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IN THIS ISSUE

Is Your Dispute, Subject To Arbitration Under Your Franchise Agreement, Going To Be Litigated In Court?

Bringing Clarity To Franchise Disclosure

Moving Forward, Franchisors Should Take A Step Back: How To Avoid The Risk Of Being Labelled A Joint Employer

Alberta Government To Extend Mature Franchisor Exemption

FRANCHISE M&A

Andrae Marrocco's recent articles on "Critical Representations and Warranties in Franchise Mergers & Acquisitions - ("Part I & II") were published in the American Bar Association's Franchise Law Journal. Please email Andrae at amarrocco@dickinsonwright.com if you would like to receive a copy.

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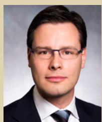

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IS YOUR DISPUTE, SUBJECT TO ARBITRATION UNDER YOUR FRANCHISE AGREEMENT, GOING TO BE LITIGATED IN COURT?

by James Ullman

As we all know, using arbitration clauses in commercial agreements is pretty commonplace—particularly in the franchise world. Yet, as two recent federal appeals court decisions make clear, attention needs to be paid to the arbitration clause to protect the parties' choice of dispute resolution. Neither decision involved franchising arrangements, yet the implications of those cases could surely affect arbitration clauses in franchise agreements.

In *Tillman v. Tillman*, 825 F.3d 1069 (9th Cir. 2016), the Ninth Circuit permitted litigation to proceed despite the parties' agreement to resolve disputes by AAA arbitration. Specifically, *Tillman* involved a legal malpractice claim brought in court by a client against her former attorneys. The litigation was stayed on motion of the law firm pending the mandated arbitration. Following preliminary arbitration hearings between the parties, the client could not pay a necessary deposit required to maintain the arbitration proceedings. The law firm was offered the opportunity to pay the client's share of costs but refused and requested that the arbitration be terminated. The arbitrator terminated the proceedings. The U.S. District Court held that it did not have authority to hear the matter under the Federal Arbitration Act ("FAA") as the claims were subject to arbitration pursuant to the parties' engagement letter. However, the Ninth Circuit reversed and held that, since the engagement letter did not expressly require that arbitration result in a dismissal or an award, arbitration had been "had in accordance with the term of the Agreement." §3 FAA. The Court of Appeals ruled that under the circumstances, litigation could proceed and the FAA's strong public policy in favor of arbitration was not violated. In reaching this conclusion, the Tillman court relied on a recent Tenth Circuit decision—*Pre-Paid Legal Services, Inc. v. Cahill,* 786 F.3d 1287 (10th Cir. 2015)—which also permitted litigation to proceed based on a party's inability to pay his share of the arbitration fees and costs.

In both *Tillman* and *Pre-Paid*, the parties' intentions to resolve disputes through arbitration should have been honored. The following practice pointers may help avoid similar results. First, a franchisor placed in this position could pay the franchisee's costs and fees with the hope of recoupment if successful on the merits. Second, you should consider carefully drafting arbitration clauses to preclude such a result.

Specifically, you should draft an arbitration clause so that it makes clear that the parties intend to forego the right to litigate claims, even where arbitration does not result in a decision on the merits—e.g., where an arbitration is terminated prematurely based on one party's failure to comply with the AAA's rules (such as non- payment).

In the context of a franchise relationship that has gone sour, it is clearly within the realm of possibility that a disgruntled franchisee may be unable or unwilling to pay arbitration costs. However, parties often do not contemplate a "two cracks at the apple" situation, such as those at issue in *Tillman* and *Pre-Paid*. Juxtaposed, if franchisors chose arbitration hoping that the costs and fees would be too burdensome for their franchisees to afford, *Tillman* illustrates that the Ninth Circuit is willing to create a safe harbor to allow parties in dispute to fully resolve their issues, rather than be defaulted.

BRINGING CLARITY TO FRANCHISE DISCLOSURE

by Ned Levitt

From time to time, a case comes along which synthesizes not only some specific rules about conduct, but helps to guide everyone about the fundamental intent and principles behind the franchise legislation. The recent Ontario case, *Raibex Canada Ltd. v. ASWR Franchising Corp*.,[1] decided by Mr. Justice W. Matheson and now subject to appeal, is just such a case.

1. The Essential Facts

While there are additional parties, facts and issues, the following describes only those parties, facts and issues which make this case one of the most important franchise disclosure cases in many years.

ASWR Franchising Corp. ("ASWR") is a franchisor of the AllStar Wings and Ribs franchise system. An affiliate of ASWR enters into head leases for the franchised locations and subleases to the ASWR franchisees. On October 16, 2012, ASWR delivered a disclosure document to Mr. Ramy Bastaros. There was no head lease attached to the disclosure document, as no location had been selected. A company named Raibex Canada Ltd, ("Raibex"), which is owned by a Mr. Bastaros, signed an AllStar franchise agreement on November 21, 2012.

The court accepted that Mr. Bastaros had intended to invest no more than $400,000, but had ultimately agreed to a business plan that called for a $600,000 investment, plus $50,000 for working capital. It was very germane to the decision that Mr. Bastaros had been told that the conversion of an existing restaurant could significantly reduce his investment over what would be required to build from a shell building. The disclosure document stated that the cost of establishing the restaurant from a shell would be in the range of $805,500 to $1,153,286. However, there was no estimate for the cost of establishing the franchise by the conversion of an existing restaurant, even though almost all of the existing AllStar franchises were conversions.

The disclosure document attempted to address the lack of cost estimates for conversion by stating that, "the cost to convert… is highly site specific and can therefore vary dramatically from location to location" and that, "the Franchisor has no reasonable means of estimating or predicting those costs with any certainty".

Some months later, a location was selected for conversion to an AllStar restaurant, a head lease was executed by the franchisor's affiliate and construction was commenced. However, the head lease required a substantial and unusual $120,000 payment for prepaid rent and security deposit. Additionally, approximately one month prior to opening in March 2014, Raibex was advised that the cost to convert the restaurant would be over $1,000,000.

2. The Litigation and the Issues

Raibex refused to pay to ASWR the full construction costs or the $120,000 prepaid rent and security deposit. On July 21, 2014 ASWR served a default notice on Raibex, then a termination notice on August 1, 2014 and assumed control over the franchise.

On July 25, 2014, Raibex served a notice of rescission claiming $1,280,000 from ASWR and its affiliates. In December 2014, Raibex commenced an action for this amount and for a declaration that it had validly rescinded the franchise agreement.

Raibex's position was that it was entitled to rescind the franchise agreement because of the omission from the disclosure document of critical material facts. The disclosure document did not include a copy of the head lease (which included the obligation to pay $120,000 for prepaid rent and security deposit) or an estimate of the costs to convert the premises.

ASWR argued that, as the location had not been selected at the time of disclosure (or even before the franchise agreement was signed) it was not possible to provide the missing facts to Raibex and that the disclosure obligations under the AWA end when the franchise agreement is signed. ASWR also argued that it is a very common practice among franchisors to disclose and have franchise agreements signed prior to finding an appropriate location for the franchised business.

3. The Decision

With the concurrence of all parties, this main issue was disposed of through a summary judgment process. The essence of the judgment, which was rendered in favour of Raibex, was that, where there are facts of sufficient materiality, which are not known to the franchisor, the franchisor is unable to provide the statutorily mandated disclosure and sign a binding franchise agreement. The court held that the terms and conditions of the head lease and the actual costs of converting the premises were such critical material facts. It is obvious that the unusual $120,000 payment under the lease and the franchisor's representations as to the likelihood of the costs to convert the premises being significantly less than building out a shell played a very important part in the judge's thinking.

Some pundits have already suggested that this case stands for the proposition that disclosure is not possible until the location is

selected and a head lease is available. However, Justice Matheson states clearly "**In the circumstances of this case**, it was premature to purport to deliver the disclosure document under the AWA and enter into a franchise agreement".[2] Justice Matheson further states, "**The facts before me** illustrate the materiality of the Head Lease **in this particular case**…I leave open the possibility that proper disclosure could be made in those circumstances even though it was not made here."[3]

It would seem that, if the franchisor could have described the important provisions of a possible head lease (including the large pre-paid rent and security costs) and some reasonable range of conversion costs, complete disclosure could have been possible in this case. So it is submitted that this case stands for the proposition that proper disclosure is not possible until all material facts can be presented to the franchisee. This is a broad and clarifying concept in franchise disclosure and can come into play in other scenarios including when a foreign franchisor has not ascertained the cost of establishing a franchise in Canada and attempts to put that burden on the prospective franchisee.

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[1] 2016 ONSC 5575.
[2] *Ibid* at para. 3.
[3] *Ibid* at para. 75.

MOVING FORWARD, FRANCHISORS SHOULD TAKE A STEP BACK: HOW TO AVOID THE RISK OF BEING LABELLED A JOINT EMPLOYER

by Andrae J. Marrocco

Franchisors in the United States are experiencing increased risk of being classified as a joint employer. While there has been extensive discussion about the dangers for franchisors, Canada's laws appear to be moving toward a similar approach, causing Canadian franchisors to be rightfully nervous about the prospect of assuming the employment-related obligations of their franchisees.

Law

United States

Traditionally, in the United States, if a franchisor exercised "direct and immediate" control over matters essential to the employment terms and conditions of a franchisee's employees, such as daily tasks, working conditions, hiring and firing, the franchisor was at risk of being considered a joint employer. In more recent decisions of the National Labor Relations Board ("**NLRB**"), the NLRB has refined its standard of control to include "indirect control" and franchisors that reserve the right to exert control, extending liability to franchisors that may be far removed from their franchisees' final decision-making.

In evaluating whether a franchisor possesses sufficient control over franchisee employees to qualify as a joint employer, the NLRB will consider whether an employer has exercised control over the terms and conditions of employment indirectly through a franchisee, or whether the franchisor has reserved the right to do so. The NLRB has noted that franchisors may even be found liable as a joint employer if their franchise agreement was drafted to imply control over employment, even if actual control is not exercised.

Canada

Under Canadian common law, where a franchisor and franchisee act "as a single, integrated unit" and a franchisor has effective control over the employees of its franchisee, they may be designated a common employer for the purposes of employment liability. In Ontario, associated or related businesses found to be under common control or direction are considered to be one employer under the *Labour Relations Act, 1995* ("**LRA**"). Similarly, a franchisor may be treated as an employer of its franchisees' employees under Ontario's *Employment Standards Act, 2000* ("**ESA**") if activities are carried on between the franchisor and franchisee with the intent or effect to directly or indirectly avoid liability. In cases involving employee claims under the ESA, Canadian courts and tribunals may look beyond corporate structures and use a "common sense" approach to assess whether the franchise relationship has been structured so as to avoid liability under the ESA.

In March 2016, the Ontario Ministry of Labour ("**MOL**") announced a review of the *LRA* and the *ESA* that could result in a new joint employer regime potentially similar to the NLRB's recent approach in the US. In an interim report published on July 26, 2016, the Special Advisors to the MOL presented a range of options for addressing joint employer status that include: (i) expressly excluding franchise relationships from the *LRA*, (ii) establishing clear statutory criteria for a related employer designation, particularly in a franchise context, or (iii) maintaining the status quo. The MOL has stressed that these options are preliminary and that no conclusions have yet been reached. Further input from stakeholders was sought on the interim report and we expect a final report to be delivered by the Special Advisors to the MOL in February, 2017.

Implications

While franchisors typically reserve the right to exert control over various decision-making aspects of their franchisees' business, such control may, even as the law currently stands, put Canadian franchisors at risk of being classified as joint employers. A finding of joint employer status can leave franchisors exposed to claims by franchisee employees for unpaid wages, overtime, vacation pay, benefits, termination notice, pay in lieu of notice, severance pay, wrongful and constructive dismissal claims, human rights claims and payroll taxes, as well as increased risk of employee unionization across franchisee lines We will wait and see whether the MOL will introduce shortly further changes to the joint employer model to increase these risks. To the extent changes are made, we expect provinces outside Ontario will take a keen interest and may follow Ontario's lead.

As the law evolves, one thing is certain - franchisors across Canada must exercise caution in their approach to the franchise relationship and to avoid reserving or exerting control over their franchisees'

business in ways that may trigger the "joint employer" classification. Below is a list of common practices that franchisors should avoid in order to limit their exposure to Canada's joint employer regime:

Employment terms:
- Participating in the hiring and firing of its franchisees' employees or contractors (including requiring franchisor approval prior to the hiring or firing of employees or contractors).
- Advertising franchisee employment opportunities.
- Setting compensation programs for franchisee employees.

Conduct with employees:
- Setting the schedules of franchisee employees.
- Conducting training programs for franchisee employees.
- Providing feedback directly to franchisee employees.
- Limiting the scope of options for franchise uniforms.
- Participating in essential employment decisions.

Business decisions:
- Dictating pricing schemes for franchisees.
- Entering into a co-insured relationship with franchisees.
- Setting requirements for franchisees to make non-essential repairs or upgrades.

Daily operations:
- Requiring franchisees to use certain employment software.
- Setting forth significant operating manuals or practice guides that contain non-essential brand propositions.
- Creating employee handbooks (if employee handbooks are used, they should be limited in scope).

To limit the risk of being classified as a joint employer, franchisors should reduce the degree of control that they reserve or exercise over their franchisees' business operations. Dickinson Wright can assist in preparing and reviewing new or existing franchise packages to ensure that they address this risk. Dickinson Wright's team of franchise lawyers can also provide training to your team regarding techniques to limit your risk.

A delicate balance exists for franchisors between providing sufficient guidance to fulfill their obligations to protect and enhance their brand, while also ensuring this direction does not leave a franchisor liable to a joint employer finding. While ultimately the decision regarding how much control that a franchisor wishes to exert over its franchisees is a business decision, franchisors in Canada should be aware of the implications for failing to take a step back, as Canada's labour and employment laws move forward under a joint employer regime.

ALBERTA GOVERNMENT TO EXTEND MATURE FRANCHISOR EXEMPTION

Under the Alberta Franchises Act Exemption Regulation, a franchisor is exempt from including financial statements in a disclosure document given to a prospective franchisee if the franchisor meets certain criteria of established size and net worth (the "Mature Franchisor Exemption"). The Alberta government considered removing the Mature Franchisor Exemption but has recently decided to extend it until its next review in 2021. In making such extension, the Alberta government has kept its legislation consistent with other provincial franchise legislation.

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