FRANCHISING - CANADA

Should franchisors avoid entering into franchise agreements before selecting a franchise location?

January 31 2017 | Contributed by Lapointe Rosenstein Marchand Melançon LLP

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Introduction

A recent Ontario Superior Court of Justice decision has created an unprecedented expansion of a franchisor's disclosure obligations, significantly affecting franchisors' disclosure practices when entering into franchise agreements before the franchise location is determined.(1)

The Arthur Wishart Act, Ontario's franchise disclosure statute, requires that a franchisor provide a prospective franchisee with a disclosure document, containing certain prescribed information as well as any material information that would reasonably be expected to have a significant effect on the value or price of the franchise or on the decision to purchase a franchise, at least 14 days before the prospective franchisee signs the franchise agreement. On September 7 2016 the Ontario Superior Court of Justice found that a franchisee, Raibex Canada Ltd, had properly exercised its right of rescission pursuant to Section 6(2) of the Arthur Wishart Act given that the franchisor, ASWR Franchising Corp, and its related entities had failed to disclose certain material information. More specifically, the court found that ASWR had failed to disclose a copy of the principal lease under which Raibex was to be bound and to provide a proper disclosure of development costs relating to the construction of the franchise location, despite such information not being available to ASWR at the time of disclosure.

This case is troubling for franchisors, for which it has been common practice to enter into franchise agreements before selecting a specific location for the franchise.

Facts

In September 2012 Mr Bastaros, the sole director and officer of Raibex, approached ASWR, the franchisor of the AllStar Wings and Ribs franchise, to express an interest in obtaining a franchise. While no specific location was contemplated for the franchise at the time, on October 16 2012 Raibex was provided with a franchise disclosure document which set out an estimate of development costs to build from a shell, but failed to provide an estimate of costs to convert a pre-existing restaurant location. Although the franchise disclosure document suggested that conversion costs would be significantly less than an initial build-out, it indicated that ASWR had "no reasonable means of estimating or predicting those costs with any certainty".(2) The franchise disclosure document also attached certain draft agreements, including a draft sublease said to be the franchisor's standard form, which stated that Raibex would accept all of the terms, covenants, conditions and obligations in the principal lease as negotiated by ASWR as tenant with the landlord. However, no draft of the principal lease was included in the franchise disclosure document.

Two weeks after the franchise disclosure document was delivered, Raibex made a formal application for a franchise, which was submitted along with a preliminary business plan indicating a development budget of C$600,000 with an additional C$50,000 for working capital. Bastaros, who

had some legal training and experience from his native Egypt, as well as some franchise experience in Canada, waived ASWR's suggestion to obtain independent legal advice by way of an email to ASWR's representative the day before he executed the franchise agreement and general security agreement on behalf of Raibex.

In late Spring 2013 ASWR found an existing restaurant that was available for lease. An affiliate of the franchisor entered into a lease with the landlord dated September 19 2013 and entered into a sublease with Raibex a month later. The principal lease provided for an initial deposit of five months' rent, together with a security deposit for the final month's rent, which, according to the sublease, formed part of the terms, covenants, conditions and obligations of the principal lease that the subtenant (Raibex, the franchisee) had agreed to comply with pursuant to the draft sublease. The initial amount due was approximatively C$120,000, which Bastaros had learned during the negotiation of the principal lease in early 2013 (he was involved throughout the process).

The conversion of the leased restaurant began in November 2013 and was substantially completed just before the franchise opened in March 2014. Approximately one month before opening, ASWR sent Raibex a letter notifying it of its contractual requirement to pay the remaining development costs and that the estimated cost for the franchise build-out was over C$1 million, which nevertheless fell within the cost range in the franchise disclosure document for an initial shell build, despite having been a restaurant conversion.

In July 2014 the franchisor's affiliate holding the lease rights for the franchise's premises invoiced Raibex for the pre-paid rent and security deposit due under the principal lease. When Raibex failed to pay such amounts and the balance of the construction costs, ASWR delivered a notice of default to Raibex. In return, Raibex served a notice of rescission, claiming C$1.28 million from ASWR and its related entities. The franchisor and related parties responded by delivering a notice of termination of the franchise agreement and the sublease, and assumed control of the leased premises and franchised business.

Decision

While ASWR had provided Raibex with a disclosure document containing all of the information in its possession at the time, the court found that material information which was necessary for Raibex to make a properly informed decision with respect to acquiring a franchise was missing. The court refused to accept ASWR's argument that disclosure could not be made on the basis that certain material information simply was not available at the time the disclosure statement was prepared. The court explained that if a franchisor were permitted to make disclosure at a premature stage and avoid rigorous disclosure requirements, then the purpose of the Arthur Wishart Act would be defeated. The court further emphasised that since franchise disclosure law aims to protect the interests of franchisees, to require that franchisors disclose only the information which is known to them at the time of disclosure would essentially enable franchisors to give disclosure at a premature stage, when material matters are not yet known, thereby encouraging the signature of franchise agreements by uninformed franchisees, while allowing franchisors to avoid statutory disclosure obligations. The court concluded that if it is simply impossible to make proper disclosure because material facts are not yet known, then a franchisor is not yet ready to deliver the statutorily required disclosure document and must await the information.

The court noted that the lease was material and a critical component of the franchise disclosure and therefore ruled that the lack of a copy of the lease in the franchise disclosure document constituted a violation of ASWR's legal disclosure obligations.

Furthermore, the court found that ASWR had failed to provide adequate financial disclosure, particularly by failing to disclose the substantial additional deposit under the lease and by providing a cost estimate for building at the franchised premises based solely on a shell, not a conversion, when all but one of its franchises as of then had been conversions. Moreover, in the court's opinion, ASWR's disclaimer contained in the franchise disclosure document stating that ASWR had "no reasonable means of estimating or predicting those costs with any certainty" was tantamount to an admission that ASWR had not fulfilled its disclosure obligations with respect to franchise costs. The court concluded that the failure to adequately disclose costs suggested that the franchise disclosure document had simply been delivered prematurely, before ASWR was in a position to properly

estimate costs.

Finally, the court noted that the Arthur Wishart Act does not allow for waivers or any mechanisms for contracting out of the franchisor's disclosure obligations, which are in no way reduced based on the sophistication of a prospective franchisee or any express waivers on their part. The court therefore found that Raibex had properly exercised its right of rescission under Section 6 of the Arthur Wishart Act and referred the assessment of damages to a master of the Ontario Superior Court of Justice.

Comment

This decision significantly expands the franchisor's disclosure obligations under the Arthur Wishart Act, introducing a timing requirement for disclosure and the execution of franchise agreements that is specifically contemplated neither by the legislation nor by previous case law. Furthermore, given the broad and non-determinative definition of 'material fact', with respect to disclosure under the Arthur Wishart Act, this decision may lead to uncertainty for franchisors as to whether they have obtained all material facts and are ready to provide complete disclosure to potential franchisees, despite certain costs not yet being known. Such situations will be especially common among franchisors when expanding in another province for the first time.

It is therefore unsurprising that the decision is under appeal and, given the significant concerns created by the trial decision within the franchise industry, the Canadian Franchise Association has sought intervener status. It remains to be seen whether this case will be upheld and followed by the courts in Ontario and other provinces with similar statutory franchise disclosure obligations in similar cases where the lease is not disclosed to a franchisee before entering into the franchise agreement, even if the location of the franchise has yet to be determined. Nevertheless, this decision has already been applied in Ontario to qualify a franchisor's disclosure as premature where it failed to provide the franchisee with the financial statements of the most recently completed fiscal year of the franchisor, as required by the Arthur Wishart Act.**(3)**

This decision also fails to explain how such disclosure requirements would apply in other situations. For example, it is difficult to envision how the principle established with respect to costs disclosure will apply in situations where the franchisee is to enter into the lease directly, after the signature of the franchise agreement.

Ultimately, the court insisted that if it is simply not possible to make proper and full disclosure because material facts are not yet known, the franchisor is not yet ready to deliver the statutorily required document. The franchisee's awareness of the absence of this material information and participation in the negotiation of the principal lease was determined to be irrelevant, as deciding otherwise was considered by the court to be tantamount to a *de facto* waiver by the franchisee of compliance by the franchisor with its statutory disclosure obligation, where a direct waiver would be unenforceable.

In order to comply with the principles established by this decision in situations where a franchise location is selected subsequent to signing the franchise agreement, it is incumbent on franchisors to ensure that all material terms of the lease obligations to be undertaken by the franchisee are otherwise disclosed in the disclosure document. As suggested by the court, a materially complete form of sublease including the provisions to be incorporated from the principal lease would presumably have been acceptable as fulfilling the franchisor's disclosure obligations if it were ultimately determined to be materially accurate.

While this case was decided in Ontario, the decision is likely to be followed in other common law provinces given the similarity of such provinces' statutory franchise disclosure requirements. In principle, the decision could also potentially find some application in Quebec where the principle of good faith under civil law also requires that franchisors make full and honest disclosure to potential franchisees of any relevant information which may have an impact on the potential franchisee's decision to enter into a franchise agreement. However, given the lack of franchise legislation in Quebec, this obligation has been limited thus far to the disclosure of information in the possession of the franchisor at the time of disclosure. Accordingly, it seems unlikely that this obligation would be extended to impose a positive obligation on franchisors in Quebec to actively collect and disclose

certain information not yet in their possession, such as the material terms of a lease intended to be sublet to the potential franchisee, before entering into the franchise agreement.

Accordingly, the safest course of conduct would be for a franchisor to wait for the principal lease to be signed before complying with its disclosure obligation, so as to include a copy of the lease and its material terms in the disclosure document. This would require the franchisor to commit time, resources and funding to the search for an appropriate location and to the negotiation of the lease for such a location without being able to extract any commitment or deposit from the potential franchisee.

Alternative courses of conduct are possible, but involve varying degrees of risk. For example, a franchisor could include in its disclosure document a form of sublease that contains all of the most adverse material terms that it could expect to be imposed in the principal lease, including a range of possible rent (which would not be materially wide), for a location in the geographical area in which the potential franchisee has expressed an interest; to the extent that the lease eventually signed contained no material variation from the initial disclosure, the court's decision in Raibex suggests this may be acceptable.

In order to avoid any significant risk without waiting for the principal lease to be signed, other approaches may be considered, such as complying anew with the disclosure requirements once the principal lease is signed or using a statement of material change if the terms of the principal lease are significantly different from those set forth in the initial disclosure. However, all of these other approaches would require a franchisor to risk the commitment of time, resources and funding to find an appropriate location and negotiate the lease, while the potential franchisee would be entitled to withdraw from the opportunity once the principal lease is signed and its material terms are confirmed, since there would be no legal obligation for the potential franchisee to acquire the franchise until fully compliant disclosure is provided. As a result, these approaches would not necessarily be more favourable to a franchisor than delaying disclosure until after the principal lease is signed and simply making the required disclosure at that time.

Franchisors must accordingly attempt to comply with *Raibex* using one of the foregoing or other creative approaches, at the very least until the Ontario Court of Appeal confirms the adequate level of disclosure required under the Arthur Wishart Act in such circumstances.

For further information on this topic please contact Bruno Floriani or Marissa Carnevale at Lapointe Rosenstein Marchand Melançon LLP by telephone (+1 514 925 6300) or email (bruno.floriani@lrmm.com or marissa.carnevale@lrmm.com). The Lapointe Rosenstein Marchand Melançon LLP website can be accessed at www.lrmm.com.

Endnotes

(1) *Raibex Canada Ltd v ASWR Franchising Corp*, 2016 ONSC 5575.

(2) *Ibid* at para 16.

(3) *2122994 Ontario Inc v Lettieri*, 2016 ONSC 6209.
