

# Franchise Law Executive Summary

## A. Introduction

This report considers whether legislation to regulate franchising should be enacted in Manitoba. It provides an introduction to franchising, an overview of existing franchise regulation in Canada and other countries and a review of the elements of Canadian legislative regimes. The Commission recommends the enactment of franchise legislation in Manitoba and makes a number of further recommendations that Commissioners believe will protect the interests of franchisees and enable them to make more informed business decisions, while recognizing the commercial interests of franchisors.

## B. Franchising Overview

A franchise is a contract between two businesses, in which the franchisor grants the franchisee the right to operate its business system in return for payment of fees and royalties. The business system typically includes intellectual property, the right to sell products or services, access to business knowledge and methods and other assets. The franchisor often provides continuing support and direction, and the franchisee agrees to comply with the franchisor's standards and usually, to operate in a way that is substantially similar to or indistinguishable from the operation of other franchises in the system. Franchising has become a common distribution method chosen by businesses, and now represents a substantial portion of the Canadian economy.

A significant attraction of franchising for the franchisee is the opportunity to enter the marketplace with reduced business risks, where there is an established franchisor that offers a successful business system. For the franchisor, franchising allows business expansion with little capital investment and provides an ongoing source of revenue from franchise fees or royalties. However, the franchise model also has disadvantages. The franchisor gives up some control and profit opportunity and its reputation can be at risk. As a result, the franchisor will usually attempt to ensure that each franchisee complies strictly with the franchisor's operational methods. The bargaining power of the parties to a franchise relationship may be dramatically unequal. The franchisor generally has more extensive business and franchising experience and has control over the terms of the franchise agreement, while the franchisee often must "take or leave" the franchise agreement as offered. The franchisee must rely to some extent on the franchisor's representations about the franchise, and continues to be at a disadvantage in terms of access to information and control of operations throughout the franchise relationship.

Areas of conflict that have been found to arise between the parties to a franchise relationship include lack of pre-contract disclosure, misrepresentation about aspects of the franchise, excessive prices for goods, equipment and services obtained from the franchisor or from required suppliers, encroachment and franchisor-imposed system wide changes.

In the absence of legislation, the franchise relationship is governed by the terms of the agreement and the law of contract. The characteristics of the relationship also give rise to a common law duty upon the parties to act in good faith.

## C. Canadian Franchise Regulation

Four provinces have taken legislative measures to regulate franchising activity. Alberta was the first to enact franchise legislation, in 1971. The Act was a registration statute that required franchisors to register with the Alberta Securities Commission and to file certain documents, including a prospectus. However, by the late 1980s, concerns had arisen about the registration and disclosure requirements, and in 1995, the Act was replaced by a new *Franchises Act* and regulations.

The 1995 Alberta Act is a disclosure statute; it requires franchisors to provide financial and other material fact disclosure to prospective franchisees, but does not require franchisor registration or document filing. The Act also includes provisions governing the franchise relationship, imposing a duty of fair dealing and protecting the freedom of franchisees to associate.

Ontario was the second province to enact franchise legislation, the *Arthur Wishart Act (Franchise Disclosure) 2000*. The Ontario Act is a disclosure statute based largely on the 1995 Alberta Act, and similarly provides for a duty of fair dealing and the right to associate. The Act does not provide for document registration or government oversight.

In August 2005, the Uniform Law Conference of Canada (ULCC) adopted the *Uniform Franchises Act* (the Model Bill) and regulations and recommended them to the provinces and territories for enactment. The Model Bill and regulations are based primarily on Ontario's Act and regulations; a mediation process is also included that is mandatory if a party to the franchise agreement initiates it.

Prince Edward Island enacted the *Franchises Act*, modeled primarily on the ULCC Model Bill, in June 2005. New Brunswick's *Franchises Act* received Royal Assent in June, 2007, and is not yet in force. The Act is a disclosure statute based closely on the ULCC Model Bill, and provides for a similar mediation process.

All Canadian franchise statutes require franchisors to disclose specific detailed information, including financial statements and the background of the franchisor, to prospective franchisees at least 14 days before the franchisee signs a franchise agreement or pays money toward the franchise. Franchisors must also disclose all material facts that would reasonably be expected to have a significant effect on the value or price of the franchise or the decision to acquire the franchise. A franchisee has the right to rescind the franchise agreement within 60 days if the franchisor fails to provide the disclosure document within the time required or if the contents of the disclosure document do not meet the statutory requirements. Where the franchisor provides no disclosure document, the franchisee may rescind the franchise agreement within two years. The franchisee also has a right of action for damages if the franchisee suffers a loss because of a misrepresentation in the disclosure document or because of the franchisor's failure to comply with the disclosure requirements.

The legislation also imposes a duty on the parties to a franchise agreement to deal fairly, and protects the right of franchisees to associate with other franchisees. No Canadian statute provides for government registration or oversight.

## D. International Franchise Regulation

In the United States, franchising is regulated by the federal government and by several state governments. Federally, franchise sales are regulated by the Federal Trade Commission Franchise Disclosure Rule. The FTC Rule requires franchisors to make detailed disclosures to prospective franchisees at least 10 business days before the franchisee pays any consideration toward the franchise or signs a contract. The Rule contains no express duty of good faith or fair dealing, and there is no filing or registration requirement. Beginning on July 1, 2008, U.S. franchisors will be required to comply with a revised FTC Rule, which adopts more extensive disclosure requirements.

In addition, several states have franchisor registration requirements modeled after securities legislation; franchisors must register with a state agency and obtain approval before offering their franchises. Several states have also enacted franchise relationship legislation to govern the relationship between the parties after the franchise agreement is signed. All of these statutes have provisions governing termination of the franchise agreement; other matters include contract renewal and transfer, territory encroachment and the purchase of goods and services from designated sources of supply.

In Australia, a mandatory Franchising Code of Conduct requires franchisors to provide disclosure at least 14 days before an agreement is signed or a non-refundable payment is made. The Code also provides for a seven day cooling-off period and mandatory mediation for dispute resolution. The Code protects the right of franchisees to associate and requires franchisors to give franchisees up to 30 days to remedy a breach before an agreement can be terminated.

## E. Manitoba Franchise Regulation

The threshold question considered by the Commission was whether legislation to regulate franchising is desirable for Manitoba. The principal argument against franchise legislation is that it may tend to have a chilling effect on the attractiveness of Manitoba as a business location. However, franchising regulatory restrictions now exist in four Canadian provinces and in the U.S., and the lack of regulation in Manitoba places prospective franchisees at a significant disadvantage in comparison to these provinces. Experience in other jurisdictions suggests that regulation may benefit the franchise industry as a whole, while a choice not to regulate may risk the development of a reputation for Manitoba as a haven for incompetent or disreputable franchisors. In the Commission's opinion, legislation to regulate franchising is clearly appropriate for Manitoba.

The Commission recognizes that consistency among the Canadian franchise statutes will increase certainty within the business environment. However, the existing franchise statutes are similar, but not uniform, and the Ontario Bar Association has recently made a number of recommendations for improvements to the Ontario regulation that, if adopted, would result in significant amendments. In the Commission's view, the ULCC Model Bill and disclosure regulation offer a useful model for Manitoba franchise legislation. However, recognizing the imbalance of power inherent in the franchise relationship, the Commission also makes additional recommendations that we believe will ensure that full information is provided to a prospective franchisee before the purchase of the franchise and provide a measure of protection for franchisees throughout the franchise relationship.

In general, the Commission is in favour of thorough pre-sale disclosure to prospective franchisees, and supports the requirement that the franchisor disclose all "material facts"

relating to the franchise. The Commission also makes several recommendations with respect to specific franchisor disclosure obligations. In the Commission's view, the requirement under current franchise statutes to disclose specific background information with respect to the directors, general partners and officers of the franchisor should be extended to disclosure respecting all individuals who have management responsibility relating to the franchise, to ensure that full disclosure is not precluded by avoiding the use of a formal title. The disclosure requirement should also be extended to affiliates of a franchisor, who are significantly connected to the franchisor through relationships of control. As well, under the current requirements, a franchisor could avoid disclosing unfavourable background information by assuming a new corporate identity. As a result, the Commission recommends extending the disclosure requirements to a franchisor's predecessors.

The Commission also makes recommendations to clarify the level and extent of disclosure required with respect to financial performance representations, and to require that cautionary language be included in the disclosure document. Where a projection or forecast of financial performance is not included in a disclosure document, the document should include a statement that no one is authorized to make projections or forecasts respecting the franchise.

Under the ULCC Model Bill, franchisors are required to disclose their policies and practices in relation to rebates and other benefits received as a result of purchases made by franchisees to designated suppliers. The Commission recommends that franchisors also be required to disclose whether the franchisor or any affiliate of the franchisor in fact received rebates or benefits in the previous year, whether the benefits formed a material part of the recipient's total revenue and whether and how rebates were shared with franchisees. The Commission recommends more detailed disclosure with respect to exclusive territories, and where an exclusive territory is not granted, that an express statement to that effect be required.

The Commission considered whether additional categories of disclosure should be included to help to inform franchisees about the nature of the relationship that may be expected with the franchisor and to provide more detailed information about the specific franchise outlet. In the Commission's view, the regulations should require disclosure of the number of lawsuits initiated by the franchisor against franchisees and the number of disputes that were resolved through mediation or arbitration. As well, franchisees should receive information as to the number of current or former franchisees that are subject to confidentiality agreements, to assist franchisees to evaluate the extent and quality of information that may be obtained by contacting others in the franchise system. Significant turnover at a franchise location or in an area may also be revealing information for a prospective franchisee; the Commission recommends that disclosure be required of the history of the franchise outlet being offered and of the closest other outlets.

It was suggested to the Commission that, given the impact of the landlord-tenant relationship on the business affairs of a franchise, particularly with the common use of cross-default provisions in franchise and lease agreements, disclosure should be required where an individual or corporation that is related to the franchisor acts as sub-lessor of the premises. The Commission agrees, and recommends that disclosure of the background of the sub-lessor be required where it is related to the franchisor.

The Commission considered whether franchisors should be authorized to use disclosure documents authorized under the law of another jurisdiction, if supplementary information is included that is necessary to comply with the Manitoba Act and regulations. The Commission agrees that the use of such "wrap-around documents" would be consistent with the goal of harmonization among the provinces and may help to limit any additional costs that franchisors might incur in complying with Manitoba's requirements. As well, the Commission is persuaded

that it is appropriate to provide some relief for franchisors for minor errors or irregularities in a disclosure document, and recommends that the regulations provide that a disclosure document is valid if it substantially complies with the Act and regulations.

Currently, Prince Edward Island is the only Canadian jurisdiction to authorize the electronic delivery of disclosure documents. Electronic delivery is consistent with Manitoba's *Electronic Commerce and Information Act*, and with current commercial practices, and may help to reduce franchisor compliance costs. However, a franchisee should have the right to receive delivery in paper form if requested.

The Commission makes several recommendations with respect to circumstances in which an exemption should be made from the 14 day advance disclosure requirement. For example, a franchisor should be able to enter into a site selection agreement (reserving a franchise site) or require a prospective franchisee to enter into a confidentiality agreement respecting the information to be provided before providing disclosure. The Commission is of the view that an exemption is also appropriate for a fully refundable deposit, within a maximum amount, if it is placed with an independent advisor.

The Commission considered whether authority should be provided, as in other Canadian franchise statutes, for regulations to be made exempting franchisors from any or all of the provisions of the Act or regulations. In Alberta, Ontario and P.E.I., regulations have been made providing for exemptions for "mature franchisors" from the requirement to include financial statements in a disclosure document. On balance, the Commission is not persuaded that "mature franchisors" are immune from subsequent financial or ethical difficulties, and recommends that the Manitoba Act not provide authority to make such regulations.

Canadian franchise statutes provide remedies for franchisees where a franchisor fails to comply with the disclosure requirements; a franchisee has a right of rescission where there has been no or inadequate disclosure and a right of action for damages if the franchisee suffers a loss because of a misrepresentation or a failure to comply with the disclosure requirements. The statutes also preserve any other rights and remedies otherwise available to the parties at law. The Commission is of the view that Manitoba franchise legislation should maintain consistency with the ULCC Model Bill with respect to the statutory disclosure remedies and the preservation of common law rights and remedies. However, the Commission also recommends that Manitoba legislation clarify that the statutory remedy of damages for misrepresentation applies to future projections and forecasts.

The Commission recommends consistency with the other franchise statutes with respect to the duty of fair dealing and the protection of the right of a franchisee to associate with other franchisees. Other franchise statutes also provide that a waiver or release by a franchisee of a right or requirement under the Act or regulations is void. While the Commission agrees with this prohibition in principle, in our view there is a distinction between a waiver of rights that is given before a dispute arises and a waiver of rights given in the settlement of a dispute that later transpires. In order to enable franchisees and franchisors to settle their disputes, the Committee recommends that the Act allow franchisees to waive a right or requirement under the Act or regulations in the context of a settlement agreement.

Canadian franchise legislation includes limited provisions to regulate the relationship between the parties to a franchise agreement, such as the duty of fair dealing. In some jurisdictions, particularly in some U.S. states and in Australia, legislation places additional restrictions on the terms that a franchisor may include in an agreement, changes a franchisor may impose or actions it may take. The Commission recognizes the differing and strongly held views within the franchise community with respect to relationship regulation. However, in the Commission's opinion, the imbalance of power between the parties during negotiations and

inherent in the franchise relationship requires that some conduct obligations be specified in legislation. Where appropriate, the obligations should be reciprocal. The Commission makes several recommendations for provisions to be included in Manitoba franchise legislation with respect to the franchise relationship, including restrictions on the termination of or failure to renew a franchise agreement, a requirement for reasonable time to remedy a breach, a provision allowing a franchisee to purchase goods and services from suppliers other than those designated by the franchisor, under certain circumstances, and a provision for a cause of action for damages for encroachment.

The Commission carefully considered whether Manitoba franchise legislation should provide for an alternative dispute resolution process. However, the Commission does not consider that such a provision is appropriate at this time. The Commission supports the voluntary use of alternative dispute resolution mechanisms, and notes that pre-trial mediation is a common practice of the Manitoba Court of Queen's Bench. Where a franchise agreement contains provisions for alternative dispute resolution, thorough disclosure of all elements of the process should be required.

While the Commission supports the use of alternative dispute resolution mechanisms, the impact of mandatory arbitration provisions on the availability of class proceedings merits further consideration. Franchise agreements are generally contracts of adhesion, and franchisees rarely have the opportunity to influence the terms of the agreement or to choose freely whether to settle any disputes that arise by arbitration. Where mandatory arbitration clauses preclude class proceedings, they may effectively deny access to justice for franchisees whose individual claims do not justify the cost, time or effort of arbitration. In the Commission's opinion, Manitoba franchise legislation should provide that a mandatory arbitration clause in a franchise agreement is invalid insofar as it prevents a franchisee from participating in a class proceeding.

The Commission considered the question of whether a franchise regulatory body should be established in Manitoba. In our view, the establishment of such a body would be premature, and is not recommended. The Commission does recommend that the Manitoba Government conduct public awareness initiatives with respect to franchising, including preparing and distributing educational material that explains franchising and franchise legislation and identifies resources that might assist prospective franchisees.

The Commission recommends that the Manitoba Government follow the P.E.I. example and circulate draft regulations for consultation before the regulations are made. The Commission also urges the Government of Manitoba to work with the governments of other provinces to ensure that franchise legislation and regulations are as effective and consistent among jurisdictions as possible, and to establish a process for ongoing consultation with stakeholder groups in Manitoba.