



Franchise Disclosure: Traps & Tips

By

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1. Introduction

Half of Canada's provinces now have franchise legislation, with more likely to follow suit. To this new reality, add a rapidly growing body of decided cases and it is no wonder that those in franchise organizations or the legal community responsible for franchise regulatory compliance are feeling a lot more stress and worry these days.

The courts have been very clear that this type of legislation is remedial and intended to address the imbalance of power in the franchisor-franchisee relationship. Some of these decisions have applied a very strict interpretation of the wording of the statutes and their regulations. As a result, even minor administrative errors can result in unexpected and costly consequences. How do you protect yourself against such consequences? The answers are: a) know the legislation thoroughly, b) understand the court interpretations of the legislation, c) stay current with new cases interpreting and applying the legislation and d) take great care in the preparation of the disclosure documents and their attachments.

This article will examine some of the traps waiting for the uniformed and some tips on how to stay safe in this increasingly dangerous world of franchise disclosure.

2. Who Should be Disclosed?

Where the prospective franchisee is an individual or several individuals, i.e. a partnership, then each of them should be disclosed separately. Where the prospective franchisee is an existing corporation, the safest approach is to disclose the corporation and everyone who owns shares in the prospective franchisee, although this is not strictly required by the statutes. In practice, however, this often occurs because the shareholders are also the guarantors of the franchise agreement and, based on existing case law, disclosure is required or the guarantors would have the right to rescind their guaranties for up to 2 years.

It is not uncommon for individuals to be disclosed and then they form a corporation just prior to the franchise agreement being executed. In this situation, the counsel of perfection is to disclose the new franchisee corporation and wait the 14 days. In real life, however, expectations are

running high and everyone just wants to finalize the deal. If so, then the recommended course of action is to at least disclose the new corporation, even if the 14 day rule is not going to be followed. In this way, the corporate franchisee's remedy of rescission will be extinguished after 60 days.

3. Delivery of the FDD

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

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. While not required by any of the provincial statutes, it is a common and highly recommended practice to have all recipients of an FDD sign and date a receipt of delivery. 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.

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.

4. Contents of an FDD

(a) Material Facts

Each Canadian franchise statute requires the full disclosure of all "material facts" relating to the franchise. This 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 courts have held that material facts include a wide array

of information that could have a potential impact upon a prospective franchisee's decision as to whether or not to invest in a franchise system. The conservative approach is to disclose any fact that could possibly have such results.

A challenge lies in the fact that the knowledge of the officers, directors, agents and employees of the franchisor is the knowledge of the franchisor. As a result, it is imperative that everyone who could learn of a material fact be canvassed about their knowledge each time an FDD is to be delivered. In smaller franchise organizations, this can be a challenge. In larger franchise organizations, it can be a nightmare. There are no easy solutions, but the more systematized and thorough the enquiry is of these people, the less likely that material facts will be missed. In larger franchisors, enquiries can be done more efficiently on a departmental basis.

(b) Earnings Projections

Although earnings projections are **not** required to be provided to prospective franchisees under the Canadian franchise statutes, if a franchisor does choose to make an earnings projection, the FDD must include a statement indicating the reasonable basis for the projection, all assumptions that substantiate the projections and the location where the underlying information is available for inspection by the prospective franchisee. A danger lies in the fact that an earnings projection can be an oral statement made by someone in authority or ostensible authority. As a result, anyone involved in the franchise sales process should be schooled about not discussing any such matters beyond what is authorized by the franchisor.

(c) Certificate of Disclosure

An FDD must be accompanied by an originally signed and dated certificate of the officers and/or directors of the franchisor warranting that all material facts have been provided and that the information provided is true. Questions have been raised as to whether or a not certificates can be signed in advance or sent for signature by someone who is a distance away, without providing those individuals with the final copy of the FDD. While the statutes do not specifically deal with such questions, these are dangerous practices, as they may lead to the impeachment of the certificate once it is proven that the signatory did not in fact review the FDD before signing the

certificate. Based upon the decided case, this could render the FDD a nullity and allow the franchisee a 2 year window in which to rescind it.

(d) Existing Franchises and Corporate Units

Across the various statutes, there are differing approaches and formulae for the disclosure of existing units in the system. In PEI, New Brunswick and Manitoba, for example, depending upon the number of existing units in the particular province, disclosure may have to be made regarding existing units in contiguous provinces. For franchisors operating in multiple provinces, this can become challenging and fraught with opportunities for mistakes. Unless there are compelling reasons to do otherwise, the best policy is to disclose in a Canadian FDD the existence of all franchised and corporate units throughout Canada.

5. Renewal and Extensions of Franchise Agreements

The provincial franchise statutes provide for an exemption from disclosure for renewals and extensions of franchise agreements. 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 because 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.

6. Transfers and Sales

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.

The best practice is for the franchisor to simply take the position that each franchisee entering the system will receive an appropriate FDD.

7. Conclusion

Franchise legislation is now a firmly established reality for the Canadian franchise marketplace. If anything changes in the future, it will most likely be the addition of other provinces to the list of those that have enacted such laws and more court cases interpreting the statutes and setting standards. The right people, with the right attitudes and training, need to be put in charge of this very important task and they will have to be diligent, meticulous and knowledgeable to keep the franchisor and the system out of harm's way.

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