

## Franchising - Canada

Transfers triggering disclosure: lessons learned

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In *2189205 Ontario Inc v Springdale Pizza Depot Ltd*<sup>(1)</sup> Ontario's Superior Court of Justice offered further interpretation of the disclosure exemptions outlined in Section 5(7) of the Arthur Wishart Act.<sup>(2)</sup> Adding to the decisions of *1518628 Ontario Inc v Tutor Time Learning Centres LLC*<sup>(3)</sup> and *MAA Diners Inc v 3 for 1 Pizza & Wings (Canada) Inc*,<sup>(4)</sup> *Springdale Pizza Depot* provides new insight into the transfer of franchises, as well as the events that may trigger a disclosure requirement on the part of franchisors.

### **Disclosure exemptions under Arthur Wishart Act**

Under the Arthur Wishart Act, franchisors have an obligation to provide disclosure documentation to prospective franchisees so that they may be fully informed when purchasing a franchise. Nevertheless, Section 5(7)(a) of the act outlines certain exemptions to the disclosure requirement, including when the grant of a franchise is done by a franchisee (ie, a resale), provided that the grant is not "effected by or through the franchisor". Moreover, Section 5(8) of the act clarifies that "a grant is not effected by or through a franchisor merely because the franchisor has a right, exercisable on reasonable grounds, to approve or disapprove the grant".

The importance of compliance with the disclosure requirements is underscored by the applicable penalties - rescission and restitution within 60 days of receiving the disclosure document if the disclosure is incomplete under Section 6(1) of the act, or within two years of signing the franchise agreement under Section 6(2) if the franchisor has provided no disclosure documentation.

### **Background to previous decisions**

On the whole, the disclosure exemptions defined in Sections 5(7)(a) of the act have been narrowly interpreted by the courts. First, in *Tutor Time* a prospective franchisee had purchased the shares of the existing franchisee and, as a prerequisite to its consent, the franchisor had required that the prospective franchisee satisfy a number of conditions, including obtaining a personal guarantee from the spouse of the principal of the prospective franchisee. In its decision, Ontario's Superior Court of Justice held that the franchisor's imposition of these additional conditions had triggered the obligation of disclosure, as the franchisor had exercised a 'power' rather than a 'right, exercisable on reasonable grounds'. As such, the grant became 'effected by or through the franchisor'. Moreover, in *3 for 1 Pizza* the court came to a similar conclusion when a franchisor took an active role in the franchise arrangements with the prospective franchisee. Specifically, all of the meetings between the parties had taken place at the franchisor's offices and the franchisor had prepared all of the contractual documents, the bill of sale and the sub-lease. Therefore, the court concluded that the grant had been effected by or through the franchisor.

### **Facts of *Springdale Pizza Depot***

*Springdale Pizza Depot* involved the resale of a franchise - which had been in operation for over one year - by an existing franchisee to a prospective franchisee. Pursuant to the franchise agreement concluded by the parties, the franchisor's consent was required for the transfer. The prospective franchisee was required by the franchisor to sign several documents, including:

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- an assignment of franchise agreement;
- a guarantee/indemnity;
- a general security agreement;
- a new guarantee;
- a subordination and transfer restriction agreement;
- an undertaking for car wrapping;
- a sub-lease agreement with an affiliate of the franchisor; and
- an acknowledgement.

Within the year following the sale, the purchasing franchisee - who had no prior experience in the operation of franchises - claimed rescission, alleging that the franchisor had failed to provide a disclosure document at the time of the transfer. From the facts described in the decision, it seemed that the existing franchisee provided to the purchasing franchisee the disclosure documentation that the existing franchisee had initially received from the franchisor a year earlier.

In its defence and cross-claim, the franchisor argued that the disclosure documentation required by the act had been provided by the existing franchisee and, subsidiarily, that the exemption in Section 5(7)(a) applied, as it "did not play an active role in the sale of the franchise" and had limited its involvement to its consent of the transaction. The franchisor also argued that the purchasing franchisee had been operating the franchised business, and was given training by the existing franchisee, for one and a half months prior to the purchase and had also been represented by an attorney during the sale. Therefore, the franchisor asserted that the purchasing franchisee had been able to make a clear and informed decision when purchasing the franchise.

### **Decision**

The Superior Court of Justice held that the franchisor's arguments were problematic as they attempted to place the onus of disclosure on the existing franchisee, when the act clearly and unambiguously requires the franchisor to provide the prospective franchisee with a disclosure document. In any event, the court found that the disclosure document provided by the existing franchisee to the purchasing franchisee was materially deficient for the following reasons:

- It had not been updated to reflect the operations of the franchised business during the first year of operations;
- It did not have the updated and audited financial statements of the franchisor;
- It did not include earnings projections;
- It did not contain the head lease with which the prospective franchisee was required to comply; and
- It did not include a certificate signed by the franchisor attesting that all material facts had been disclosed.

The court also dismissed the franchisor's argument that the purchasing franchisee had operated the franchise prior to purchase, as the court reaffirmed that disclosure by the franchisor was mandatory under the act. Finally, the court maintained that the franchisor's reliance on the exemption of Section 5(7)(a) of the act was not supported by the evidence submitted. The court held that by requiring additional documents to be signed, the franchisor had taken an active role in the transfer and had therefore triggered the disclosure requirement. Consequently, the court found that the purchasing franchisee was entitled to exercise its right to rescind the agreement under Section 6(2) of the act.

### **Comment**

In light of the *Tutor Time, 3 for 1 Pizza* and *Springdale Pizza Depot* decisions, it would appear that franchisors must maintain an extremely limited involvement when an existing franchisee transfers or resells a franchise in order to benefit from the exemption in Section 5(7)(a) of the act. Courts seem quick to conclude that the transfer of the franchised business by the franchisee is 'effected by or through' the franchisor whenever a franchisor demands additional verifications or documents from the purchasing franchisee. However, by including the conditions for transfer in the franchise agreement, the franchisor may succeed in arguing that the satisfaction of the requirements is merely an exercise of its contractual rights.

By and large, courts have applied the exemption of Section 5(7)(a) in instances where franchisors have simply engaged in the passive act of approving a transfer and have denied the application of the exemption where the franchisor required that additional conditions be met. Ultimately, franchisors may wish to consider including in their franchise agreements, as an express condition to the approval of a transfer by the existing franchisee, an assumption by the purchasing franchisee of the agreements

and documents originally signed by the transferring franchisee and its principals, rather than requiring the signature of new agreements by the purchasing franchisee and its principals directly with the franchisor or its affiliates. By remaining within the contractually stipulated conditions during the transfer process, and by keeping its distance from the logistics of the transfer process, a franchisor may be in a better position to rely on the disclosure document exemption outlined in Section 5(7)(a).

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#### Endnotes

- (1) 2010 ONSC 3695.
- (2) 2000, SO 2000, c 3.
- (3) 2006 CanLII 25276 (ON SC).
- (4) 2003 CanLII 10615 (ON SC).

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