Litigation and Distribution & Franchise Law Bulletin

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Is Your Distribution or Licensing Relationship a "Franchise" Business? The Answer Might Surprise You

Your company has dealers, distributors or licensees, but you are not in the fast food or clothing business. So, is your company a franchisor? Ontario's broadly worded franchise legislation says it might be without your knowing it. This Bulletin provides a brief overview of "inadvertent franchising" – a potential problem for those who do not think they are involved in a franchise business.

Why Does The Answer Matter?

The word "franchise" typically brings to mind fast food restaurants, clothing chains and other similar retail operations. But in Ontario, the word "franchise" has a much broader meaning thanks to the *Arthur Wishart Act (Franchise Disclosure), 2000* (the "Franchise Act"). The Franchise Act defines when a "franchise" relationship exists and imposes significant obligations on those who can be characterized as "franchisors".

Among other things, the Franchise Act requires franchisors to provide prospective franchisees with a disclosure statement containing all material financial and other information regarding the business *before* the franchisee enters into a relationship with them. The Franchise Act imposes harsh consequences if a franchisor fails to do so. The franchisee may later rescind the contract and force the franchisor to reimburse it for money the franchisee invested in the business. A franchisee can also sue for misrepresentations contained in the disclosure statement.

Additionally, the Franchise Act imposes on each party a duty of "fair dealing" in the performance and enforcement of the agreement. The duty includes an obligation to "act in good faith and in accordance with reasonable commercial standards" which, if breached by the franchisor, entitles the franchisee to sue for damages.

Given the obligations and standards imposed by the Franchise Act, it is important to know whether your relationship with dealers, distributors or licensees may be caught by the legislation. While you might not consider your company to be a "franchisor", the legislation just might.

Is Your Company a "Franchisor"?

The Franchise Act does not provide a clear answer to when a supplier and a distributor or licensee are engaged in a franchise relationship. The legislation states that, subject to some exceptions, it applies to "franchise agreements", which are defined as agreements that relate to a "franchise". This is not particularly helpful, so the legislation goes on to define what "franchise" means.

Very generally, the term "franchise" is defined as a right to engage in a business where the franchisee must make a "payment" or "continuing payments", directly or indirectly, to the franchisor before commencing, or in the course of operating, the business, *and where either*:

1. the franchisee is entitled to sell goods or services associated with the franchisor's trade-marks or commercial symbols, and the franchisor has significant control over the franchisees method of operation; or

2. the franchisee has representational or distribution rights to sell the franchisor's goods or services, regardless of whether trade-marks are involved, and the franchisor provides locational assistance to the franchisee.

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Given the breadth of this definition, there is a risk that some relationships not typically considered to be "franchises" may be caught by the Franchise Act. Unsuspecting suppliers and manufacturers may, consequently, be exposed to lawsuits brought by their distributor or licensee "franchisees" for having failed to comply with the legislation.

Unfortunately, there have been no cases decided in Ontario yet that provide any useful guidance about how the definition of "franchise" will be applied to traditional distribution or licensing networks. It therefore remains unclear, for example, whether payments made by distributors for product supplied by their suppliers in the ordinary course are sufficient to bring such arrangements within the "franchise" definition.

The American Experience

While franchise legislation in Ontario is relatively new, American franchising legislation and jurisprudence has been maturing for decades. Accordingly, it is useful to note some US experience.

Courts in the United States have often taken a hard line approach in determining whether a business relationship is entitled to the protection of franchise legislation. In one Illinois case, a forklift supplier charged its distributor for the cost of parts and service repair manuals, which the supplier required the distributor to keep on hand to repair units sold to customers. When the supplier later decided to terminate the agreement, the distributor claimed that a franchise relationship existed (in part because of the fees the supplier charged for purchasing the required manuals). The distributor claimed that state franchising legislation applied to the relationship and that the supplier had improperly terminated the distributorship agreement without good cause. The court agreed.

The Illinois *Franchise Disclosure Act* defines "franchise fee" as "any fee or charge that a franchisee is required to pay directly or indirectly for the right to enter into a business or sell, resell, or distribute goods, services or franchises under an agreement", subject to some exceptions. Regulations under the statute further provide that any payments over $500 that are required to be paid to the franchisor constitute a "franchise fee". The statute excludes payments for products purchased by a distributor for resale, but not items used to conduct the business (such as service repair manuals).

The court held that even though it took several years before the distributor's aggregate payments for the manuals exceeded $500, the distributor was nevertheless *required* to purchase the manuals, and because the manuals were not for resale, the payments amounted to a "franchise fee". The bottom line: by charging its dealer about $1,600 for manuals, the supplier inadvertently became a "franchisor". Because the supplier terminated the distributorship agreement without good cause, the supplier was ordered to pay its dealer "franchisee" over $1.5 million in damages for lost profits resulting from the improper termination and over $230,000 in legal fees.

The Illinois Court of Appeal upheld this verdict, noting that "…Legal terms often have specialized meanings that can surprise even a sophisticated party. The term 'franchise', or its derivative 'franchisee', is one of those words." The Appeal Court concluded by observing that, like many manufacturers, the supplier "simply did not appreciate how vigorously Illinois law protects 'franchises'."

Whether Ontario courts will take a similarly aggressive approach remains to be seen. It is worth noting, however, that the Ontario Franchise Act is worded even more broadly than the Illinois legislation. Unlike Illinois, the Ontario legislation does not exclude payments for product supplied by a supplier for resale by the distributor from the definition of "franchise".

Myths and Realities

Myth: "Our distributors operate under a document called a 'Distribution Agreement' or a "License Agreement", not a 'Franchise Agreement', so clearly, we are not a franchisor".

Reality: It does not matter what your agreement is called. Whether a relationship constitutes a "franchise" depends on the substance of the relationship – not the form. Simply avoiding the use of the word "franchise" in your agreements does not remove you from the ambit of the Franchise Act.

Myth: "There's no upfront franchise fee or ongoing royalty obligation, so it can't be a franchise."

Reality: Payments by a franchisee for any number of things (including payments for product, supplies or equipment, manuals, training, advertising, or even refundable working capital deposits) may satisfy the "payment obligation" referred to in the definition of "franchise".

Myth: "Our dealer operates under its own trade name, so it can't be a franchise."

Reality: If you provide locational assistance to your dealers or distributors, they do not need to use your trade-marks to be caught by the definition. Moreover, any use of, or reference to, your trade-marks by a distributor may be sufficient to satisfy the definition of "franchise".

Myth: "They run their own business without any control by us, so it can't be a franchise."

Reality: Any guidance, or even the offer of assistance, may satisfy the control element referred to in the definition of "franchise". Where a supplier provides its distributor or dealer with a list of retail outlets or accounts for the goods to be sold, or assistance in securing locations where the products may be displayed, this may be enough.

Conclusion

Without you knowing it, your distribution or licensing network may in fact be a "franchise" business. Given the obligations imposed by the Franchise Act, the implications could be costly for those "inadvertent franchisors" who have not complied with the legislation. If you have any concerns about whether your business might be caught by the Franchise Act, you should review this matter with your counsel.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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