Disclosure Exemptions: Risky Business

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Introduction

Raiders of the Lost Ark was released when I was in university (and when my co-author, so he claims, was in high school). Never mind the sequels, movie franchises, TV shows or video games that it later inspired, Indiana Jones conveyed the essential message in the first film (though it always seemed to evade the grasp of the villain): when the treasure appears too easily within your reach, look carefully for hidden traps, else the floor beneath you may collapse leaving nothing between you and the snake pit. (George Lucas might quarrel with my recollection of the plot, and you might wonder what this has to do with franchising.) If you perceive an opportunity to avoid the time, effort and money of issuing a disclosure document by using one of the exclusions or exemptions under the Arthur Wishart Act (or other provincial Franchises Acts), tread carefully, else you find yourself with no protection from a claim for rescission.1

The Arthur Wishart Act in Ontario, the Franchise Acts of the provinces of Alberta, Prince Edward and New Brunswick and the proposed Franchise Act in Manitoba offer franchisors various exemptions from the obligation to provide disclosure to prospective franchisees. Additionally, these Acts set out certain business arrangements that are excluded entirely from characterization as franchises and therefore fall outside all of the rights and obligations covered by these Act. Unfortunately, the language used in some of the exemptions is ambiguous, making them difficult to apply with certainty. Further, with the exception of two of the exemptions, there has been very little judicial interpretation to provide any clarity. The consequences of failing to provide disclosure to a prospective franchisee can be quite serious. Therefore franchisors should carefully weigh the risks of non-compliance against the costs of compliance before relying on any disclosure exemption.

In contrast, there is much less ambiguity regarding the exemption/exclusion criteria under federal franchise legislation in the United States. This is due to the fact that the Federal Trade Commission (“FTC”) regulates franchising at the federal level and has been tasked with drafting, amending, interpreting and enforcing the FTC Franchise Rule (the “FTC Rule”). The FTC has published helpful guidance regarding this legislation. In the FTC Rule Statement of Basis and Purpose, the FTC Staff sets out the policy reasons for the exemptions that were added in 2007. The FTC Compliance Guide provides guidance regarding the scope of the FTC Rule exemptions and exclusions. Practitioners also have access to FTC Staff Advisory Opinions regarding the original FTC Rule and the FTC Rule Frequently Asked Questions (FAQs) regarding the amended FTC Rule. All of these federal resources can be accessed on the FTC website.2

In this paper we will identify the exceptions and disclosure exemptions available in Canada, their conditions and prerequisites and the limitations associated with each. Where possible, we will also attempt to draw on U.S. regulatory guidance to help interpret them.

The Scope of Franchise Legislation

We have franchise legislation in five provinces in Canada. Compliance with the legislation involves fulfilling a duty of fair dealing, observing the franchisees’ right of association and issuing a disclosure documents to every prospective franchisee at least fourteen days prior to the earlier of (a) the signing of any franchise agreement or related agreement by the franchisee, and (b) payment of any consideration by or on behalf of the franchisee to the franchisor or a franchisor’s associate. The legislation applies to business arrangements that fall within the definition of “franchise” as set out in the Acts, with the exception of a number of business structures that are expressly excluded from the application of the legislation. Businesses hoping to avoid the application of the Acts may try to structure their business arrangements to fall outside the definition of “franchise” or to fall within one of the express exclusions from the application of the Acts.


2 http://www.ftc.gov/bcp/menus/resources/guidance/franchise.shtm
The Franchise Definition

Although the definition of a franchise varies among the jurisdictions, the Ontario definition provides a good point of reference to start a discussion on the statutory exclusions and exceptions available, because it is arguably the broadest of all the statutory definitions.

The Arthur Wishart Act (Franchise Disclosure) (the “Ontario Act”) states that:

“franchise” means a right to engage in a business where the franchisee is required by contract or otherwise to make a payment or continuing payments, whether direct or indirect, or a commitment to make such payment or payments, to the franchisor, or the franchisor’s associate, in the course of operating the business or as a condition of acquiring the franchise or commencing operations and,

(a) in which,
(i) the franchisor grants the franchisee the right to sell, offer for sale or distribute goods or services that are substantially associated with the franchisor’s, or the franchisor’s associate’s, trade-mark, service mark, trade name, logo or advertising or other commercial symbol, and
(ii) the franchisor or the franchisor’s associate exercises significant control over, or offers significant assistance in, the franchisee’s method of operation, including building design and furnishings, locations, business organization, marketing techniques or training, or

(b) in which,
(i) the franchisor, or the franchisor’s associate, grants the franchisee the representational or distribution rights, whether or not a trade-mark, service mark, trade name, logo or advertising or other commercial symbol is involved, to sell, offer for sale or distribute goods or services supplied by the franchisor or a supplier designated by the franchisor, and
(ii) the franchisor, or the franchisor’s associate, or a third person designated by the franchisor, provides location assistance, including securing retail outlets or accounts for the goods or services to be sold, offered for sale or distributed or securing locations or sites for vending machines, display racks or other product sales displays used by the franchisee.3

The definition falls into two parts. First, the definition of what is often referred to as a ‘business format franchise’ has three primary elements: (i) payment for the right to engage in the business, (ii) substantial association with the franchisor’s trade-mark, and (iii) significant control or assistance in the franchisee’s method of operation. The second part of the definition, relating to what may be referred to as a ‘product distribution franchise’, also has three elements: (i) payment for the right to engage in the business, (ii) the grant of representational or distribution rights (whether or not a trade-mark is involved) and (iii) location assistance.

It is outside the focus of this paper to fully discuss what is captured by the “franchise” definition and what escapes its scope. However, it is worth noting that a number of questions arise in applying the definition. For instance, it is not clear how the term “substantial” is intended to be used in terms of the association between the goods and services and the franchisor’s trade-mark. Must the “substantial association” extend to the franchisee’s business as a whole? What qualifies as “significant” control or assistance?

As mentioned above, U.S. regulatory guidance may provide some assistance. For example, the FTC Compliance Guide states that the amount of reliance on a franchisor’s control or assistance is an indicator of significance. Reliance is likely to be great if the franchisee is inexperienced in the franchised business. The Guide also states that to be significant the control or assistance must related to the “overall method of operation” as opposed to a small part of the business. It lists a number of actions that constitute significant control, including site approval, site design or appearance requirements, hours of operation and production techniques. It also list a number of actions that do not constitute significant control, including trademark controls designed to protect the mark and health or safety restrictions required by federal or state law. There are similar examples regarding assistance.4

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3 AWA, s. 1(1)
Exclusions

The Canadian franchise statutes expressly provide that a number of business arrangements are excluded entirely from the application of the Acts.

(i) Distribution Arrangements / Reasonable Wholesale Payment

In the Franchises Act (PEI) (the “PEI Act”), the Franchises Act (New Brunswick) (the “New Brunswick Act”) and the Manitoba Bill 15 proposed franchise act (the “Manitoba Bill”), there is an exclusion for pure distribution relationships. These acts exclude those “arrangements arising out of an agreement, (i) for the purchase and sale of a reasonable amount of goods at a reasonable wholesale price, or (ii) for the purchase of a reasonable amount of services at a reasonable price”.5

Where a distributor requires its customers to pay amounts in excess of reasonable prices or reasonable wholesale prices, the inference is that the amounts may contain ‘hidden fees’ relating to the operation of a franchise. Similarly, where a distributor requires that its customers purchase goods in amounts that are in excess of what would be considered reasonable for the operation of the business, there is a credible perception that the payment for the additional goods relates to consideration for the grant of a franchise. For this exclusion to be effective, the franchisor must ensure that the price required to be paid for goods does not exceed a reasonable wholesale price, that the price required to be paid for services does not exceed a reasonable price and that the quantum of goods required to be purchased does not exceed a reasonable amount. Further, additional fees, such as for advertising or for the use of a trademark, risk the business arrangement being taken out of this exclusion.

The reasonable wholesale payment exclusion is not entirely straightforward, however. How to make the determination of a “reasonable amount” is unclear. If the required amount exceeds the needs of the customer but does not deviate materially from minimum order quantities for distributors in the industry, does that qualify the amount as being “reasonable”? In determining “reasonable price” or “reasonable wholesale price” what comparables are considered? If one can identify at least one other situation in which such a price was charged in the market, does that make it “reasonable”? Do you consider negotiating power? What additional economic factors do you consider?

The Franchises Act (Alberta) (the “Alberta Act”) also limits the applicability of the legislation to distribution arrangements by excluding reasonable wholesale payments from the definition of “franchise fee”6. This carve out in the definition of “franchise fee” does not automatically make the legislation non-applicable, but it does minimize the likelihood of a pure distribution arrangement being classified as a franchise.

The Ontario Act has no comparable exclusion to that of the reasonable wholesale payment. Therefore, it is where distribution arrangements are at the greatest risk of being classified as franchises.

(ii) Employer-Employee Relationships

All of the franchise statutes in Canada, other than Alberta’s, expressly exclude employer-employee relationships from their ambit.7 The legislation does not provide any guidance on this exclusion. However, whether an employment relationship exists will likely be determined using the control test used when assessing whether an individual is an employee or an independent contractor.8 The greater degree of franchise control exercised over the franchisee, the more likely the relationship begins to resemble one of employment.

The control analysis was applied in the franchise context prior to the establishment of the Ontario Act in Head v. InterTan Canada Ltd., where a judge found a franchise relationship to be that of employment due to the degree of control exercised by the franchisor.9 There have also been a number of recent U.S. cases holding janitorial

5 FAPEI, s. 2(3)(g); FANB, s. 2(4)(g); Bill 15, s. 2(3)(j)
6 FAA, s. 1(1)(f)
7 AWA, s. 2(3)(1); FAPEI, s. 2(3)(a); FANB, s. 2(4)(a); Bill 15, s. 2(3)(a).
franchisees to be employees and not independent contractors. Some of these cases were brought under state Independent Contractor Statutes and focus on the fact that the franchisees didn’t previously operate an independently established janitorial service and that janitorial services were within the scope of the business operated by the franchisor, while also considering the level of control. In general, employment law carries more onerous obligations than those required by franchise law. Franchisors should be cautious when imposing significant control measures over the business operations of a franchisee or else risk inviting employment law requirements into their franchise arrangements.

(iii) Partnerships
Partnerships are another type of business relationship expressly excluded by franchise legislation in every Canadian jurisdiction other than Alberta. Again, the legislation provides no guidance on this exception. The exclusion of partnerships could arguably include limited partnerships. However, it is worth noting that in the United States, the FTC interpreted the exclusion of partnerships under the old FTC Rule as being applicable only if all the partners are bona fide general partners. The partnership exclusion was removed from the amended FTC Rule. The FTC determined that it was redundant because partnerships do not meet the definitional elements of a franchise. However, the FTC was quick to point out that this determination only applies to general partnerships.

The lack of Canadian guidance on the partnership exception makes it unwise for a business to rely on it unless it is certain that all the partners are equally contributing general partners.

(iv) Co-operatives
Co-operatives are also excluded from the franchise acts in Ontario, PEI, New Brunswick and the Manitoba Bill. Unlike the other excluded business arrangements, the franchise legislation in the applicable jurisdictions does define what will be considered a co-operative for the purposes of the acts. For example, the Ontario Act specifically excludes the following four types of co-operatives: (i) organizations incorporated under Ontario’s Co-operative Corporations Act; (ii) organizations incorporated under the Canada Cooperatives Act, (iii) “co-operative corporations” as defined in the Income Tax Act and (iv) buying co-operatives defined as:

a) an organization operated on a co-operative basis by and for independent retailers that,
   i) purchases or arranges the purchase of, on a non-exclusive basis, wholesale goods or services primarily for resale by its member retailers, and
   ii) does not grant representational rights or exercise significant operational control over its member retailers;

The co-operative exclusion appears to be clear and unambiguous and can be applied with little risk where appropriate.

(v) Certification Arrangements
The franchise acts in every Canadian jurisdiction, other than Alberta, eliminate the applicability of the franchise legislation to “arrangement[s] arising from … agreement to use a trade-mark, service mark, trade name, logo or advertising or other commercial symbol designating a person who offers on a general basis, for consideration, a service for the evaluation, testing or certification of goods, commodities or services”. Possible examples could include an organization that certifies whether a product is fair trade or organic. This exclusion is relatively limited in its scope and application, and thus is not particularly helpful for avoiding the obligations of franchise law.

11 AWA, s. 2(3)(2); FAPEI, s. 2(3)(b); FANB, s. 2(4)(b); Bill 15, s.2(3)(b)
12 Supra at note 4 page 15
13 AWA, s. 2(3)(3); FAPEI, s.2(3)(c); FANB, s.2(4)(c); Bill 15, s.2(3)(c)-(f)
14 O. Reg. 581/00, Sec. 1
15 AWA, S. 2(3)(4); FAPEI, s. 2(3)(d); FANB, s. 2(4)(d); Bill 15, s. 2(3)(g)
(vi) Single Licenses
Another business arrangement expressly excluded from legislation in Ontario, PEI and New Brunswick and the Manitoba Bill is the single license. A single license is an “arrangement arising from an agreement between a licensor and a single licensee to license a specific trade-mark … or other commercial symbol where such licence is the only one of its general nature and type to be granted by the licensor with respect to that trade-mark or … commercial symbol”.16 Use of a trade mark is a common element in both the single license exception and the definition of a “franchise”. One would think that any trade mark license in the above-mentioned provinces would not constitute a franchise unless the other definitional elements were present in the business arrangement, including significant control or assistance in the franchisee’s method of operation. It is not clear whether the exclusion is intended to apply even where there is the exercise of significant control.

It is noteworthy that in the U.S. the FTC, in Staff Advisory Opinions commenting on the old FTC Rule, suggests that the essential difference between single trademark licenses and franchises is the degree of control exercised.17 Franchisors usually apply active control over a franchisee’s business operation; for example by mandating the hours of operation and by providing management instructions. In contrast, the FTC provides in its Staff Advisory Opinions that true licensors only exercise passive control, such as requiring quality control inspections.

Further, the Staff Advisory Opinions interpret the exclusion as applying only in circumstances where the license is a single exclusive grant, stating that “[i]f the totality of the circumstances suggests that the licensor intends to offer, or reserve the right to offer, more than a single exclusive license, then the exclusion will not apply”.18 However, the FTC does consider this exclusion applicable in “collateral product” licensing situations.19 Collateral product licensing occurs where a licensor permits the use of their trademark in one context (i.e. the “Lego” logo), but also licenses the use of the trademark in another context (i.e. use of “Lego” logo on clothing items).20 The single license exclusion was deleted from the amended FTC Rule because, in the FTC’s view, single license arrangements do not fall within the scope of the franchise definition.

Although the interpretation of this exclusion in Canada is not completely clear, and there is no apparent applicable case law, the guidance from our neighbours to the South appears helpful.

(vii) Leasing Arrangements
The Ontario Act includes an additional exclusion for specific lease arrangements. This exclusion applies where a tenant retailer leases space inside another larger retailer. However, the exception is limited to circumstances where the tenant is not required or advised to purchase goods or services from the larger retailer or an affiliate of the larger retailer.21

This exclusion would be valuable in specific leasing arrangements such as a watch repair or hair salon business operating within a department store. In those instances the business may use the department store’s trademark in its name and would likely have to comply with significant operational controls, including staffing and service standards, hours of operation and, potentially, use of the department store’s POS system. The Alberta Act contains a disclosure exemption for such leasing arrangements; however the rest of the Alberta Act would continue to apply to such arrangements.22

A franchisor relying on this exclusion must be aware that it is only available in Ontario (and as a disclosure exemption in Alberta); therefore the same leasing arrangement in another jurisdiction may be considered a franchise.

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16 AWA, S. 2(3)(5); FAPEI, s. 2(3)(e); FANB, s.2(4)(e); Bill 15, s.2(3)(h)
17 Informal Staff Advisory Opinion 05-1, March 2, 2005 and Informal Staff Advisory Opinion 00-3, March 20, 2000
18 Informal Staff Advisory Opinion 00-3, March 20, 2000
19 Supra at note 4 page 16
20 Informal Staff Advisory Opinion 05-1, March 2, 2005
21 AWA, S. 2(3)(6)
22 FAA, s. 5(1)(g)
(viii) Oral Agreements
All of the Canadian legislation, other than Alberta’s, excludes oral franchise agreements from the obligations imposed on the franchise relationship. This exclusion is only available where there is absolutely no written evidence of any material term of the franchise arrangement.23

(xi) Crown Arrangements
Both the Ontario Act and the PEI Act have carve-outs for the Crown. In Ontario, the Act does not apply to any franchise-like arrangement with the Crown or an agent to the Crown.24 This language suggests that neither party would need to comply with the legislation. However, in PEI the exclusion states that the “Act does not bind the Crown”.25 The language of the PEI Act suggests that the non-Crown party to the agreement would still be responsible for any legislative obligations.

Exemptions from Disclosure
All the Canadian jurisdictions with franchise legislation exempt franchisors from their disclosure obligations under specific conditions. However, the exempt situations vary slightly from jurisdiction to jurisdiction and most are drafted in an ambiguous manner. In addition, courts generally construe the exemptions narrowly to help facilitate the legislative purpose of redressing the power imbalance between the franchisor and the franchisee.26 Any franchisor intending to rely on a disclosure exemption would be wise to weigh the costs of disclosure compliance against the risks of not adequately meeting the particulars of any one exemption.

(i) Sale by the Franchisee
The sale of franchises by franchisees (a transfer of a franchise) is exempt from disclosure under Canadian franchise legislation in certain circumstances. This exemption has been the subject of considerable judicial interpretation and, hence, the exemption for which we have the most guidance. To qualify for this exemption, the following conditions must be met:

- the franchisee must not be the franchisor, an associate of the franchisor or a director, officer or employee of the franchisor or the franchisor’s associate;
- the grant or sale must be for the franchisee’s own account;
- if a master franchise is being granted, it must include the entire franchise; and
- the grant of the franchise cannot be effected by or through the franchisor.27

Further, a grant is not effected by or through a franchisor merely because,

- (a) the franchisor has a right, exercisable on reasonable grounds, to approve or disapprove the grant; or
- (b) a transfer fee must be paid to the franchisor in an amount set out in the franchise agreement or in an amount that does not exceed the reasonable actual costs incurred by the franchisor to process the grant.28

In the 2003 case of MAA Diners Inc. v 3 for 1 Pizza and Wings (Canada) Inc.29,  

23 AWA, S.2(3)(7); FAPEI, s. 2(3)(f); FANB, s. 2(4)(f); Bill 15, s. 2(3)(i)
24 AWA, s. 2(3)(8)
25 FAPEI, s. 2(3)(h)
27 AWA, s. 5(7)(a); FAA, s. 5(1)(a); FAPEI, s. 5(7)(a); FANB, s. 5(8)(a); Bill 15, s. 5(11)(a)
28 AWA, s. 5(8); FAA, s. 5(2); FAPEI, s. 5(8); FANB, s. 5(10); Bill 15, s. 5(16)
Case law on the resale exemption suggests that franchisors must only play a “passive” role in the resale of a franchise for the sale not to have been “effected by or through the franchisor”. In 2189205 Ontario Inc., Nancy Van Dorp and Dean McCoy v. Tutor Time Learning Centres, LLC, William D. Davis and Frank Jerneycic, the court held that requiring a spouse of the franchisee to execute a guarantee went beyond the passive act of transfer approval. The requirement for a guarantee by a non-officer, non-shareholder of the transferee was not one of the many items listed in the franchise agreement as a condition to the franchisor’s consent to a transfer by the franchisee. The court found that the imposition of the additional condition by the franchisor resulted in the grant of the franchise being effected by or through the franchisor and was therefore not exempt from disclosure. In 917246 Alberta Ltd. v. Panda Flowers (1999) Ltd. (“Panda Flowers”) appears to offer the franchisor greater leeway in its involvement in a franchise transfer without the transfer being found to be effected by or through the franchisor. In Panda Flowers, the franchisor actively encouraged the purchase of the franchise and changed two terms of the franchise agreement. Despite these actions, the court surprisingly held that the disclosure exemption was still available, since there was evidence that the purchaser had done significant due diligence with the assistance of an accountant and a lawyer, was given an opportunity to walk away from the transaction, and never requested a disclosure document.

However, the Alberta case 2189205 Ontario Inc. v. Springdale Pizza Depot Ltd., the judge found that the franchisor's acts of introducing the purchaser and the franchisee, participating in negotiations, placing the burden of obtaining his/her consent on the franchisee, and requiring the execution of additional agreements, collectively, resulted in the transfer being effected by the franchisor.

In the U.S., there is no specific exemption for a sale by the franchisee under the FTC Rule. The FTC takes the position that such an exemption is not required because a franchisee is not creating a franchise relationship with the transferee and the transferee is not entitled to disclosure, unless the franchisor plays a significant role in the sale. The example of a significant role given in the FTC Compliance Guide is providing financial performance information to the prospective transferee. If this occurs, the franchisor would be required to give the prospective transferee a copy of its disclosure document.

At a practical level, a franchisor should be very wary of using this exemption from disclosure in any franchise transfer. The risk of a franchisor’s typical involvement in approving a franchise transfer leading to a potential finding that the transfer was “effected by or through a franchisor” is too high, relative to the cost savings in not preparing or updating a disclosure document.

(ii) Sale to an Officer or a Director

An exemption from disclosure is available when the franchise is sold to a person who has been an officer or a director of the franchisor or the franchisor’s associate for at least six months. A definition of “officer” can only be found in the Alberta Act, which states that an officer is “a person designated officer by by-law”. Presumably, the other acts would adopt the definition of “officer” as prescribed by business and corporation legislation applicable in the jurisdiction.

A further difference among the statutes is that in PEI, New Brunswick and Manitoba the franchisee must have been an officer or director in the immediately preceding six months for the exemption to apply. It Ontario and Alberta it is arguable whether the officer or director must have held his or her position immediately prior to the grant of a franchise.

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30 2189205 Ontario Inc. v. Springdale Pizza Depot Ltd., 2011 ONCA 467
31 [2006] OJ No. 3011 (SCJ) at para 49
32 Supra at note 30 para 47
33 (2004), 44 BLR (3d) 117
34 Ibid. at para 18
35 Supra at note 4 page 18
36 AWA, s. 5(7)(b); FAA, s. 5(1)(b); FAPEI, s. 5(7)(b); FANB, s. 5(8)(b); Bill 15, s. 5(11)(b)
37 FAA, s. 1(1)(r)
(iii) Sale to an Existing Franchisee

The sale of an additional franchise to a current franchisee is also exempt from disclosure if the additional franchise purchased is substantially the same as the existing one held by the franchisee. Although the two franchises do not need to be exactly the same, it is unclear how similar they must be for the exception to apply.

Further, in every jurisdiction other than Alberta, this exemption is only available if there has not been a “material change” since the existing or latest renewal or extension of the franchise agreement was entered into. “Material change” is defined by the legislation as:

- a change in the business, operations, capital or control of the franchisor or franchisor’s associate,
- a change in the franchise system or a prescribed change, that would reasonably be expected to have a significant adverse effect on the value or price of the franchise to be granted or on the decision to acquire the franchise and includes a decision to implement such a change made by the board of directors of the franchisor or franchisor’s associate or by senior management of the franchisor or franchisor’s associate who believes that confirmation of the decision by the board of directors is probable.

Given the breadth of the definition of material change, one would think that if there has been any significant passage of time between the grant of the two franchises, the risk of a franchisee being able to assert that a material change occurred prior to the grant of the additional franchise would outweigh any savings in cost and effort in not issuing disclosure. For this reason, it would be a rare situation where use of this exemption would be advisable.

(iv) Sale by a Third Party

This disclosure exemption is limited to the sale of a franchise administered by a person with a legal right to carry out the sale on behalf of a person other than the franchisor. The legislation lists the following as those who may take advantage of this exemption: executors, administrators, sheriffs, receivers, trustees, trustees in bankruptcy and guardians.

(v) Fractional Franchise

“Fractional franchises” are also exempt from the statutory disclosure obligations. The term “fractional franchise” refers to the grant of a franchise to sell goods or services within an existing business operated by the franchisee. For example, the grant of franchise for a coffee kiosk within a big-box bookstore may qualify as a fractional franchise.

To qualify for this disclosure exemption, the sales arising from franchised products or services as anticipated by the parties, or that should be anticipated by the parties at the time the franchise agreement is entered into cannot exceed 20% of the business of the franchisee. It is important to note that the sales threshold is anticipatory. The actual sales of the franchised product may later exceed 20% without voiding the application of this disclosure exemption.

This exemption is rampant with interpretation problems, however. First, it is not entirely clear what is meant by “total sales of the business”. Is it only the sales of the location containing the fractional franchise or does it include every business location worldwide? Second, it seems reasonable to ask whether there needs to be any commonality between the type of products being franchised and the franchisee’s underlying business. In other words, is there a difference between the grant of a franchise to “sell goods or services within a business” and the grant of a franchise to operate a ‘business within another business’? Thirdly, in Ontario and Alberta the time period for which the sales should be anticipated is not clear (although in PEI, New Brunswick and Manitoba the period is one year).

The FTC Rule’s fractional franchise exemption differs in a number of ways from the legislative exemption in Canada, making direct comparisons impossible. However, the FTC provides some interesting guidance as to how certain elements of this exception are interpreted in the U.S. Specifically, the FTC Compliance Guide indicates that the 20%
calculation applies to the entire business of the franchisee and is not limited to the specific location where the franchised products are to be sold.\(^{43}\) FTC Staff Opinions also provide valuable advice on how to generate a sufficient record of evidence that both parties, at the time the franchise relationship was established, made reasonable estimates of the projected sales of the franchised product within the larger business.\(^{44}\) They indicate that the use of past experience and historical data is a good indicator that the estimates are reasonable. Interestingly, to qualify for the fractional franchise in the U.S., the franchisee (or any of the franchisee’s current directors or officers, or any current directors or officers of a parent or affiliate) must have operated a business in the same line of business as the type of products or services to be sold by the franchise for a period of at least two years prior to the grant of the franchise.\(^{45}\)

Given the current lack of guidance as to the appropriate use of the fractional franchise exemption in Canada, franchisors are advised to take a conservative approach to the use of this exemption.

(vi) Franchise Agreement Renewal and Extension
Disclosure is not required when an existing franchise agreement is renewed or extended.\(^{46}\) However, this exception is only available in Ontario, PEI, New Brunswick, and Manitoba when there has not been an interruption in the operation of the franchisee’s business and there has not been a material change since the franchise agreement or the latest renewal or extension of the franchise agreement was entered into.\(^{47}\) It is not clear what is meant by an “interruption in the operation of the franchisee’s business”, although presumably it is referring to continuity in the operation of the business between the end of the term of the original franchise and the commencement of the renewal or extension term. As discussed above in relation to the exemption for the sale of an additional franchise, in many cases the risk of the occurrence of a material change occurring between the date of the original grant of the franchise (or the date of latest renewal or extension of the franchise agreement) and the grant of the renewal or extension would appear to outweigh the savings achieved by avoiding disclosure.

(vii) Small Purchase
Disclosure is not required for the grant of a franchise if the franchisee is required to make a total annual investment to acquire and operate the franchise in an amount that does not exceed $5000.\(^{48}\) The ambiguous drafting raises many questions as to its application. Does the reference to “investment” refer only to an initial capital investment (such as for machinery or equipment) or does it include ongoing costs to “operate the franchise”? For instance, would monthly rent payments be included in the calculation of the “total annual investment to acquire and operate the franchise”? What about royalty fees? Does the use of the word “required” mean that only mandatory or contractual payments are included in the calculation of annual investment and that expenditures by a particular franchisee in excess of the mandatory payments are to be excluded from the calculation? The ambiguous drafting of this exemption would make it difficult to use with any confidence in all but rare situations.

(viii) Short Duration
A disclosure exemption is available for franchise agreements of a short duration, except in Alberta.\(^{49}\) To rely on this exemption, the franchise agreement must be valid for one year or less and it cannot involve a non-refundable franchise fee. The PEI Act, New Brunswick Act and the Manitoba Bill also require that the franchisor provide location assistance.

The drafting of this exemption is also ambiguous. It is unclear whether an agreement renewed each year will still be eligible for this exemption. Similarly, the absence of a definition of “franchise fee” makes it difficult to ascertain what types of payments constitute a “non-refundable franchise fee”.

\(^{43}\) Supra at note 4 page 8
\(^{44}\) Informal Staff Advisory Opinion 98-6, August 12, 1998 and Informal Staff Advisory Opinion 97-1, February 7, 1997
\(^{45}\) Supra at note 4 page 8
\(^{46}\) AWA, s. 5(7)(f); FAA, s. 5(1)(d); FAPEI, s. 5(7)(f); FANB, s. 5(8)(f); Bill 15, s. 5(11)(f)
\(^{47}\) Ibid.
\(^{48}\) AWA, s. 5(7)(g)(i); FAA, s. 5(1)(e); FAPEI, s. 5(7)(g); FANB, s. 5(8)(g); Bill 15, s. 5(11)(g)
\(^{49}\) AWA, s. 5(7)(g)(ii); FAPEI, s. 5(7)(h); FANB, s. 5(8)(h); Bill 15, s. 5(11)(h)
Fortunately, the recent case TA & K Enterprises Inc. v. Suncor Energy Products ("Suncor") provides guidance on how the provision is interpreted. Therefore, the term is determined by considering the specific period when legal rights and obligations are enforceable. Interestingly, the court found that the franchise agreement in question was valid for less than a year despite the agreement being signed prior to its effective start date and it being automatically converted into a month-to-month tenancy at the end of the agreement’s one year term.

Suncor also helped clarify the meaning of “franchise fee”. The court expressly held that royalty fees are not franchise fees. Further, the court’s decision explained that a franchise fee is “a fee paid for the right to become a franchisee”, much like a membership fee. Despite Suncor’s insightful analysis of the short duration exemption, it is uncertain whether future cases will read the provision quite so liberally.

(ix) Multi-Level Marketing Plans
There is also a disclosure exemption in the franchise legislation in each jurisdiction, other than Alberta, for those franchisors governed by Section 55 of the Competition Act. Section 55 of the Competition Act prescribes its own disclosure obligations for “multi-level marketing plans”. A multi-level marketing plan is defined as a:

plan for the supply of a product whereby a participant in the plan receives compensation for the supply of the product to another participant in the plan who, in turn, receives compensation for the supply of the same or another product to other participants in the plan.

In respect of representations regarding compensation made to prospective participants, Section 55 of the Competition Act requires operators and participants to provide fair, reasonable and timely disclosure of the compensation likely to be received and the amount of compensation actually received by typical participants in the multi-level marketing plan within the knowledge of the operator of the plan. Failure to do so can result in a discretionary fine and/or imprisonment up to 5 years. This exemption does not provide much relief from the obligations of disclosure, since franchisors owning multi-level marketing franchises are still required to make disclosure under the Competition Act and the failure to do so carries significant penalties.

(x) Substantial Investment
The Ontario Act has an additional disclosure exemption available where a franchisee invests more than $5,000,000 over one year for the acquisition and operation of the franchise. Again, the drafting of this legislation provides no guidance on what types of payments are included in the calculation of the $5,000,000 investment. The FTC Rule has a similar exemption, but it refers to “initial investment” as opposed to payments over a one year period. The FTC Compliance Guide indicates that initial investment means the expenses paid through opening and the first 3 months of operations. It excludes expenses such as rent, royalties and advertising costs that are paid outside the initial investment time period. Additionally, initial investment excludes the costs associated with franchisor provided financing and undeveloped land costs. Whether Ontario courts would follow an approach similar to the FTC’s interpretation of what constitutes an investment is unknown.

50 2010 ONSC 7022
51 Ibid. at para 67 – 69.
52 Ibid. at para 61
53 Ibid. at para 61 - 62
54 AWA, s.5(7)(g)(iii); FAPEI, s.5(8)(i); FANB, s. 5(8)(i); Bill 15, s. 5(11)(i)
55 Competition Act, s. 55(1)
56 Competition Act, s. 55(3)
57 AWA, s. 5(7)(h)
58 Supra at note 4 page 10
59 Supra at note 4 page 10
60 Supra at note 4 page 10
Further, it is unclear whether the Ontario exemption will permit pooling of funds by several smaller investors. By comparison, the FTC Compliance Guide makes it clear that at least one individual in an investor group must invest at the $1 million level because the exemption is premised on the assumption that a franchisee’s ability to pay $1 million equates with sophistication.  

The lack of guidance on how to calculate the $5,000,000 investment requirement could make use of the exemption risky except in situations in which the investment is sufficiently in excess of the required amount as to provide a cushion for types of costs which may later be excluded from the calculation by judicial interpretation.

(xii) Ministerial Discretion

In Alberta, franchisors may also apply for a discretionary exemption from any or all of the requirements of the Alberta Act by filing the required documentation with the appropriate government body.

Some franchise registration states in the United States offer a similar discretionary exemption. Franchise practitioners have successfully obtained discretionary exemptions in cases where they can show that the protection afforded by the state’s franchise law is not warranted. For example, the FTC Rule exempts franchise sales to large franchisees. Large franchisees are those that have been in business for at least 5 years and have a net worth of at least $5 million. The franchisor may be able to make the case, to the regulator in a state that does not have a corresponding large franchisee exemption, that such a large prospective franchisee is sophisticated enough to protect his, her or its own interests without the need for state mandated franchise registration and disclosure.

Conclusion

As discussed above, franchisors must provide disclosure to every prospective franchisee. Failure to do so gives rise to a right of rescission by the franchisee. If the remedy of rescission is granted, the franchisor must: (i) refund all payments it received from the franchisee other than payments made for the purchase of inventory, supplies or equipment; (ii) purchase all the remaining inventory, supplies and equipment (that was purchased pursuant to the franchise agreement) at a price equal to the price paid by the franchisee; and (iii) compensate the franchisee for any additional losses incurred in the acquisition and operation of the franchise.

The severe consequence for non-compliance with the statutory disclosure obligations heightens the risk associated with reliance on ambiguously drafted exclusions or exemptions. Whenever a business intends to rely on an exclusion from the application of a provincial franchise statute or a franchisor intends to rely on an exemption from the obligation to disclose to a prospective franchisee, it must assess its confidence that the exclusion or exemption clearly applies. It must also weigh the potential consequences of non-compliance with the benefits or savings to be achieved to ensure that avoiding the obligations under the franchise statutes is warranted.

61 Supra at note 4 page 12
62 FAA, s. 6(1)
63 AWA, s. 6; FAA, s. 13; FAPEI, s. 6; FANB, s. 6; Bill 15, s. 6
64 AWA, s. 6; FAA, s. 14; FAPEI, s. 6; FANB, s. 6; Bill 15, s. 6