they lost their competitive advantage in the marketplace. The trial judge had to consider competing arguments as to whether Midas could do what it did under the contract and heard competing arguments involving the interpretation of the contract when considering whether the franchisees raised a viable cause of action. The trial judge found that the entitlement to the 14½% discount was not an express term of the contract and it was also clear that Midas could make changes to the system. Nevertheless, the trial judge certified the case as a class action and identified these as the following common issues, which I will paraphrase.

1. Did Midas breach its obligations of good faith and fair dealing by terminating the Midas product supply system and

substituting and implementing the distributorship agreement, including, without limitation, by:

- a. retaining the full 10% royalty after it ceased to sell products at a discount to class members;
- b. by negotiating and receiving rebates, allowances or other consideration from third-party suppliers of products on account of the class members' purchases of products; or
- c. by funding its warranty obligations through rebates provided by third-party suppliers of products?

2. If a breach of the duty of good faith is found, was Midas unjustly enriched at the class members' expense by retaining the full 10% royalty after it ceased to sell products to class members?

3. Justice Cullity then certified issues relating to damages and the appropriate remedies.

Effectively what the Court found was that although the 14½% discount was not made an express term of the contract, the reference to the "Midas System" in the agreement may well be said to incorporate that advantage and therefore the franchisees raised a

viable cause of action as to whether Midas acted in breach of its duties of good faith and fair dealing when it made its system changes in 2003.

Midas relied on the entire agreement clause in the franchise agreement to dispute the franchisee's ability to introduce evidence about the 14½% discount. The judge noted that franchise negotiations are usually marked by an inequality of bargaining power between the parties. This notion is important where a franchisor seeks to rely on an entire agreement clause as they will be enforced strictly and are subject to principles relating to unconscionable bargains. The judge stated that "entire agreement clauses are not to be considered as licenses to make, and subsequently resile from, pre-contractual representations and undertakings with complete impunity" and they do not purport to deal with every aspect, or all obligations arising under, the relationship between the franchisor and franchisee. In *Midas*, this was recognized by references to the "Midas System" in the franchise agreement, which covered policies that did not make their way into the franchise agreement. Therefore, such policies are not caught by entire agreement clauses.

As we also noted from the *Quiznos*' class action case, one of the issues is whether Quiznos' distribution scheme will be found to have been a breach by Quiznos of its

duty of good faith owed to the franchisees. So clearly, the duty of good faith is being taken seriously by the courts and ought to be taken seriously by all practitioners and participants in the industry.

So although franchise class actions are prima facie viable, I entitled my theme “Franchise Class Actions - *Alive But How Well?* Let’s look at the ‘how well’ of my theme. Often class action cases by their nature are not post-mortem cases. They concern issues which may be continuing in the franchise system while the lawsuit is ongoing. Therefore, franchisees are interested not only in obtaining redress for issues about past conduct but they are often seeking to make fundamental changes in the franchise system on an ongoing basis to prevent harm from continuing. So despite the viability of franchise class actions, given the circumstances that exist in this relationship, there is a very real opportunity for franchisors to undermine the class and this can be done in a number of ways.

The principal way this may be able to be done is by utilizing common provisions of franchise agreements which require franchisees to provide releases at various stages of the relationship such as a condition of obtaining a renewal or transfer. This was precisely the circumstances in the Midas class action where, in a preliminary motion,

the Court had to decide whether releases given by franchisees pursuant to renewals and transfers of their respective franchise agreements were unenforceable for purposes of the class action claims.⁸

The Court considered the Arthur Wishart Act which expressly prohibits a franchisor from forcing a franchisee to waive or release its rights under the Act and which also prohibits a franchisor from interfering with a franchisee's right to associate with other franchisees, in any forum and for any purpose. The Court found that the right of association includes associating for the purpose of bringing a franchise class proceeding and that any provision in a franchise agreement which has the effect of waiving a right under the Act or interfering with the right of association would be a nullity. Therefore, the Court prevented Midas from using the standard form provision in its franchise agreement to compel class members to release it from the claims certified in the class action.

The Midas motion decision also shed light on the 'applicable law' provisions which are found in franchise agreements. The Midas franchise agreement entered into with each of Midas' Canadian franchisees stated that the laws of Ontario governed the

⁸ Reasons for decision available at:
<http://www.canlii.org/en/on/onsc/doc/2009/2009canlii56298/2009canlii56298.html>

relationship. Midas argued that when it chose to have the laws of Ontario govern the relationship with its non-Ontario franchisees, it did not mean to include the *Arthur Wishart Act*. The Court rejected this argument and concluded that the adoption of the law of Ontario as the law of the contract included the rights and protection under the Ontario statute.

The developments on these issues are going to affect the way franchise agreements are drafted. They are going to affect the content of disclosure documents and they are going to affect the advice that counsel should be giving when dealing with a disgruntled group of franchisees or even individual franchisees.