

In the know Sotos

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Justice Andromache Karakatsanis

The partners of Sotos LLP take great pleasure in welcoming the Prime Minister's announcement of the nomination of Justice Andromache Karakatsanis to the Supreme Court of Canada. Justice Karakatsanis was a founding partner of the firm and, following a successful career in private practice, went on to a number of leading administrative and judicial positions including, most recently, as a judge of the Ontario Court of Appeal. She is a prolific writer and agile thinker with a strong sense of fairness and compassion which qualities will serve Canada well. We are proud of her accomplishments and of our association with her.

Sotos welcomes Peter Viitre, Christine Jackson and Shane Murphy

by John Sotos

Twenty eleven has been a growth year for many of our clients with expansions both at home and internationally ... and to serve them better, we grew right along.

I am pleased to announce the addition, over the summer, of three new members to our team.

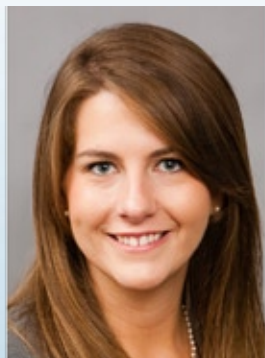
First, on July 1, Peter Viitre joined us as a partner in our corporate group. Peter comes to us from a large national law firm, where his practice included not only franchising and other retail and distribution advice, but also mergers and acquisitions and the provision of general corpo-

rate and commercial advice to clients in a wide range of industries at varying stages of development. His experience and expertise allows us to broaden our array of services and bolsters our already strong corporate team.

Joining Peter on the corporate side is Christine Jackson, whose practice encompasses all aspects of franchising and corporate and commercial law. Prior to joining us, Christine served as a judicial clerk in the Office of the Chief Justice at the Ontario Superior Court of Justice after completing a distinguished law school career.

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Sotos welcomes new lawyers



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Last, but not least, we also welcome Shane Murphy as our newest litigation associate. Shane holds a master's degree from the London School of Economics, is a graduate of the McGill University Faculty of Law, where he served as the Executive Editor of the McGill Law Journal, and articulated at a large national Canadian firm. His practice includes all manner of commercial disputes,

with a focus on franchising and class actions.

Each of Peter, Christine and Shane bring new skills, experiences and vitality to our firm that we are putting to good use in serving the needs of our clients. The strength of any service organization is the quality of its people and I'm proud of all of them. I encourage you to contact them directly.

Franchise disclosure exemption comes under review

by *Christine A. Jackson*

Knowing whether or not you can safely rely on an exemption to franchise disclosure can have multi-million dollar implications. A recent decision of the Ontario Court of Appeal is the first to consider the short duration disclosure exemption and provides much needed clarity for franchisors hoping to avoid the hefty costs associated with Ontario disclosure obligations.

The case involved a rescission claim by a franchisee operating a gas station under the franchisor's Sunoco brand name. The franchisee had entered into a franchise agreement with the franchisor for a one-year term, with no option to renew. The franchisor later merged with Petro-Canada and, following the merger, wrote the franchisee extending the franchise agreement for an

indefinite period, on a month-to-month basis.

A few months later, the franchisor again wrote the franchisee enclosing a termination letter and offering a transition payment in exchange for the franchisee agreeing to operate until August 2010, some 21 months following the entering into of the initial one year agreement. The franchisee rejected the offer, claiming the right to rescind the agreement and seeking a return of all payments made to the franchisor since entering into the franchise agreement on the basis that it was never provided a disclosure document.

The franchisor disputed the rescission claim relying on the short duration disclosure exemption. This exemption provides that disclosure is *not* required if: (i) the franchise agreement is not valid for longer than one year; *and* (ii) does not involve the payment of a non-refundable franchise fee. The franchisor argued that it was not required to provide the franchisee with a disclosure document as the franchise agreement met both requirements of the exemption.

The Superior Court of Justice agreed with the franchisor, holding that both requirements of the exemption had been met and the franchisee was therefore not entitled to rescind the franchise agreement. The Ontario Court of Appeal upheld the decision.

In considering the first requirement, the court agreed with the motion judge that the franchise agreement was only valid for one year as that was "the time frame during which the franchisee [was] bound to certain rights and obligations." Notwithstanding that the first requirement

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refers to the *validity* of a franchise agreement, the court's focus was on the stated *term* of the agreement as it was during this period that the franchisee could not walk away from the franchise.

The court further held that the month-to-month extension did not make the franchise agreement valid for longer than one year as this reasoning would, in the words of the motion judge, "make conduct illegal that was proper when it occurred." Put another way, it would penalize a franchisor based on events which occurred in the future and could not have been known at the time of signing the franchise agreement.

Notable also was the court's treatment of the indemnity and confidentiality provisions of the franchise agreement. Although both provisions survived termination or expiration, the court found that the survival did *not* extend the term of the franchise agreement as these provisions only came into effect upon the franchise agreement being terminated or expiring. A terminated or expired agreement, in the eyes of the

court, could not be considered valid for the purpose of the exemption.

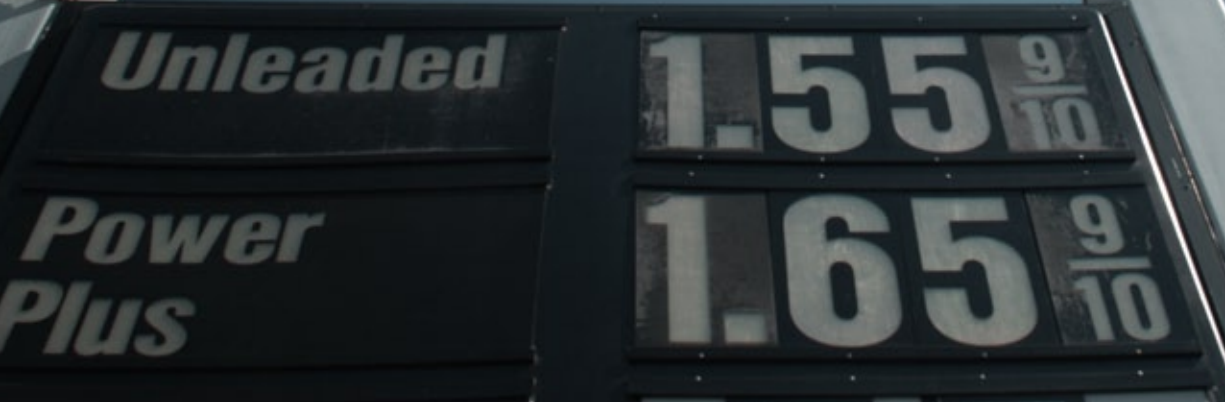
Turning to the second requirement, that is, no non-refundable franchise fee, the court again upheld the finding of the motion judge that a franchisee fee had not been paid. Specifically, the court found that the royalty payments required of the franchisee did not fall within the scope of "franchise fee." In reaching this conclusion, the court stated that "a franchise fee is in the nature of a fee paid for the right to become a franchisee. It does not include royalties or payments for goods and services." A franchise fee, then, is a sort of "initiation-like" fee, and because there was no such fee in the franchise agreement, the exemption applied.

What can franchisors and franchisees take away from this decision? In determining the validity period of a franchise agreement the courts will look to the intention of the parties at the time of signing the franchise agreement. Where parties do not contemplate an extension beyond one year at the outset, a subsequent agreement to

extend will not operate retroactively so as to require disclosure, and will not bar a franchisor from relying on the exemption. Furthermore, while not extending to royalty fees, the definition of "franchise fee" remains quite broad and can include such fees as non-refundable deposits or any payment to enter the system other than payments for goods and services. Franchisors hoping to rely on the exemption must therefore ensure no such fee is obtained from a prospective franchise, either directly or indirectly.

Despite the outcome of this decision, the short duration disclosure exemption remains very narrow and will only apply in rare circumstances. If you are a franchisor seeking to rely on a disclosure exemption, you will be well served to obtain legal advice in advance of entering into a franchise agreement with a prospective franchisee.

Sotos LLP represented the franchisee in this decision. For more information on the case contact David Sterns or Allan D.J. Dick.



Disclosure documents and franchise resales: what franchisors should know

by John Yiokaris

Earlier this summer, our firm won an important decision in the Ontario Court of Appeal. This decision reinforces best practices for franchisors that provide disclosure documents to franchisees that purchase existing franchises from other franchisees. At issue was the interpretation of an exemption from giving a disclosure document under the *Arthur Wishart Act (Franchise Disclosure)*, 2000 (the “Act”).

Prior to being heard by the Court of Appeal, the lower court declared that a former Pizza Depot franchisee that had purchased its franchise from a previous franchisee had validly rescinded its franchise agreement since it never received a disclosure document and so, the franchisor was liable to pay damages to it as required by the Act. The franchisor took the position that it wasn’t obligated to provide any disclosure document since it was exempted from doing so. The franchisor appealed the lower court’s decision arguing that the lower court had erred in its interpretation and application of a certain exemption to providing a disclosure document, specifically, Sections 5(7)(a)(iv) and 5(8) of the Act.

By way of background, Section 5(7)(a)(iv) of the Act provides that a franchisor does not need to provide a prospective franchisee with its disclosure document where the “grant of the franchise is not effected by or through the franchisor”. Section 5(8) of the Act states, in part, that a grant of a franchise 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 franchisor argued that it played no role in the sales process or in arranging the agreement of purchase and sale between the franchisee who sold its franchise (the vendor franchisee) and the franchisee that eventually rescinded its franchise

agreement (the rescinding franchisee). Accordingly, the franchisor claimed that it was exempt from providing disclosure in this resale situation pursuant to Section 5(7)(a)(iv) of the Act. However, the Court of Appeal disagreed with the franchisor.

The Court reminded the parties of an earlier Court of Appeal decision in *Salah v. Timothy’s Coffees of the World Inc.* where the court observed that the purpose of the Act is “to redress the imbalance of power as between franchisor and franchisee” and to “provide a remedy for abuses stemming from this imbalance.” With this in mind, the Court of Appeal accepted our arguments that exemptions from the duty of disclosure in the Act are to be “narrowly construed” in order to advance the purpose of the Act which is to protect franchisees. Using those parameters as a guideline, the Court of Appeal found the following facts:

- i. the franchisor had directed the rescinding franchisee to this particular business;
- ii. the franchisor had some involvement in the negotiations for the agreement of purchase and sale of the assets of the business between the vendor franchisee and the rescinding franchisee. To use the words of the Court, the franchisor “was not merely a passive participant in this resale”;
- iii. the agreement of purchase and sale required the rescinding franchisee (not the vendor franchisee as is typically the case) to obtain the consent of the franchisor and thus deal directly with the franchisor; and
- iv. the franchisor required the execution of certain documents by the rescinding franchisee that the vendor franchisee had not been required to sign.

All of these circumstances, taken together,



supported the lower court’s decision that the resale was brought about or caused to happen by or through the franchisor. Further, the Court of Appeal held that the franchisor went beyond the passive role of merely exercising its rights to approve the resale of the franchise business within the meaning of Section 5(8) of the Act. Accordingly, the rescinding franchisee had the right to rescind and the franchisor was liable to pay damages to the rescinding franchisee.

The courts have now signaled that franchisors must be very careful in relying upon the exemptions from having to provide a disclosure document. Not only will the courts narrowly construe any exemptions to disclosure, they will take a hard look at the facts surrounding the franchisor’s involvement in the resale process. In reviewing the resale process, the courts will look at both the franchisor’s role in facilitating any transaction and the requirements that the franchisor asked the parties to fulfill. Moreover, when it comes to resales, franchisors will also need to weigh the risks involved in relying upon an exemption to disclosure document against providing a site specific disclosure document. In light of this very important decision, franchisors should seek legal advice before they try to take advantage of any of the exemptions to the disclosure document under the Act.

Popping the question: disclosing earnings potential to franchise buyers

by David Sterns

How much money will this business make? That is the question on the mind of everyone who considers buying a franchise. No rational person would consider buying a franchise without wanting an answer to this question. And yet, it is a very tricky one for the franchisor to answer if it wants to stay within the bounds of the law.

Ontario's franchise protection statute, the Arthur Wishart Act (Franchise Disclosure), 2000, and its associated Regulation put limits on how information about the profitability of the business can be disclosed to the potential buyer of a franchise.

The Wishart Act radically changed the way franchises are sold. Before the Act came into effect, many franchisors would provide a franchisee with a pro forma statement showing profitability at various sales levels. In some cases, few franchisees in the system had ever actually achieved those sales levels. This had the potential to mislead purchasers. Other times, a franchisor would provide back-of-the-napkin profitability information to the purchaser that could not be verified. The franchisor usually insulated itself with disclaimers that told the franchisee not to rely on the information even though the sole purpose of providing the information was to induce the franchisee to buy the business.

The Wishart Act was supposed to change all of that. It requires a franchisor to deliver to the potential buyer of a franchise a pre-sale disclosure



document that discloses all material information about the business and the franchise system. If a franchisor wishes to give information about the potential profitability of the franchise, it must do so in the form of an earnings projection in the disclosure document itself. To ensure that the information in the earnings projection

is verifiable, the disclosure document must state the reasonable basis for the earnings projection, the assumptions underlying it and a location where information is available for inspection that substantiates the projection. The disclosure document must also contain

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Popping the question

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a certificate attesting to its completeness and accuracy. Failure to comply with these strict requirements exposes the franchisor and the individuals who signed the certificate to significant liability.

Although the Wishart Act has been around for over ten years now, old practices die hard. This is especially true when it comes to statements about the profitability of the franchise. Some franchisors try to circumvent the Act by giving pro formas or profitability statements outside of the disclosure document. Sometimes this is done for the ostensible purpose of assisting the franchisee in preparing a business plan to obtain bank financing. Another method is to send the franchisee an "information package" containing what are said to be "typical" earnings experiences of other franchisees, along with a disclaimer. Many sales brokers employed by franchisors fall into the trap of giving this sort of information to potential purchasers outside of the disclosure document.

All of these practices are now prohibited in Ontario. The only place where earnings information can be disclosed to a potential purchaser of a franchise is in the disclosure document. If the disclosure document says that the franchisor 'does not provide earnings projections, then no such information can be provided. If the franchisor does provide earnings information, it must provide it in the disclosure document itself and not in any other format.

The Wishart Act was intended to stamp out all forms of representations about earnings other than those contained in a disclosure document. Circumventing the restrictions in the Act can land the franchisor and any franchise sales people in hot water.

Disclosure in the context of an ongoing franchise relationship - The case of General Motors' dealers "wind-down" agreements

by *Allan D.J. Dick*

In May, 2009, General Motors of Canada Limited ("GM"), entered into agreements ("WDA") with 230 of its dealers to wind down their businesses as part of GM's restructuring and efforts to obtain billions of dollars in government "bail-out" money.

The dealers were given less than a week to accept the offers made to them and were threatened by GM that if all of the dealers did not take up the offer, GM would invoke insolvency proceedings.

Prior to the "wind-down" offer being made by GM, many of the franchisees

had retained the Toronto Law Firm of Cassels Brock & Blackwell ("CBB") to deal with GM as a body of dealers.

Unbeknownst to the dealers, CBB was already representing the Canadian government which was involved as the primary source of the bail-out funds. CBB did not act for the dealers when the wind-down offers were presented. The dealers were told to consult with their local lawyers.

Our firm, together with the firm of Weir & Foulds, commenced a class action on behalf of the dealers against GM and CBB. The position being

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argued is that the dealers were entitled to receive a disclosure document before they were provided with the WDA to sign. There was no dispute that no disclosure documents were given to the dealers.

The action against CBB centres upon that firm allegedly having had a conflict of interest and allegedly abandoning the dealers when faced with the offers to wind down.

On March 1, 2011, following a contested hearing, Justice George Strathy of the Ontario Superior Court of Justice, certified the actions against both defendants. In His Honour's Reasons for Decision, Justice Strathy reviewed the purpose of franchise and class proceedings legislation as espoused in previous cases.

In His Honour's decision, Justice Strathy reaffirmed that "there are aspects of franchise claims that may promote the goals of both the Arthur Wishart Act ("AWA") and the Class Proceedings Act."

Justice Strathy certified the following common issues to proceed to a common issues trial as against GM:

- (a) Is GM a franchisor within the meaning of the franchise legislation?
- (b) Are all class members entitled to the benefit of the statutory duty of fair dealing right of association by virtue of the choice of law provisions in the standard GM Dealer Sales and Service Agreement and the WDA;
- (c) If GMCL owed a duty of fair dealing to the Class Members, did GM breach this duty by:
 - i. delivering the WDA to the Class Members on or after May 20, 2009 and requiring their acceptance by 6 p.m. EST on May 26, 2009;
 - ii. not disclosing to the Class Members the identities of dealers offered a WDA;
 - iii. stating in the Notice of Non-Renewal and WDA that GM "will not be renewing the Dealer Sales and Service Agreement" between GM and

each of the class members at the expiry of its current term on October 31, 2010;

iv. stating in the WDA that "it has always been and continues to be [GM's] position that the franchise statutes are not applicable to the Dealer Agreement or the relations between GM and Dealer and/or Deliver Operator";

v. stating in the Notice of Non-Renewal, the WDA and the May 19, 2009 HIDL broadcasts the GM's offer of the WDA was conditional upon all of the Non-Retained Dealers accepting the offer on or before May 26, 2009; or

vi. breaching any terms of the WDA;

(d) Did GM have a duty to disclose material facts concerning its restructuring to franchisees at the time of soliciting the WDA? If so, did it fail to disclose material facts and did it breach such duties;

(e) If all Class Members have a statutory right to associate, did GM interfere with, prohibit, restrict, penalize, attempt to penalize or threaten to penalize the Class Members' exercise of this right for any of the same reasons set out above;

(f) Are the waiver and release contained in s.5 of the WDA null, void and unenforceable in respect of the class members' statutory rights;

(g) Was GM required to deliver to each class member a disclosure document within the meaning of the franchise statutes, at least fourteen days before the class member signed the WDA;

(h) By virtue of GM's failure to deliver any disclosure document:

i. is each class member entitled to rescind the WDA within two years of signing the WDA or the grant, if in Alberta;

(i) Is each class member which delivers to GM a notice of rescission or notice of cancellation, as the case may be, in respect of the WDA within two years entitled to statutory compensation?

In addressing GM's position that the WDA

was not a franchise agreement requiring disclosure Justice Strathy stated: "Nor can I say that the policy of the (AWA) runs contrary to imposing an obligation of disclosure when the franchisor proposes to make an important and unilateral amendment to the franchise agreement. One could certainly argue that an amendment that involves the franchisee divesting itself of its investment, and surrendering important rights under its franchise agreement is every bit as significant as its initial decision to invest in the first instance. To put this point in context, consider that Trillium and the other 239 franchisees who had been offered the WDA were essentially being told by GMCL, "if this offer is not accepted by every last one of you, there is a strong possibility that we will seek protection from our creditors and you may get nothing." It does not strike me as unreasonable, or inconsistent with the statutory purpose, to suggest that GMCL had an obligation to make full and fair disclosure of all material facts known to it that might reasonably affect the franchisees' decision".

The following common issues were certified as against CBB:

- Did CBB owe contractual duties to some or all of the class members and, if so, did it breach those duties;
- Did CBB owe fiduciary duties as lawyers to some or all of the class members and if so, did CBB breach those duties;
- Did CBB owe duties of case to some or all of the class members and, if so, did it breach those duties?

On January 12, 2012, the Ontario Divisional Court will decide CBB's appeal of Justice Strathy's decision and will decide whether Justice Strathy was correct in certifying issues (d) and (e) as against GM.

The case raises the issue of when disclosure must be provided in the context of an ongoing franchise relationship. We shall continue to provide updates on the developments in this action which are otherwise available to be read on our firm's website at www.sotosllp.com.

The exception to the exception: directors' liability and what you need to know

by Christine Jackson

Taxes. Nobody likes them, but we all have to pay them, and for some directors a recent decision out of the Tax Court of Canada in *Snively v. The Queen* may mean continued liability even after resignation. This decision serves as a caution for directors of corporations that continue to manage the affairs of a corporation after resignation.

Under subsection 323(1) of the *Excise Tax Act*, a director of a corporation is personally liable for the failure of his or her corporation to remit GST/HST. There is an exception to this rule, however, under subsection 323(5) of the *Excise Tax Act* which protects directors from personal liability where they have ceased to be a director of the corporation for two or more years.

But what does it mean to cease being a director? According to the court's decision in *Snively*, resignation as a director alone may not suffice. In finding Donald Snively, a former director, personally liable for the failed tax remittances of a corporation he had previously resigned from, the court looked to the definition of "director" found in subsection 115(4) of Ontario's *Business Corporations Act*. This subsection states that where a corporation has no directors, an individual may be deemed to be a director where he or she manages or supervises the management of a corporation. In effect, this subsection creates a sort of exception to the exception, which can leave some directors vulnerable to liability irrespective of their resignation as a director.

This exception to the exception, then, raises the issue of when the limitation period in subsection 323(5) of the *Excise Tax Act* begins to run? Or, put another way, how does a deemed director cease to act as a director? Citing a previous court decision, the court in *Snively* indicated that a deemed director may cease to act as such "by giving notice to the corporation and actually stop managing or supervising the management of the company." Managing or supervising the management of the company includes such things as participating in board meetings, signing board resolutions, approving and signing income tax returns, making or participating in administrative decisions or decisions to sell, or giving instructions in the name of the corporation.

What does this mean for directors of corporations in those provinces with deemed director provisions similar to

Ontario? The answer is simple, liability will continue until the director sufficiently distances himself or herself from the corporation. This, however, may prove problematic for a number of corporations where one individual wears the many hats of shareholder, director, and officer. In that case, it will be difficult, if not impossible, for a shareholder to ever be fully insulated from the liability normally imposed on a director. The solution may be to ensure corporations are properly wound up to avoid any lingering incidents of management, and, of course, to properly remit GST/HST.

If these issues relate to your corporation, you will be well served to obtain legal advice in advance of making any corporate changes. Counsel can guide you through the implications of the options available to you and alert you to any risks.

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