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Franchise Law Webcast:
Trends Affecting Franchise Systems
Operating in Canada

April 25, 2019

McMillan LLP

Vancouver
Calgary
Toronto
Ottawa
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Speakers

Moderator

- John Clifford, Partner

Panelists

- Brad Hanna, Co-Chair, Dispute Resolution, Franchise and Distribution, International Arbitration
- Mitch Koczerginski, Associate
- Andrae Marrocco, Co-Chair, Franchise and Distribution
- Adriana Rudensky, Associate

Topics for Discussion

- Overview of Franchise Legislation in Canada
- Accidental Franchise
- Deficient Disclosure May Lead to Rescission of Franchise Agreement
- Disclosure and Drafting Tips following Raibex
- Disclosure Pain Points for Foreign Franchisors
- Modernizing the Franchise Agreement
- Cybersecurity Issues
- Damages Upon Rescission
- Territory Encroachment
- Termination Issues
- Franchise Sales
- Franchise M&A Transactions
- Restrictive Covenants



Overview of Franchise Legislation in Canada

Mitch Koczerginski



Overview of Franchise Legislation in Canada

Provincial Legislation

- There are currently six (6) provinces that have enacted franchise-specific legislation:
 1. Alberta;
 2. Ontario;
 3. Prince Edward Island;
 4. New Brunswick;
 5. Manitoba; and
 6. Most recently, British Columbia.
- Each provincial franchise statute requires franchisors to provide prospective franchisees with a disclosure document at least 14 days before the prospective franchisee signs any agreement or pays any money to the franchisor.
- The disclosure document is intended to provide prospective franchisees with sufficient information to make informed business decisions about whether to become a franchisee.

Overview of Franchise Legislation in Canada

Disclosure

This pre-sale disclosure regime is one of the most significant aspects, and the primary focus, of Canadian franchise legislation.

Each statute also contains two (2), basic “relationship” provisions:

1. Duty of fair dealing in its performance and enforcement of the franchise agreement; and
2. the right of franchisees to associate with each other.



Accidental Franchise

Adriana Rudensky



Accidental Franchise

Although most provincial statutes have a similar test for what constitutes a franchise, the main elements that must be present are the payment element, the association element and the control element.

1. The Payment Element:

- The franchisee is required to make a payment or continuing payments, or has a commitment to make a payment, to the franchisor or its associate, in the course of operating the business or as a condition to acquiring the franchise.

2. The Association Element:

- The franchisor grants the franchisee the right to sell or distribute goods or services that are substantially associated with a trade-mark, trade name, logo or advertising or other commercial symbol owned by or licensed to the franchisor or the franchisor's associate.

3. The Control or Assistance Element:

- The franchisor or its associate exercises, or has the right exercise, significant control over, or provide significant assistance in, the franchisee's method of operation, including building design and furnishings, locations, business organization, marketing techniques or training.

Accidental Franchise

What to do if you have an accidental franchise and haven't been complying with Canadian franchise legislation?

In such circumstances you have a few options:

1. See if your business qualifies for an exemption from either the disclosure obligations under franchise legislation or from the application of the legislation altogether. Use with caution as exemptions are narrowly construed.
2. Check to see whether the two-year period for bringing rescission claims has expired.
3. Discuss other ways to mitigate the risk of rescission and loss with your legal counsel, such as terminating existing agreements and obtaining a release or providing late disclosure.



Deficient Disclosure May Lead to Rescission of Franchise Agreement

Mitch Koczerginski

Deficient Disclosure May Lead to Rescission of Franchise Agreement

Rescission

- Franchisors must provide prospective franchisees with a disclosure document that contains all “material facts” necessary to permit the franchisee to make an informed decision to invest in the franchise.
- The remedy of choice for most franchisees is to rescind the franchise agreement:
 1. Within 60 days after receiving the disclosure document, if the franchisor failed to provide the disclosure within the time specified by the legislation, or if the disclosure did not meet certain prescribed requirements.
 2. A franchisee can rescind the franchise agreement within two years if the franchisor never provided the disclosure document.
- In cases where a disclosure document is found to be deficient, it will not matter whether the franchisee actually based its decision to invest in the franchise on the deficient disclosure document. The franchisee will be permitted to rescind within the applicable time period.

Deficient Disclosure May Lead to Rescission of Franchise Agreement

There is a growing body of case law developing in which technical deficiencies are considered fatal.

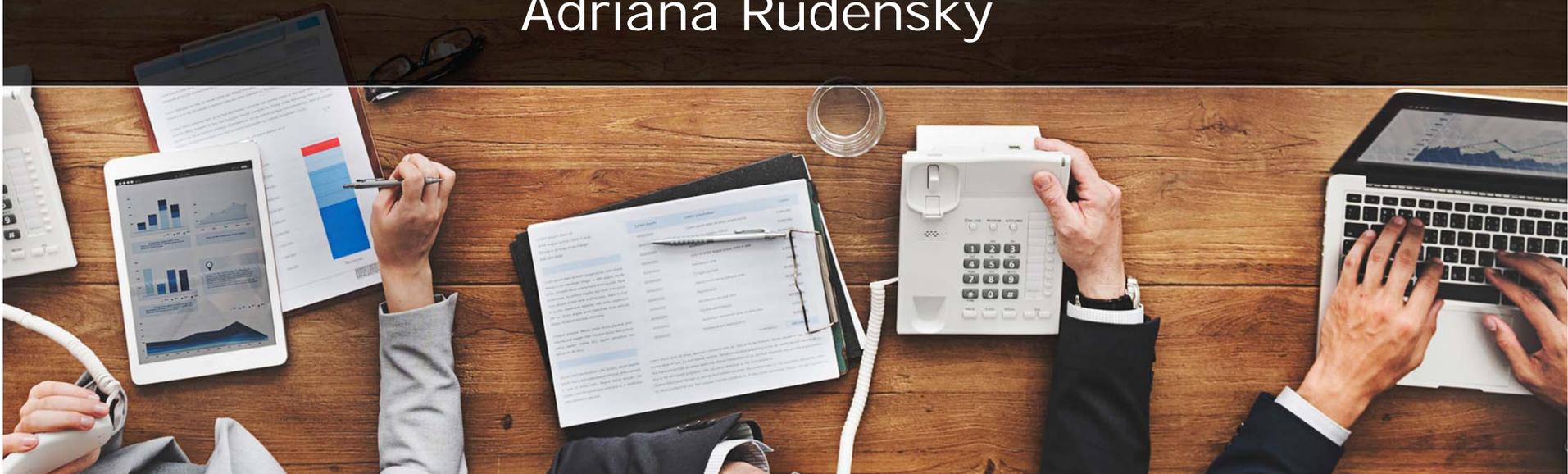
- Examples:

1. Failure to deliver a disclosure document as one document at one time;
2. Failure to include a copy of the offer to lease or a known head lease; and
3. Failure to include a certificate signed by an officer or director (or if there is more than one, then the signature of two officers or directors is required).



Disclosure and Drafting Tips following Raibex

Adriana Rudensky



Disclosure and Drafting Tips following Raibex

- While the outcome of the Raibex case is highly fact-specific, there are a couple drafting tips that can be gleaned from the appeal decision that may contribute to a court's finding that disclosure was adequate:
 1. The franchise agreement includes a collaborative site selection process between the franchisee and franchisor that constrains the franchisor's ability to enter into a lease without considering the franchisee's legitimate interests.
 2. The franchise agreement allows the franchisee to 'opt-out' of the lease or the franchise agreement if the parties cannot agree on a site.
 3. If drafting a refund provision in connection with the franchisee's exercise of an opt-out, limit amounts that reduce the amount refunded so that the franchisee is made closer to whole.
 4. Include strongly worded cost disclaimer language in your FDD, such as warning the franchisee that cost estimates can vary greatly and that the franchisee should maintain a contingency reserve. If you are a foreign franchisor entering the Canadian market and only have estimates based on foreign operations, make sure you identify this.

Disclosure and Drafting Tips following Raibex

- Although not expressly contemplated in Raibex, the decision has also impacted the process for providing adequate disclosure by franchisors by way of a Statement of Material Change or SMC:
 - An SMC is intended to inform a franchisee of any material adverse change following delivery of a FDD but before the franchise agreement is signed or any money is paid by the franchisee.
 - Post-Raibex, as a vehicle for providing a franchisee with all material information needed to make an informed investment decision, SMCs are increasingly being used to disclose new information that is not necessarily adverse to the franchisee's decision. Franchisors should be cautious if adopting this approach.



Disclosure Pain Points for Foreign Franchisors

Adriana Rudensky



Disclosure Pain Points for Foreign Franchisors

What are some of the key disclosure areas in a FDD that foreign franchisors expanding into Canada should pay close attention to?

1. Financial Statements

- Pursuant to Canadian franchise legislation, unless an exemption applies, the Canadian franchisor must include its financial statements in a disclosure document.

2. Earnings Projections

- The only place such information should be provided is in an FDD or if necessary, a statement of material change. Such statements should not be given orally or in a piecemeal/informal fashion after the FDD has been delivered.

3. Lists of Current and Former Franchisees

- The number of Canadian franchisee outlets may impact your disclosure obligations, particularly when purchasing above or below 20 locations in a regulated province or in Canada
- Under Canadian franchise laws, you will need to list all franchisee and franchisor outlets operating in Canada as of the date of disclosure, as well as certain information about locations that have closed in the franchisor's last three fiscal years.



Modernizing the Franchise Agreement

Andrae Marrocco



Modernizing the Franchise Agreement

Three key areas for consideration when modernizing your franchise agreement:

1. Technology
2. System Changes
2. Sophisticated Transactions



Cybersecurity Issues

Andrae Marrocco



Cybersecurity Issues

- Privacy Obligations
- Determining Information Flow and Use
- Cybersecurity Measures



Damages Upon Rescission

Mitch Koczerginski



Damages Upon Rescission

Damages

- When a franchisee is entitled to rescind the franchise agreement – whether within the 60 day or two-year window – the franchisor has to compensate the franchisee for all losses they sustain while operating the franchise and refund anything paid by franchisees over the course of the relationship.
- Specifically, within 60 days of the effective date of rescission, the franchisor must:
 1. Refund any money received from or on behalf of the franchisee (other than money for inventory, supplies or equipment);
 2. Buy back any remaining inventory that the franchisee had purchased pursuant to the franchise agreement at a price equal to the purchase price paid by the franchisee;
 3. Buy back any supplies and equipment that the franchisee had purchased pursuant to the franchise agreement at a price equal to the purchase price paid by the franchisee; and
 4. Compensate the franchisee for any losses incurred in acquiring, setting up and operating the franchise.



Territorial Encroachment

Brad Hanna



Territorial Encroachment

- There are surprisingly a few Canadian cases on the subject.
 - Encroachment claims will only increase in the future as a result of online sales and other delivery models.
1. Not giving your franchisees an exclusive territory will not insulate you from an encroachment claim.
 - If the encroachment substantially nullifies the bargain contracted for by your franchisee, good faith may come to its rescue.
 2. Craft your territory and reservation of rights clauses carefully.
 - Make sure the territory is identified clearly and precisely to avoid disputes about where the boundaries are.
 3. Do an impact study before you permit encroachment.
 - As always, consider the interests of your franchisees when making significant decisions.



Termination Issues

Brad Hanna



Termination Issues

- Your franchise agreement does not fully define your termination rights.
- Your relationship with your franchisees, including your termination rights, is also governed by external forces outside the agreement – most importantly, the statutory and common law duty of good faith and fair dealing.
- The duty of good faith requires franchisors to:
 - Act honestly, reasonably and fairly whenever they interpret, enforce, or exercise any discretionary power under the agreement; and
 - At least consider the interests of their franchisees when making decisions – you have to be mindful of the impact your decision will have on the franchisee.

Termination Issues

5 Tips When Considering Termination

1. Review the history of communications with your franchisee to assess whether there are any ticking time bombs that may compromise your ability to terminate.
2. Ensure that you do not terminate for some collateral purpose.
3. Do not discuss the possible termination of one franchisee with any other franchisees in the network. The franchisee being terminated should always be the first to know of its pending termination.
4. Apply the franchise agreement to your franchisees consistently. When terminating for a particular reason, you should ensure that other franchisees with similar defects in performance have been or are being treated the same way.
5. Have an eye on when the two year rescission window expires when issuing a notice of termination.



Franchisor Sales

Andrae Marrocco



Franchisor Sales

- Strategy and Planning
- Training
- Record Keeping



Franchise M&A Transactions

Andrae Marrocco



Franchise M&A Transactions

- Increased M&A Activity

- Three key areas of inquiry:
 1. The intangible assets

 2. Franchise regulation

 3. Franchisee community



Restrictive Covenants

Brad Hanna



Restrictive Covenants

Before making the decision to enforce a restrictive covenant there are 3 critical things to consider:

1. What does the clause say? The courts will not fix your restrictive covenant if it is ambiguous or overbroad.
2. Are your documents in order?
3. Can you demonstrate that you have a legitimate commercial interest for enforcing the restrictive covenant?



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