

## Introduction

There is a growing number of Canadian provinces enacting franchise disclosure legislation and a growing number of decided cases providing guidance as to the obligations of franchisors under these statutes. Currently, the provinces of Alberta, Manitoba, Ontario, Prince Edward Island, New Brunswick, and British Columbia have such legislation. These statutes are consistent in requiring the delivery of a comprehensive franchise disclosure document before a prospective franchisee pays any money or enters into an agreement relating to the franchise.

The court decisions to date have demonstrated a clear judicial predisposition to a strict interpretation of the wording of the statutes and a willingness to afford aggrieved franchisees their requested remedies.

All of these statutes provide for the significant remedy of rescission for non-disclosure or sufficiently defective disclosure. The courts have also demonstrated a willingness to find sufficient defects to support a rescission remedy even from minor administrative errors.

There is a growing body of legal literature discussing many aspects of franchise disclosure legislation in Canada. However, what is missing is a concise summary of some of the key areas of the disclosure process which, if not handled properly, can lead to devastating and unexpected consequences.

## What This Guide is Intended to Do

This guide is intended to highlight, for those preparing and delivering franchise disclosure documents, a summary and checklists of many of the “must do” or “must consider” matters. Some of the sections are directed to all preparers of disclosure documents, some to particular preparers and some to specific situations giving rise to the need to disclose.

## What This Guide is Not Intended to Do

This guide is not a manual on how to prepare a franchise disclosure document. Rather, it deals only with a small number of critical topics in the disclosure process. Most of all, this guide is not intended to be legal advice for the reader or to replace the need to use other material in the preparation of franchise disclosure documents or for competent legal advice from a lawyer experienced in franchise law.

## Your Assistance is Welcome

We will be updating this compliance guide from time to time as the legislation changes and the case law evolves. We would welcome comments from users on any errors or omissions they find or suggestions on how to make it more effective for its intended purposes.

## Section 1: FOR EVERY DISCLOSURE DOCUMENT

### Material Facts

Each of the existing provincial franchise disclosure statutes and their regulations require that franchise disclosure documents, (“FDDs”) contain a comprehensive amount of information about specific matters. In addition, each franchise statute also requires franchisors to disclose all “material facts,” which is a broadly defined term. The key aspect of the definition is a test as to whether or not the fact being considered for inclusion in the FDD would have a significant impact on the decision of a prospective franchisee to purchase the franchise or the price the prospective franchisee would be willing to pay. The conservative approach is to disclose any fact that could possibly have such results.

**Challenge:** Making certain that everyone in the franchisor organization that could learn of a material fact is canvassed about such facts before the FDD is finalized for delivery to the specific prospective franchisee.

### All Agreements Must be Attached to FDD

Each of the statutes requires that every agreement the prospective franchisee is expected to sign must be attached to the FDD. To be certain, even the most innocuous agreement should find its way into the FDD. This includes agreements with third parties that the franchisor requires as a condition to the grant of the franchise.

### One Document

An FDD must contain all required information and attachments delivered as one document at one time. One exception to this rule exists under the Manitoba Franchises Act which allows a franchise disclosure document to be delivered in parts at different times. In such circumstances, the date of delivery of the disclosure document is the date of the delivery of the last document.

### Financial Statements

Unless exempt from financial disclosure, every franchisor must attach its financial statements for the last completed fiscal year. However, if those financial statements have not yet been prepared, the franchisor may use the statements for the prior fiscal year up to 180 days following the end of the last fiscal year of the franchisor. The financial statements must be either audited or prepared to a review engagement standard. A new franchisor gets a break, in that it can use simply an opening balance sheet for its first fiscal year and for 180 days following the end of the first fiscal year.

**Challenge:** The financial statements must be those of the franchisor and it is advised not to use financial statements that are consolidated with financial statements of affiliated corporations.

## Certificate

An FDD must be accompanied by an originally signed and dated certificate of the franchisor. If the franchisor has only one director or officer, it must be signed by that person. If the franchisor has more than one director or officer, it must be signed by at least two persons who are officers or directors of the franchisor.

**Challenge:** Ensure that the person signing the certificate does so when the complete FDD is available to them for review, i.e. signing a certificate in advance of the preparation of the FDD and its review is ill-advised.

## Delivery Method

The typical way in which FDDs are delivered is personally or by registered mail. The New Brunswick statute, Manitoba statute, Ontario statute, PEI statute and the British Columbia statute also specifically allow delivery by courier. The PEI, Manitoba, Ontario, British Columbia and New Brunswick statutes are the only provincial statutes which permit delivery of disclosure documents electronically. Multiple conditions attach to this option however.

**Challenge:** Even where the statute specifically permits delivery by courier, if the FDD is being delivered in this manner, it is wise to have the party effecting the delivery ask for picture ID and execute a brief affidavit as to whom they delivered the FDD. An exact copy of the FDD, with a copy of the signed certificate and the original receipt should be retained in the files of the franchisor.

## When Delivered

An FDD must be delivered not less than 14 days before the prospective franchisee signs an agreement or pays any money relating to the franchise.

**Challenge:** It is best to make the 14 days clear days, i.e. do not count the day the FDD was delivered and do not take money or have documents signed on the 14th day following delivery.

## Obtain Receipt

While not required by any of the provincial statutes, it is a common and highly recommended practice to have all recipients of an FDD to sign and date a receipt of delivery. The two exceptions to this rule exist under the British Columbia and the Ontario statutes which require a confirmation of receipt of delivery if the disclosure document is delivered by electronic means.

## Record Keeping

A complete copy of the signed FDD and all signed receipts should be retained for future reference.

## Section 2: RENEWALS

The provincial franchise statutes provide for an exemption from disclosure for renewals and extensions of franchise agreements. The two exceptions to this rule are the Alberta statute and the British Columbia statute. Under the British Columbia statute, this exemption is conditional on there being (i) no interruption in the operation of the business under the franchise agreement, and (ii) no material change since the signing of the original franchise agreement or the last renewal agreement. With the exception of Alberta, however, this exemption is conditional on there being no material change since the signing of the original franchise agreement or the last renewal agreement. In order to avoid the risk of a material change being found, especially since the time leading up to the renewal or extension is often considerable, with lots of changes in a franchise system, the best practice is to provide an up-to-date FDD upon each renewal and extension.

The system's standard FDD often needs to be adapted for renewals and extensions in, at least, the following areas:

1. Change the section respecting "Costs Necessary to Establish the Franchise" to "Costs Necessary for Renewal of the Franchise" and list only the costs which may be required for renewal or extension including extension of lease, leasehold improvements, equipment updates, renewal fees, etc.
2. Attach copies of all agreements the franchisee will be required to sign on renewal or extension, i.e. new franchise agreement, new lease document, guarantees, etc.
3. If a new form of franchise agreement is being used on renewal or extension, modify the sections of the FDD, as necessary, which refer to the content in the franchise agreement which might have changed, i.e. royalty and advertising contribution rates, restrictions imposed on the franchisee, exclusivity of a territory, termination, further renewal, transfers, etc.

## Section 3: REALES OF FRANCHISES BY FRANCHISEES

All of the provincial statutes provide for an exemption from disclosure for the resale of a franchise by the franchisee. However, there are a number of conditions to that exemption, the most problematic being the condition that the sale not be effected "by or through the franchisor." There is no definition of that phrase in the various statutes (although the franchisor is free to reasonably approve the buyer and take a transfer fee, subject to some restrictions) and the case law is still evolving. Add the reality that franchisors have a considerable stake in who buys the franchise and the process by which the new parties become franchisees in the system and one can see that franchisors may easily become so involved in the resale that the disclosure requirement is triggered.

Best practice is for the franchisor to simply take the position that each franchisee entering the system will receive an appropriate FDD. The system's standard FDD would have to be modified in a number of ways, including:

1. A section should be added summarizing the essential facts of the resale, including a reference to the fact that the franchisor makes no representations or warranties concerning the existing franchised business or its financial performance, unless that is the case. Provided, however, the franchisor should indicate what information it does have regarding the financial performance of the franchised business, with the added caveat that the financial information has not been verified by the franchisor, unless that is the case. This latter suggestion comes from the belief that such information would amount to a material fact.
2. Make certain that all agreements the new franchisee will be required to sign are attached to the FDD, including any new franchise agreements, franchise agreements being assigned, lease agreements, guarantees, etc.
3. The costs to establish the franchise should be replaced with the costs necessary to effect the purchase of the franchise.

## **Section 4: SALE OF A CORPORATE UNIT**

For the sale of a corporate unit the system's standard FDD should be provided. It is recommended that a section be added to the FDD summarizing the sale transaction and that the agreement of purchase and sale be added as a scheduled agreement to the FDD. Whether or not the franchised business being sold is owned by the franchisor or a related corporation, all relevant financial and operational information concerning the business should be disclosed as material facts.

## **Section 5: PROVINCES WITHOUT FRANCHISE LEGISLATION**

A franchisor is not required to provide a franchise disclosure document to a prospective franchisee in provinces that have not enacted franchise disclosure legislation. However, many franchisors elect to provide their system's standard FDD to a prospective franchisee in any event, to allow the prospective franchisee to make a more informed decision about the franchise investment. Should you elect to provide an FDD to prospective franchisees in provinces without franchise legislation, it is recommended that you provide the prospective franchisee with a letter advising that, while disclosure is not required in the province in which the franchise business will be operated, the franchisor has elected to provide its system's standard FDD. In the letter, the prospective franchisee should be cautioned that the information included in the FDD may not relate to the province in which the franchise business will be operated or the franchise being acquired and that the FDD is being provided for information purposes only. In these circumstances, no executed certificate should be included in the FDD.

## **Section 6: U.S. FRANCHISORS**

U.S. franchisors are very familiar with franchise disclosure legislation, as they must comply with U.S. federal and many state regulations. While the Canadian provincial franchise statutes have many similarities to the U.S. statutes, there are some fundamental differences which must be taken into consideration when a U.S. franchisor enters the Canadian market.

## **Triggering Event for Disclosure**

All of the provincial franchise statutes are the same as far as the events that trigger the requirement to provide a franchise disclosure document: the payment of any money or the signing of any agreement by the franchisee in relation to the franchise. No other activity, i.e. face-to-face meetings, will result in the requirement to provide a disclosure document to a prospective franchisee.

## **Master Rights for All of Canada**

While no court has ruled on the question, it is widely assumed that most of the provincial statutes take jurisdiction when master or other franchise rights are granted for all of Canada. Best practice dictates that a U.S. franchisor provide a franchise disclosure document, which is compliant with all of the provincial franchise statutes, to such a prospective franchisee.

## **Use of U.S. Disclosure Documents**

A number of provincial franchise statutes specifically allow for the use of foreign franchise disclosure documents, which have been conformed for the particular franchise statute and none of the provincial statutes prohibit their use. However, it is common for U.S. franchise disclosure documents to contain much information that is not relevant to the Canadian context, thus creating the possibility that the conformed U.S. disclosure document will violate the "clear and concise" rule present in many of the provincial statutes. Combining this with the fact that the cost and time needed to conform a U.S. disclosure document are very close to the cost and time to prepare the appropriate Canadian disclosure document, it is common for U.S. franchisors to prepare and use a "made in Canada" franchise disclosure document.

## **Costs**

It is important for U.S. franchisors to ascertain the Canadian equivalent of all costs referenced in the franchise disclosure document, including: construction costs, costs of supplies and inventory, operating costs, labour costs, leasing costs, food costs, etc. While the similarities between Canada and the U.S. are great in many areas, there are many differences which can make a franchise disclosure document inaccurate.

## **Financial Statements**

Each of the provincial statutes requires that the financial statements of the franchisor be included in the disclosure document and must be audited or prepared to a review engagement standard. The U.S.-based financial statements of an American franchisor may be used, but they need to be prepared in accordance with standards that are at least equivalent to the Canadian standards. The best practice is to have a Canadian chartered accountant review the U.S.-based financial statements and add any notes to the U.S.-based financial statements necessary to meet those standards.

## **Section 7: UPDATES**

Unlike in the United States, there is no requirement in Canada to do an annual update of the entire FDD. Rather, much of a Canadian FDD needs to be current and up-to-date each time the document is delivered to a prospective franchisee. The following is a list of certain items required in an FDD and the time frames in which they must be updated:

1. Unless indicated otherwise, each item of disclosure must be accurate and current to the date of delivery of the disclosure document. Some items of particular concern are:
  - a. Directors and officers who might change from time to time;
  - b. Costs of establishing the franchise;
  - c. Litigation, insolvency proceedings and administrative proceedings; and
  - d. List of existing franchisees.
2. As soon as new financial statements are prepared for the previous fiscal year, they must replace the existing financial statements used in the franchisor's standard form FDD. Such new financial statements must be prepared no later than 180 days following the end of the last fiscal year.
3. The following items relate to fiscal years:
  - a. Advertising fund:
    - percentage of the fund spent on national campaigns and local advertising in the two preceding fiscal years
    - percentage of the fund retained by the franchisor, the franchisor's parent or the franchisor's associate in the two preceding fiscal years
    - projection of the amount of the franchisee's contribution to the fund
    - projection of the percentage of the fund to be spent on national or local advertising campaigns for the current fiscal year
    - projection of the percentage of the fund to be retained by the franchisor, the franchisor's parent or the franchisor's associate in the current fiscal year
  - b. Former franchisees:
    - name, last known address and telephone number for those who left the system in the last fiscal year
    - reasons for the closure of each franchise during the last three fiscal years

## **Section 8: MATERIAL CHANGES**

Between the date of disclosure and the earlier of the signing of the franchise agreement or the payment of money by the franchisee, the franchisor must provide the prospective franchisee with a statement describing any "material changes" that occur as soon as practicable after the change has occurred. Only the provinces of New Brunswick, Manitoba and Prince Edward Island prescribe any form or technical requirement for a notice of change, other than the notice has to be in writing. It would, however, be a good practice to use a form which

complies with the regulations under the franchise statutes of these three provinces. Note that the requirements for the signatories to the statement of material change in New Brunswick and the certificate in Manitoba and PEI are the same as the requirements for FDDs, i.e. if the franchisor has more than one officer or director, then two signatures are required. It is also recommended that a written receipt of the notice of material change be obtained.

The question arises about how to deal with situations where key agreements and/or facts are simply not known or available at the time the original FDD is delivered to a prospective franchisee. A good example of this is when the franchisee is disclosed before the location is selected and the lease is obtained, whether or not a franchise agreement is signed. It may be that this will be considered by a court in the future as being such a "material fact" that proper disclosure is not possible without the existence of the lease. At a minimum, the best practice is the lease should be disclosed in a statement of material change and the prospective franchisee or existing franchisee is given a reasonable opportunity to review the lease and seek professional advice.