FRANCHISE LAW

By Adam Ship

FRANCHISE LAW

Overview

The franchise business model is commonly used in Canada and has experienced significant growth over the last decade. According to the Canadian Franchise Association, the leading national franchise industry group, approximately 1,200 franchised brands operate in Canada through 76,000 franchised units, employing directly or indirectly more than 1.9 million Canadians and generating approximately C$100 billion in annual revenue. Franchising is common across many industries in Canada, including quick-service restaurants, hospitality, home care, automotive retailing, telecommunications retailing, education and beauty/cosmetics.

Foreign franchisors can expand into Canada with or without opening a brand office or incorporating a local subsidiary. These decisions will be driven in large part by tax considerations.

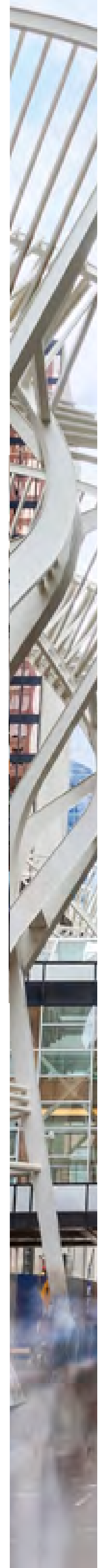
Foreign franchisors often pursue expansion in Canada through master franchising or area development arrangements with Canadian companies that have a track record of successfully bringing foreign brands to the Canadian market. These structures essentially involve the foreign franchisor delegating a number of the roles that it usually plays in its domestic market to the Canadian master franchisee or area developer. A master franchisee will have territorial rights to grant sub-franchises on its own account and will often provide ongoing support to local sub-franchisees. The rights of an area developer, by contrast, are limited to opening multiple units directly or through an affiliate.

Foreign franchisors can also directly franchise in Canada. This involves the foreign franchisor (or its Canadian subsidiary) entering into franchise agreements with individual franchisees for specific units in Canada.

Several areas of Canadian law interact with the franchise business model in specific ways. Below, we focus on the most direct form of legal regulation of franchising in Canada: franchise-specific legislation. We also include a section on Québec.

Franchise-Specific Legislation in Canada

The jurisdiction to regulate franchising is held by Canada's provinces. To date, six provinces have enacted franchise-specific legislation: Ontario,



British Columbia, Alberta, Manitoba, New Brunswick and Prince Edward Island (Statutory Provinces).

While there are subtle differences between the franchise statutes found in the Statutory Provinces, they are largely consistent and focus on pre-sale disclosure. It is common for franchisors in Canada to use national Franchise Disclosure Documents (FDDs) where they grant franchises in more than one Statutory Province. Many franchisors will also voluntarily provide their national FDD to prospective franchises in non-statutory provinces.

A franchisor granting franchises in one of the Statutory Provinces must provide a prospective franchisee with an FDD not less than 14 days before the earlier of either: (i) the signing of the franchise agreement; or (ii) the payment of consideration by the franchisee.

FDDs must contain all material facts, which includes both facts that are specifically prescribed in the regulations passed under the applicable franchise statutes and all other facts that could reasonably be expected to have a significant impact on the value of the franchise or the franchisee's decision to purchase the franchise.

For example, the regulation passed under the Ontario franchise statute currently prescribes more than 25 different categories of information that must be included in an FDD. Some of the key subject areas include: (i) detailed background information about the franchisor, its directors and officers; (ii) upfront costs to the franchisee to establish the franchise; (iii) information concerning the closure of other franchises in the system; (iv) information about specific policies and practices of the franchisor, such as those imposing restrictions on goods and services to be sold and those relating to volume rebates or other financial benefits obtained by the franchisor; (v) information concerning the expenditures of any advertising fund to which the franchise must contribute; and (vi) information concerning territorial rights granted to the franchisee and/or reserved to the franchisor.

The FDD must also include all agreements relating to the franchise, as well as all other material facts beyond those specifically prescribed.

A number of court decisions have interpreted Canadian franchise legislation as requiring an FDD to include facts and information that are material to the individual location being granted to a franchisee, for example: (i) an FDD must include any head-lease entered into between the franchisor and the third-party landlord where the franchisor requires the franchisee to be responsible for the head-lease through a mandatory sublease; and (ii) one court has found an FDD to be deficient where it failed to disclose that the previous owner of the franchise seriously mismanaged the location.

As a result of these and other similar decisions, FDDs in Canada are drafted to include not only facts that are material to the franchisor and the franchise system, but also facts that are material to the individual franchise being granted.

Additionally, every FDD must contain the franchisor's financial statements in either audited or review-engagement form for the most recently completed fiscal year, unless an exemption is available to the franchisor. The FDD can include an opening balance sheet for the franchisor if either the franchisor has been operating for less than one year or 180 days have not yet passed since the end of the franchisor's first fiscal year.

Each of the Canadian franchise statutes currently contains an exemption from the requirement to include financial statements for large, mature franchisors that meet the prescribed criteria.

Where a "material change" occurs between the delivery of an FDD and the signing of the franchise agreement or the payment of consideration, a franchisor must also provide the prospective franchisee with a Statement of Material Change describing those material changes. This must be delivered as soon as practicable after the change has occurred.

Canadian franchise legislation contains a number of exemptions from the requirement to deliver an FDD. There are differences in the exemptions available in the various Statutory Provinces and the courts have generally interpreted the exemptions narrowly. Generally speaking, the exemptions are limited to where: (i) the franchisee already has intimate knowledge of the franchise system; (ii) the financial risk to and investment by the franchisee are very small; or (iii) the franchisee acquires the franchise from a third party without any active involvement of the franchisor.

Statutory rescission is the primary remedy to a franchisee who fails to receive an FDD or who receives a deficient FDD. Statutory rescission gives the franchisee the right to both terminate all franchise and ancillary agreements with the franchisor without penalty or further obligation and substantial financial compensation to put the franchisee back into its pre-sale position.

Given the scope of the rescission remedy, franchisors granting franchises in the Statutory Provinces have strong motivation to ensure their FDDs are fully compliant and up to date each time they are delivered to prospective franchisees. The length of time during which a franchisee may seek rescission depends on the gravity of the deficiency in the FDD: (i) a 60-day limitation period for minor, non-material deficiencies; or (ii) a two-year limitation period for significant deficiencies or failure to provide an FDD.

In addition to pre-sale disclosure, Canadian franchise legislation also establishes reciprocal duties of good faith and fair dealing for parties to a franchise agreement and provides franchisees with the right to associate with one another.

The duty of good faith requires the franchisor to consider the legitimate interests of its franchisees before exercising contractual rights, and imposes a standard of commercial reasonableness on the parties. The application of the duty is highly fact-dependent and there is a large body of case law that has interpreted the duty in the context of different types of franchise disputes.

Franchisors are prohibited from interfering with or restricting franchisees' statutory right to associate with one another in any way and any provision in a franchise agreement that attempts to restrict association between franchisees is void. This provision has been interpreted by Canadian courts to provide franchisees with the right to join together in litigation against the franchisor, for example in a class action.

All Canadian franchise legislation expressly prohibits parties to a franchise agreement from contracting out of or waiving any of the rights or duties contained in such legislation. This means that a foreign franchisor granting franchises in the Statutory Provinces cannot use a choice-of-law clause or any other provision in its franchise agreements to avoid the application of these franchise-specific statutes.

Québec Civil Law

While there is no specific franchise legislation in force in Québec, the Civil Code of Québec (CCQ) may impose substantive obligations on franchisors.

Under the CCQ, “external clauses” (that is, contractual terms and conditions contained in ancillary documents outside the franchise agreement) must be brought to the attention of prospective franchisees at the pre-contractual phase to be enforceable against the franchisees. This may apply to certain provisions of a franchisor’s operations manual which contain what are akin to contractual terms and conditions.

The Québec Court of Appeal has held that the duty of good faith under the CCQ requires a franchisor to bring to the attention of a prospective franchisee any information that might have a decisive impact on the prospective franchisee’s willingness to enter into the franchise agreement (9150-0595 *Québec inc. v. Franchises Cora inc.,* 2013 QCCA 531). This constitutes a form of pre-sale disclosure obligation embedded within the CCQ’s duty of good faith.

Once a franchise agreement has been entered into, the CCQ may also impose substantive implied obligations on franchisors, outside the written terms of the contract. In the franchising context, Québec courts have recognized fairly broad implied duties on franchisors arising from the nature of the franchise relationship, including:

— To inform.

— To provide technical and commercial assistance.

— To co-operate and collaborate.

— Loyalty.

— To respect the other party’s reasonable expectations and commercial interests.

— To treat parties in similar situations consistently.

— To assist a co-contractor in difficulty and mitigate contractual damages despite clear contractual terms.

— To take reasonable measures to maintain the strength and relevance of the brand.

— Not to create false expectations.

— To exercise one’s rights reasonably.

The above duties are owed by a franchisor to each individual franchisee and to the entire network of franchisees. The Québec courts have applied these implied duties to sanction conduct by franchisors, even where the franchise agreement did not expressly prohibit the applicable conduct.

For example, in one of the leading cases on the duty to co-operate in franchising, the franchisor developed a market strategy that put certain of its own corporate stores in direct competition with its franchisees. Nothing in the franchise agreement prevented the franchisor from competing with its franchisees and, in fact, the franchise agreement expressly favoured the franchisor on this issue. However, the Québec Court of Appeal held that the franchisor had breached its "implied obligations which form part of the broader contractual scheme." In the court's view, the franchisor's liability flowed from failing to assist its franchisees in adapting to the system change. The court held that the franchisor, bound by an obligation of good faith and loyalty to its franchisees, had a duty to work with them to prevent economic harm or at least minimize the impact of the system change (*Provigo Distribution inc. v. Supermarché A.R.G. inc.*, 1997 CanLII 10209 (QC CA)).

In 2015, the Québec Court of Appeal applied its earlier decision in *Provigo* in the context of a dispute between franchisor Dunkin Brands and some of its Québec franchisees. Based on the theory of implied obligations and the duty of good faith, the court read into the franchise agreement an implied obligation on the part of the franchisor to protect and enhance its brand and found that the franchisor had failed to do so. The franchisor was found liable for its failure to do anything in the face of the collapse of the brand in the regional market. Rather than respond to the franchisees' concerns regarding its declining brand, the franchisor sought to impose an expensive renovation program and required franchisees to sign a release preventing them from bringing a lawsuit of any kind against the franchisor. The court held that the franchisor had breached its implied duty to its franchisees and awarded substantial damages (*Dunkin' Brands Canada Ltd. c. Bertico inc.*, 2015 QCCA 624). The Québec Court of Appeal's reasoning was cited with approval by the Supreme Court of Canada in 2019 (*Modern Cleaning Concept Inc. v. Comité paritaire de l'entretien d'édifices publics de la région de Québec*, 2019 SCC 28).