

9 THINGS YOU SHOULD DO RIGHT NOW TO PROTECT YOUR FRANCHISE SYSTEM DURING THE COVID-19 PANDEMIC

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Business closures arising from the COVID-19 outbreak have wreaked havoc on the franchise industry. While restrictions are expected to be relaxed in the coming days and months, it is unknown how long a return to “normal” might take. When businesses re-open, it is unclear whether customer volume will return to pre-COVID-19 levels. The unfortunate reality is that some franchisees and suppliers may not have the financial viability to withstand the extent of the business interruption.

Franchisors want to know what they should be doing right now in order to mitigate legal and commercial risks that may result from the pandemic and to better prepare for emergency business interruptions in the future. In this bulletin, our team of franchise lawyers across a broad range of practice areas suggest nine tips to help franchisors manage the crisis.

1. **Stay current on regulatory notices and changes**

McMillan has a number of resources to assist franchisors in staying current on all regulatory notices and changes taking place across Canada. These resources can be found on our website [here](#). We have a team of lawyers dedicated to assisting clients to respond to and comply with government orders, such as closure of non-essential services businesses, as well as assisting clients to assess their readiness to return-to-work. McMillan LLP and McMillan Vantage, our partner communications and government relations firm, have developed a three-point Return-to-Work Health Check to help companies, associations and not-for-profits navigate the new normal – a more rules-based economy with comprehensive restrictions that vary by sector, geography and COVID-19 context.

Franchisees often rely on their franchisors to collect this information and relay it to their franchise network. It is therefore essential for franchisors to remain current and informed about developments (across all relevant jurisdictions) including with respect to:

- i. changing health and economic conditions as they relate to COVID-19;
- ii. regulatory policies and orders from all levels of government, and how such regulations are being interpreted; and

iii. the relief and stimulus packages available.

In each case, franchisors should understand how these developments impact and apply to the franchise system (and particularly the franchisees).

2. Determine whether you or your franchisees qualify for government support programs

The federal and provincial governments of Canada have established a number of government programs to support companies, including franchisors, operating in Canada that are faced with financial difficulties as a consequence of the COVID-19 pandemic. Eligibility for such benefits, and the quantum and nature of support offered, will depend on the particular circumstances and operations of any particular franchisor.

The following is a non-exhaustive list of federal government support measures:

- the Canada Emergency Wage Support (CEWS) program generally provides eligible employers that have suffered certain minimum reductions in qualifying revenue with a subsidy equal to 75% of eligible remuneration (to a maximum of \$847 per week per employee);^[1]
- the government has implemented a number of programs delivered through the Business Development Bank of Canada (“**BDC**”) and Export Development Canada to provide businesses with access to liquidity and working capital during these uncertain times. Such lending programs include (i) the Business Credit Availability Program, (ii) BDC COVID-19 Working Capital Loans, and (iii) the BDC Capital Bridge Financing Program;^[2]
- the Canada Emergency Commercial Rent Assistance (CECRA) program provides forgivable loans to commercial property owners to cover 50% of the rent payments of eligible small business tenants. A qualifying small business generally must (i) generate no more than \$20 million in gross revenue (at the ultimate parent level), (ii) have been paying less than \$50,000 per month in gross rent per location, and (iii) either suffered a 70% drop in revenues from pre-COVID-19 levels, or temporarily ceased operations; and^[3]
- the federal government has extended the due date for various tax remittances and tax returns. Most notably, the government has extended the deadline for remitting certain taxes due under Part I of the Income Tax Act (Canada) until September 1, 2020, as well as certain amounts due in respect of GST/HST and custom duties until June 30, 2020.^[4]

3. Consider whether your contracts have force majeure clauses that relieve contractual obligations during a pandemic

Supply chains around the globe have been crippled as a result of COVID-19 and both franchisees and franchisors are asking whether the situation relieves them, or their counterparties, of their contractual

obligations.

The first thing franchisors should do is review their contract to see if it contains a force majeure provision and obtain legal advice about its applicability. A force majeure clause alters the parties' contractual obligations when an extraordinary and unforeseeable event beyond their control prevents one or more of them from fulfilling those obligations. Not all contracts contain force majeure clauses, and there is no one standardized form of clause in those that do. Whether a particular force majeure provision relieves a party of liability as a result of COVID-19 (or its consequences) very much depends on the precise wording of the clause (courts typically interpret such provisions narrowly and strictly). The burden is on the party seeking to rely on a force majeure clause to satisfy a court that it applies in the circumstances.

To successfully invoke a force majeure clause based on COVID-19, the party seeking to do so must prove five things:

1. That COVID-19 or its implications (e.g. government shut-down orders) *fall within the scope of the clause* (the fact that the words “epidemic or pandemic” are not used may not be fatal if the provision includes a “catch-all” or basket clause);
2. That COVID-19 or its implications have *sufficiently impacted your contractual obligations* (many clauses expressly specify the degree of impact the event must have in order for the clause to be triggered);
3. That COVID-19 or its implications were *the cause of your failure to perform or delay* (if there is another reason, which falls outside the scope of the force majeure clause, the provision is unlikely to apply);
4. That the party took *sufficient steps to avoid and mitigate* COVID-19's impact (the party must show that there were no commercially reasonable alternatives that could have avoided or minimized not only any losses, but also the occurrence of the event itself – the other party has a duty to mitigate the losses it suffers as a result of the failure or delay); and
5. That the party *complied with any other relevant contractual requirements*, such as providing *proper notice* of the force majeure event.

If your contract does not have a force majeure clause, parties may still have recourse to the common law doctrine of frustration. According to the Supreme Court of Canada, frustration applies where “a situation has arisen for which the parties made no provision in the contract and the performance of the contract becomes a thing radically different from that which was undertaken by the contract”. The fact that a party's obligations have become more onerous or more expensive to perform is not sufficient – the situation must make it unjust to hold the parties bound to their agreement. Unlike force majeure (which only excuses a party from its force majeure-related obligations), however, frustration brings the entire contract to an end. Legal advice should be obtained as early as possible so that you are aware of the practical and strategic considerations of invoking

force majeure or frustration (or when facing a counterparty who is doing so).

4. Consider whether the enforcement of strict contractual rights is consistent with the reasonable expectations of the parties in the circumstances

The occurrence of COVID-19 related business interruptions requires businesses to make difficult decisions that will no doubt have a negative impact on other business partners, including, potentially, franchisees. Businesses can of course enforce contractual rights. However, as always, when considering strategic options for coping with the consequences of the pandemic, businesses must have regard to their contractual and statutory duty of good faith and fair dealing.

The requirement to exercise contractual powers in good faith is an implied term of all commercial agreements. Moreover, franchise legislation in each of PEI, Ontario, Alberta, Manitoba, New Brunswick and British Columbia also codifies this duty. The duty of good faith and fair dealing includes, among other things, a duty not to exercise a discretionary contractual power in a manner that is inconsistent with the reasonable expectations of the parties. Generally speaking, Canadian law requires that whenever a party exercises a discretionary contractual power it must do so reasonably and in a manner consistent with the reasonable expectations of the parties and not arbitrarily, capriciously, or for some collateral or improper motive.

When making decisions that will have a negative impact on other business partners, including franchisees, it is critical to carefully consider the motivation behind the decision and whether or not the decision is consistent with reasonable expectations of the parties having regard to the present circumstances.

5. Carefully review the date on notices of rescission delivered by franchisees

The province of Ontario suspended limitation periods and other procedural time periods in which any step must be taken in a proceeding or an intended proceeding. Other jurisdictions have issued similar suspension orders. These orders should not impact the time period in which a franchisee must deliver a notice of rescission in order to preserve its rescission right under applicable franchise legislation.

The Ontario Court of Appeal has found that a rescission claim only crystalizes after a franchisee has delivered a proper notice of rescission and a franchisor has not complied with the statutory obligations that follow. On this basis, it is not appropriate to characterize a notice of rescission as a “step taken in a proceeding” or even in an “intended proceeding.” The notice of rescission is more properly characterized as a business letter that triggers certain statutory obligations upon the franchisor.

Some franchisees may opportunistically interpret applicable suspension orders as extending the time period for delivery of a notice of rescission. Franchisors that receive a notice of rescission after the suspension order has been lifted should therefore carefully consider the timeliness of such notice.

6. *Protect your supply chain by monitoring the solvency of your suppliers*

Financial distress is a reality for many in the COVID-19 environment. Financial distress of suppliers can create a number of issues for franchisors, including interruptions in the supply chain, loss of product and loss of deposits, among other things. If insolvency proceedings are commenced in respect of a supplier under one of Canada's insolvency statutes, a franchisor may become an unwilling participant in such proceedings, which can increase legal costs and expenses for franchisors.

Franchisors should consider proactively monitoring the solvency of their suppliers by keeping note of:

- Delays in delivery of orders of supplies;
- Cutbacks in supplier services;
- Requests to alter payment terms in supply contracts or other desperate communications;
- Unresponsiveness to communications;
- Delivery to the franchisor of garnishments or other demands from the creditors of the supplier;
- Tax liens registered against the supplier or its assets;
- Personnel/leadership changes; and
- Industry rumours.

Franchisors should consider taking steps to proactively manage supplier solvency issues by properly structuring supply agreements to:

- Provide for payment upon delivery instead of in advance;
- Take immediate delivery of supplied goods instead of storing purchased goods with the supplier;
- Allow the franchisor to seek other suppliers if production is disrupted;
- Include clear termination and "no assignment" clauses in such agreements; and
- Grant the franchisor a license to any key process or technology of the supplier.

If an insolvency proceeding is commenced with respect to a supplier, the type of proceeding will impact whether a supplier will continue to supply during the proceeding and whether it may be able to honour its warranty obligations. Franchisors should proactively seek legal advice in these circumstances in order to better protect their interests.

7. *Guard against fraud when purchasing goods during the pandemic*

As the COVID-19 pandemic rages on internationally, fraudsters are pivoting their strategies to cash-in on the supply chain disruptions experienced by businesses and governments alike with respect to the sourcing of certain goods. Franchisors should closely monitor supply chains to ensure that their franchisees are able to

meet their customer demands. Given these disruptions, franchisors and their franchisees may be forced to source goods from new suppliers. In this environment, it is critically important to vet new suppliers carefully, particularly where it will be difficult to inspect the goods before shipment.

Fraudsters may be offering counterfeit goods (i.e. goods made or sold under another company's brand name without the brand owner's authorization) which are typically of inferior quality, or grey market goods (legitimately branded goods but approved for sale in another jurisdiction), either of which may not meet regulatory standards concerning health and safety for those goods in the franchisor's jurisdiction(s). Fraudsters may also be falsely claiming to be affiliated with large, well-known businesses with established and reputable brands^[5].

Franchisors should complete stringent due diligence when negotiating an agreement with a new supplier, to make sure that:

- i. the source is reputable and reliable and that the goods will actually be provided to the franchisor and its franchisees;
- ii. the goods are legitimate, not counterfeit and meet all applicable standards in the franchisor's jurisdiction(s); and
- iii. the delivery will be on time.

If possible, the franchisor should arrange for physical inspection of the goods by a trusted and knowledgeable agent before they are shipped. For example, recently, a union's announcement of a new supplier ultimately revealed a counterfeit producer of personal protective equipment, which have been and are in great demand during this COVID-19 crisis^[6].

Obviously, the supply of counterfeit, inferior and substandard goods to franchisees and their subsequent sale of such goods may pose a threat to public health and safety and could materially damage the reputation and goodwill of the franchise system brand^[7]. As the old adage goes – "if it sounds too good to be true, it probably is".

8. Consider updating your franchise disclosure document

While franchise legislation in Canada does not explicitly require a franchise disclosure document (FDD) to describe information about unique market or economic conditions, such as those triggered by the COVID-19 pandemic, the legislation does require franchisors to disclose all "material facts". A "material fact" includes any information about the business, operations, capital or control of the franchisor or franchisor's associate, or about the franchise system, that would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the decision to acquire the franchise. System changes triggered by the

COVID-19 pandemic may constitute “material facts” but may also impact disclosure regarding prescribed information, such as information about franchisee training and the regulatory framework under which the system operates. Failing to disclose all “material facts” or other prescribed information can form the basis of a franchisee rescission claim and/or a claim for damages for misrepresentations contained in the FDD.

While a franchisor’s disclosure obligations likely do not rise to the level of requiring it to speculate on the long-term economic effects and possible impacts such effects may have on the franchise system, franchisors must carefully consider whether their FDD ought to include new information arising from the current pandemic. For instance, the pandemic has undoubtedly impacted how franchisees operate their franchise business, reduced performance and even caused insolvency events or closures. It has likely also caused franchisors to make or plan for system-wide changes, such as implementing new policies, practices or processes, suspending programs, instituting new relief measures or altering existing supply chain arrangements. Some Canadian jurisdictions with franchise legislation also require the FDD to include information about any licence, registration, authorization or other permission that the franchise requires to operate. The FDD must also describe all training and other assistance provided to franchisees. Franchisors should stay current on regulatory orders from all levels of government and consider whether any necessitate changes to their FDD. If changes in the manner or type of training provided to franchisees have occurred due to the pandemic, such information should also be disclosed in the FDD.

The FDD must contain information that is current at the time it is delivered to a prospective franchisee. As the circumstances surrounding the COVID-19 pandemic are evolving on a daily basis, franchisors should frequently re-visit and update their FDD. The franchisor should carefully monitor for “material changes” that occur after delivering the FDD (but prior to the prospective franchisee signing the franchise agreement), as the franchisor will need to issue a statement of material change in such circumstances in order to comply with legislative requirements.

9. Update health and safety policies

In light of the global pandemic, franchisors are reviewing and updating their health and safety policies to address COVID-19 specific issues, but also with a view to enhancing policies and procedures on a going forward basis. This process involves reconsidering protocols, processes and persons involved at all levels of a franchise system, from the franchisor’s employees and service providers to the ultimate customers serviced by franchisees. In many jurisdictions, governments have issued guidance and new regulations that should be taken into account when policies are updated.

Some key recommendations for updating health and safety policies include:

- i. reviewing the legal rights and mechanisms available (in franchise agreements and operations manuals)

- for both implementing and monitoring system changes;
- ii. communicating with franchisees regarding the rationale and legal framework for proposed changes;
 - iii. consider consultation with franchisees for input and feedback (before and after implementation);
 - iv. recording proposed changes with robust legal documentation that addresses all legal concerns associated with the system change and monitoring; and
 - v. observing applicable franchise laws, such as the obligation to act in good faith toward franchisees, to minimize the risk of later claims. Some of the items in this bullet list can assist franchisors in satisfying their obligation to act in good faith.

With respect to (iv), above, the legal terms should allow for flexibility to, among other things, permit further updates, and should adequately cater to the ever-changing legal environment (for example, mandated closures of non-essential services businesses).

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[1] For additional details, please refer to: [The Canada Emergency Wage Subsidy](#)[ps2id id='1' target='']

[2] For additional details, please refer to: [Federal Government Relief Programs](#)[ps2id id='2' target='']

[3] For additional details, please refer to: [Rent Relief for Small Businesses Commercial Landlords](#)[ps2id id='3' target='']

[4] For additional details, please refer to: [CRA covid-19 Filing Payment Dates and CRA covid-19 Frequently Asked Questions](#)[ps2id id='4' target='']

[5] See "[3M Files Suit Against Alleged Counterfeit PPE in Canada](#)"[ps2id id='5' target='']

[6] See "[39 million masks never materialized at hospitals, sparking a federal investigation](#)"[ps2id id='6' target='']

[7] See "[COVID-19: From counterfeit medical masks to fake treatments, criminals cashing in on pandemic panic](#)"[ps2id id='7' target='']

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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