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Recent Developments in Franchising and Distribution Law

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September 12, 2012

Four Recent Significant Franchise Cases

1. The one-year term/no franchise fee exemption from the disclosure requirements under the Act;
2. Franchisor pricing of goods and the duty of good faith;
3. The validity of a release given by a franchisee to preclude claims against franchisors; and
4. The duty of franchisors to promote and enhance their brands.

1. DODGING THE DISCLOSURE DOCUMENT REQUIREMENT - THE ONE-YEAR TERM/NO FRANCHISE FEE DISCLOSURE EXEMPTION

The *Arthur Wishart Act (Franchise Disclosure), 2000,* S.O. 2000, c. 3 (the "Act") requires franchisors to provide a disclosure document at least 14 days before the franchisee signs any agreement or makes any payment:

> 5.(1) A franchsior shall provide a prospective franchisee with a disclosure document and the prospective franchisee shall receive the disclosure document not less than 14 days before the earlier of,
>
> (a) the signing by the prospective franchisee of the franchise agreement or any other agreement relating to the franchise; and
>
> (b) the payment of any consideration by or on behalf of the prospective franchisee to the franchisor or franchisor's associate relating to the franchise.

1. DODGING THE DISCLOSURE DOCUMENT REQUIREMENT - THE ONE-YEAR TERM/NO FRANCHISE FEE DISCLOSURE EXEMPTION

One exemption to the disclosure obligation, contained in section 5(7)(g)(ii) of the Act, provides that no disclosure document is required if the franchise agreement is not valid for longer than one year and does not involve the payment of a non-refundable franchise fee:

> 5.(7) This section does not apply to…
>
> (g) the grant of a franchise if…
>
> (ii) the franchise agreement is not valid for longer than one year and does not involve the payment of a non-refundable franchise fee.

1. DODGING THE DISCLOSURE DOCUMENT REQUIREMENT - THE ONE-YEAR TERM/NO FRANCHISE FEE DISCLOSURE EXEMPTION

In October of 2011, the Ontario Court of Appeal released its decision in *TA & K Enterprises Inc. v. Suncor Energy Products Inc.* (2011), ONCA 613 (CanLII).

This is the first reported decision that considers the one-year term/no franchise fee disclosure exemption contained in the Act – and it represents a significant victory for franchisors.

1. DODGING THE DISCLOSURE DOCUMENT REQUIREMENT - THE ONE-YEAR TERM/NO FRANCHISE FEE DISCLOSURE EXEMPTION

Implications of the *TA & K Enterprises Inc. v. Suncor Energy Products Inc.* decision:

1. To take advantage of the one-year term/no franchise fee exemption, the franchise agreement should be **expressly limited to a term of twelve months or less and should not automatically renew**. Enter into new franchise agreements every year.

2. Ensure that there are **no upfront fees required** to be paid by the franchisee that could be characterized as payments made for the right to acquire the franchise. In other words, make sure royalty fees are just that – royalty fees.

3. It provides **some judicial support** for the argument that payments made by distributors to suppliers for products at *bona fide* wholesale prices are sufficient to make distributors "franchisees" under the Act.

2. FRANCHISOR PRICING OF GOODS AND THE DUTY OF GOOD FAITH

In February of this year, the Ontario Superior Court released its decision in *Fairview Donut Inc. v. The TDL Group Corp.* (2012), ONSC 1252 (CanLII).

This is an important decision with wide-ranging ramifications for franchisors.

2. FRANCHISOR PRICING OF GOODS AND THE DUTY OF GOOD FAITH

Two Tim Hortons' franchisees commenced a proposed class action for $2 billion. In short, the plaintiffs alleged that two operational changes made by Tim Hortons to the franchise system significantly eroded the ability of franchisees to earn profits.

Specifically, Tim Hortons required its franchisees to do two things:

1. Switch from scratch baking donuts to a new par-baking method; and

2. Make lunch items, including soups and sandwiches, available for sale at all times when the stores are open.

2. FRANCHISOR PRICING OF GOODS AND THE DUTY OF GOOD FAITH

Implications of the *Fairview Donut Inc. v. The TDL Group Corp.* decision:

1. Ensure that your franchise agreements contain **express provisions** stipulating that the franchisor is **not required to sell** products to franchisees **at the price paid by the franchisor** and that the franchisor is entitled to profit, and **not pass on rebates** to franchisees, in setting its prices.

2. The decision is **helpful to franchisors in defending loss leader or other legitimate pricing strategies** that are most effective if implemented uniformly across the system.

3. The duty of fair dealing **does not trump** the franchise agreement. Rather, the relevant inquiry is whether the franchisor's conduct, taken as a whole in the context of the contract agreed to by the parties, demonstrates good faith and fair dealing. The court emphasized that the changes Tim Hortons made to its franchise system were rational business decisions made for valid and economic reasons, and were made **after consulting with franchisees** before implementing the changes.

3. THE VALIDITY OF A RELEASE GIVEN BY A FRANCHISEE TO PRECLUDE CLAIMS AGAINST FRANCHISORS

In March of this year, the Ontario Superior Court decided *Dodd v. Prime Restaurants of Canada Inc.* (2012), ONSC 1578 (CanLII).

3. THE VALIDITY OF A RELEASE GIVEN BY A FRANCHISEE TO PRECLUDE CLAIMS AGAINST FRANCHISORS

The plaintiffs (who operated an East Side Mario's restaurant as a franchisee) assigned their company into bankruptcy and the defendant franchisor took over operating the restaurant.

The plaintiffs and defendant entered into a mutual release providing that:

1. both parties would release each other from all debts, claims and actions.

2. the defendant would pay the plaintiffs' interest on debt owing, and use its best efforts to find a buyer for the restaurant that would assume the debt and to have the lender release the plaintiffs from the debt obligation.

3. THE VALIDITY OF A RELEASE GIVEN BY A FRANCHISEE TO PRECLUDE CLAIMS AGAINST FRANCHISORS

A few weeks after signing the release, however, the plaintiffs served a notice of rescission of the franchise agreement and subsequently commenced an action against the defendant for breach of contract, misrepresentation and rescission.

3. THE VALIDITY OF A RELEASE GIVEN BY A FRANCHISEE TO PRECLUDE CLAIMS AGAINST FRANCHISORS

Implications of the *Dodd v. Prime Restaurants of Canada Inc.* decision:

1. Ensure that the franchisee understands, and **expressly acknowledges** his/her understanding of, the claims that they have and that the release will bar those claims in future.

2. Insist that the franchisee obtain **independent legal advice about** the meaning and implications of the release and confirm that ILA was obtained in the release.

3. Make sure the franchisee acknowledges in the release that the settlement terms **are not unfair or improvident** and that it bargained freely, knowingly and without any imbalance of bargaining power.

4. THE FRANCHISOR'S DUTY TO PROMOTE ITS BRANDS

In *Bertico Inc. et al. v. Dunkin' Brands Canada Ltd.* (2012), QCCS 2809 (CanLII), a decision released by the Quebec Superior Court in June of this year, the Court held that a franchisor is required to promote its brand, fight off competitors and protect its market share for the benefit of the franchisees.

The decision has the potential to become a landmark decision that imposes additional obligations on franchisors and that develops new law in the area of franchisor-franchisee relations.

4. THE FRANCHISOR'S DUTY TO PROMOTE ITS BRANDS

The Court relied upon provisions in the franchise agreement and the preamble of a subsequent amendment to conclude that the franchisor "had assigned to itself the principal obligation of protecting and enhancing its brand".

The most significant of these provisions was a section in the franchise agreement that provided:

> [The franchisor agrees] to continue its efforts to maintain high and uniform standards of quality, cleanliness, appearance and service at all DUNKIN DONUTS SHOPS, thus ***protecting and enhancing the reputation of*** DUNKIN DONUTS CANADA, DUNKIN DONUTS OF AMERICA INC. ***and the demand for the products*** of the DUNKIN DONUTS SYSTEM and, to that end, to make reasonable efforts to disseminate its standards and specifications to potential suppliers of the FRANCHISEE upon the written request of the FRANCHISEE (emphasis added).

4. THE FRANCHISOR'S DUTY TO PROMOTE ITS BRANDS

Beyond finding that the franchisor was expressly required to protect its brand, the Court also held that franchisors are bound by implied obligations which are "incident to" franchise agreements by their nature, confirming that:

> The franchisor is bound to furnish to its franchisees any tools necessary to, if not prevent economic losses, at least minimize their impact on the franchisees. ... the franchisor must act in concert with the franchisees ***to develop an adequate commercial response allowing the franchisees to minimize their losses and to reposition their business in an evolving market*** (emphasis added).

4. THE FRANCHISOR'S DUTY TO PROMOTE ITS BRANDS

Implications of the *Bertico Inc. et al. v. Dunkin' Brands Canada Ltd.* decision:

1. The decision arguably, and dramatically, **expands the scope of liability** for franchisors – both inside and outside of Quebec.

4. THE FRANCHISOR'S DUTY TO PROMOTE ITS BRANDS

Implications of the *Bertico Inc. et al. v. Dunkin' Brands Canada Ltd.* decision:

2. It is **difficult to draw a bright line** around the type of **conduct or inaction that will result in liability**, and that which will not. Among other things, the *Dunkin'* case does not demarcate, among other things:

    - When the principle that franchisors are not the insurers or guarantors of the success of their franchisees (as the Court at least recognized) gives way to franchisors being held liable for their failure to adequately promote the franchise system;
    - How much market share must be lost for a court to conclude that the franchisor failed to address the problem or failed to adequately promote its brand for the benefit of franchisees; or
    - What specifically must a franchisor do to demonstrate that it has complied with its obligations to promote the brand, particularly when the franchisor suffers a loss of market share to a competitor despite its efforts to address same.

4. THE FRANCHISOR'S DUTY TO PROMOTE ITS BRANDS

Implications of the *Bertico Inc. et al. v. Dunkin' Brands Canada Ltd.* decision:

3. **Can franchisors protect themselves** against similar claims by including exculpatory language in their franchise agreements?

   There are **significant enforceability issues** regarding any such clauses for at least two reasons:

   i. First, the Dunkin' Donuts case arguably provides that, even in the absence of an express contractual provision obliging the franchisor to promote and enhance the brand, franchisors are required to do so implicitly by the very nature of a franchise agreement. Any clause that endeavours to remove or restrict this fundamental implicit obligation can be expected to be **viewed negatively by the courts**; and

   ii. Second, franchisees will attack the enforceability of these types of clauses by claiming that they are **unconscionable, unfair or against public policy**, and because they are **void by virtue of s. 11 of the *Arthur Wishart Act***, which voids any "purported waiver or release by a franchisee of any right given" under the Act.

The Law On Inadvertent Franchisors

Where Are We Today?

The Problem and The Issue

- Certain business relationships are not typically considered franchisor-franchisee relationships in the business world: dealerships; distributorships; or the granting of a license.

- Under what circumstances can these business relationships be subject to the *Arthur Wishart Act*?

The Question That Must be Asked

- The *Arthur Wishart Act (Franchise Disclosure), 2000,* S.O. 2000, c. 3 (the "Act") defines a *franchisor* as one or more persons who grant or offer to grant a *franchise*.

- What is a franchise?

- The complete answer is under section 1(1) of the Act

What is a Franchise: The 'Short' Answer

1. A right to engage in a business where the franchisee is required, by contract or otherwise, to make or commit to make a payment or continuing payments to the franchisor as a condition of acquiring the business or in the course of its operation;

AND WHERE EITHER

2. (a) (i) the franchisor grants the franchisee *the right to* sell/offer for sale/distribute goods or services that are substantially associated with the franchisor's trade-mark, service mark, trade name, logo or advertising or other commercial symbol; **AND**

(ii) the franchisor exercises significant control over, or offers significant assistance in, the franchisee's method of operation (ie- location, marketing, training).

OR

(b) (i) the franchisor grants the franchisee *the representational or distribution rights to* sell/offer for sale/distribute goods or services supplied by the franchisor; **AND**

(ii) the franchisor, or any designated third person, provides location assistance (including securing retail outlets).

In Other Words a Franchise is…

1. Where a franchisor grants a right to engage in a business to a franchisee in exchange for payment(s) (the "Payment");

AND WHERE EITHER

2. (a) The franchisor grants the franchisee the right to sell or distribute goods or services associated with its commercial marks and symbols AND exercises control over or offers significant assistance in the franchisee's method of operation (the "Right to Sell/Control").

OR

(b) The franchisor grants the franchisee the representational or distribution rights to sell or distribute goods or services supplied by the franchisor AND provides location assistance (the "Right to Distribute/Assist") .

Three Categories of Case Law Consideration

– There is limited case law defining the parameters of what types of business relationships may be deemed ‘franchises’ under the Act

1. Category 1 – Cases Where the Existence of a Franchise was Not Contested;
2. Category 2 - Cases Where the Existence of a Franchise was a Triable Issue;
3. Category 3 – Cases Where the Definition of Franchise is Interpreted.

Category 1 – Cases Where the Existence of a Franchise Was Not Contested

– Cases where the parties may not have contemplated that they were entering into a franchise relationship when the relationship started, but where they did not contest it being deemed as such by operation of the Act in Court.

1. *Payne Environmental Inc. v. Lord & Partners Ltd.* (2006), 14 BLR (4th) 117 (Ont Sup Ct)
   - The plaintiff was granted an exclusive right to promote the defendant manufacturer's environmentally-friendly products;
   - Franchisor-franchisee language was absent from negotiations and the agreement;
   - The plaintiff was not provided with a disclosure document and brought a motion for summary judgment, which was successful;
   - The defendant did not dispute that the Act applied to the relationship

Category 1 – Cases Where the Existence of a Franchise Was Not Contested

2. *Paul Sadlon Motors Inc. v. General Motors of Canada Ltd.,* 2011 ONSC 4432 (Ont Sup Ct)
   - The plaintiff car dealer's motion for an interlocutory injunction enjoining the defendant from implementing changes was dismissed;
   - No specific finding as to whether the General Motor's ("GM") dealership agreements make reference to 'franchisor-franchise' language;
   - No specific reference to the application of the Act in this motion but the Court assumed a franchisor-franchisee relationship;
   - GM did not dispute for the purposes of the motion that it was subject to a duty of good faith and fair dealing under the dealership agreement.

Category 1 – Cases Where the Existence of a Franchise Was Not Contested

3. *Stoneleigh Motors Ltd. v. General Motors of Canada Ltd.,* 2010 ONSC 1965, 71 BLR (4th) 271 (Ont Sup Ct)
   - The plaintiff car dealer's motion for a stay of proceedings was dismissed, whereas the motion to strike was granted in part;
   - Action brought by a plaintiff class of car dealers alleging that GM violated the duty of fair dealing and to act in good faith;
   - In its Statement of Defence and Motion Record GM denied that the Act applied, arguing that it did not require a Payment or exercise significant control over or offer significant assistance in the method of operation;
   - For the purposes of the motion only, and without prejudice, GM agreed that the dealer agreements were franchise agreements.

Category 2 - Cases Where the Existence of a Franchise was a Triable Issue

– Cases where the issue as to whether a franchisor-franchisee relationship existed was not assumed for the purposes of the motion but where the Court considered whether it was a triable issue.

1. *674834 Ontario Ltd. v. Culligan Canada Ltd.* (2007), 28 BLR (4th) 281 (Ont Sup Ct)
   - The plaintiff bottled water distributor was granted an interlocutory injunction restraining the defendant manufacturer and licensor of water-related products from terminating distribution rights until trial;
   - The defendant manufacturer denied that its trademark license agreement was the same as its standard form franchise agreement;
   - The Court considered indicia that suggested the plaintiff was a franchisor and others that suggested it was a distributor and decided that there was a serious issue to be tried.

Category 2 - Cases Where the Existence of a Franchise was a Triable Issue

2. *Tupperware Canada Inc. v. 1196815 Ontario Ltd.* (2008), 164 ACWS (3d) 614 (Ont Sup Ct)
   - The plaintiff distributor brought a motion for summary judgment on an action to collect on a promissory note, whereas the defendant operators counterclaimed for a declaration that the distributorship agreement was a franchise agreement;
   - The plaintiff and defendants agreed that this issue was a genuine triable issue.

Category 2 - Cases Where the Existence of a Franchise was a Triable Issue

3. *Hino Truck Centre (Toronto) Ltd. v. Hino Motors Canada Ltd.,* 2009 CarswellOnt 6584 (WL Can) (Ont Sup Ct)
   - The defendant truck manufacturer/seller brought a motion for summary judgment against its dealer for moneys owing on the sale of a truck fleet, whereas the plaintiff dealer sought damages for improper termination of the dealer agreements;
   - The Court granted the motion for summary judgment on the debt but decided that the question of whether the Act applied and the defendant owed a duty of good faith to the plaintiff dealer was an issue for trial;
   - The defendant relied upon: *1323257 Ontario Ltd. v. Hyundai Auto Canada Corp.* (2009), 55 BLR (4th) 265 (Ont Sup Ct).
   - Enforcement of the judgment was stayed;

Category 2 - Cases Where the Existence of a Franchise was a Triable Issue

4. *Trillium Motor World Ltd. v. General Motors of Canada Ltd.,* 2011 ONSC 1300 (Ont Sup Ct)
   - The plaintiff car dealers commenced an action against the defendant manufacturer for breach of the duty of fair dealing, right of association and the franchisor's disclosure obligation;
   - One issue was whether the Wind-Down Agreements ("WDA") signed by the plaintiff car dealers were franchise agreements;
   - The plaintiff car dealers successfully brought a motion for certification of a proposed class action, whereas the defendant law firm failed in its motion to stay the action as against it. The issue was to go to trial;
   - GM has historically maintained that dealership agreements are not franchise agreements and that the relations between GM and its dealers are not subject to the Act;
   - GM admits in the motion that its relations with these dealers are subject to the Act, but denies that the WDA is a franchise agreement.

Category 3 – Cases Where the Definition of "Franchise" is Interpreted

– Cases where the Court considers the definition of 'franchise' to determine if each element is satisfied on the facts of the case.

1. *Ahmed v. 3 for 1 Pizza & Wings (Canada) Inc.,* 2004 CarswellOnt 255 (WL Can) (Ont Sup Ct)
   - A successful motion by the pizza business operator for an order granting rescission of the management agreement, as a franchise agreement subject to the Act, on the basis of non-disclosure;
   - The Court finds:
     - The operator was granted a right to carry on the business for a one-year term renewable at their option in exchange for a $30,000 security deposit;
     - The operator was required to use distinctive labels, designs, trademarks, products and advertising material for the business model, licensed through an intermediary corporation;
     - Significant control was exercised over the business on product approval, quality standards, business hours and the appearance and training of employees.

Category 3 – Cases Where the Definition of "Franchise" is Interpreted

2. *Di Stephano v. Energy Automated Systems Inc.,* 2010 ONSC 493, 68 BLR (4th) 209 (Ont Sup Ct)
   - The defendant manufacturer successfully brought a motion for a stay of the proceeding wherein the Ontario 'distributors' sought a declaration that the reseller and dealer agreements were subject to the Act and further sought rescission for non-disclosure;
   - The Court considered the definition of 'franchise' and found:
     - The plaintiff distributors were required to pay $30-40,000 for training if they wished to be granted the right to sell the defendant's branded products, which satisfied that part of the definition;
     - The mandatory 5-day initial training program, limitation on selling competing products and grant of non-exclusive territory were not found to be a sufficient basis to find significant control or assistance being exerted over the distributors;
     - It was not ongoing assistance provided over the duration of the agreement, as required by the Act. The training program was about learning about the product and not any particular method of operating the business.

Category 3 – Cases Where the Definition of "Franchise" is Interpreted

2. *1706228 Ontario Ltd. v. Grill It Up Holdings Inc.,* 2011 ONSC 2735 (Ont Sup Ct)
   - The plaintiff purchased a fast food restaurant in a mall from the defendant. The parties entered into a sublease, license agreement and asset purchase agreement. The plaintiff refused to sign a draft franchise agreement and the transaction did not close;
   - The Court found that the definition of 'franchise' was satisfied;
   - The plaintiff obtained a judgment for the rescission of each agreement under the Act on the basis of non-disclosure;
   - The Court considered the definition of 'franchise' and found:
     - The plaintiff paid over $112,000 in deposits and license fees to the defendant and in exchange the defendant granted the plaintiff the right to sell food that, under the license agreement, was substantially associated with the restaurant name and trademark;
     - The defendant did not exercise control over the plaintiff but did offer significant assistance with respect to the restaurant's construction, design, equipment, location, menu, training and branding.

Franchises in Financial Distress

Dealing With Franchises in Financial Distress

- Things to consider:
  - What is the root cause of the franchisee's financial woes?
  - What does the franchise agreement say? Defaults? Termination rights?
  - Does the Franchisor supply the Franchisee on credit?
  - Does the Franchisor have security? Is it perfected?
  - What are the leasing arrangements? Is the Franchisor liable for rent obligations?

Dealing With Franchises in Financial Distress (Cont'd)

- Risks to Franchisors in insolvency proceedings:
  - Stay of termination rights
  - Forced assignment of franchise agreement
  - Forced assignment of subleases

Dealing With Franchises in Financial Distress (Cont'd)

- Risks to Franchisors in insolvency proceedings:
  - Risk of damage to brand in a liquidation
  - Franchisor may need to fund "soft-landing" for franchisee
  - Secured creditors and other priority claims

Questions?

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