

# In the know Sotos

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## Confusing Renewal Clauses and the Duty of Fair Dealing – Ontario Court of Appeal Addresses Both

By John Yiokaris

*A right of renewal of a franchise agreement can very rarely be inferred from the surrounding circumstances of the franchise relationship and the statutory duty of fair dealing. With respect to express rights of renewal, the Ontario Court of Appeal recently affirmed the lower court's decision in Salah v. Timothy's Coffees of the World Inc. This decision serves as a caution to franchisors.*

The plaintiff was a franchisee operating a *Timothy's* coffee shop franchise in the food court of an indoor shopping complex. The franchisee entered into a franchise agreement and a sublease agreement with the defendant franchisor for a term commencing in 2001 and expiring in 2005. The franchisee had an *express* right of renewal, albeit one spread across the franchise agreement and sublease agreement. Prior to signing the franchise agreement, the franchisor represented to the plaintiff that if it was able to renew the head lease at the same location within the shopping complex it would extend an offer to renew the franchise documentation to the plaintiff. Once the head lease expired, however, the franchisor terminated its relationship with the franchisee and entered into new franchise agreements with a new

franchisee in another location within the same shopping complex.

The plaintiff argued that it had a right to renew its franchise agreement at the new location, or at the very least, was entitled to damages due to the franchisor's breach of the duties of good faith and fair dealing. The plaintiff submitted that if the franchisor was able to secure a head lease in the same shopping complex that was sufficient to trigger any promise of renewal. The franchisor argued that there was no right of renewal in the franchise agreement and if in fact there was a right of renewal, it was contingent upon the franchisor securing a head lease at the exact same location within the shopping complex and did not extend to other parts of the complex. It argued that since it was unable to

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[ 180 Dundas Street West, Suite 1250 :: Toronto, Ontario M5G 1Z8 :: 416.977.0007 :: sotosllp.com ]

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secure a head lease in the exact same location within the shopping complex, it was entitled to treat the franchise agreement as expired and was thus free to enter into a new franchise agreement with a new franchisee at the new location.

The Courts agreed with the plaintiff, holding that the franchisor breached its duties by failing to communicate adequately with the franchisee and by actively misleading the franchisee into thinking that the franchisor would permit the franchisee to renew its franchise agreement. In the period leading up to the expiration of the franchise agreement, the franchisor was lackluster in its communications. The franchisor did not advise the franchisee that it would be unable to secure a new head lease in the franchisee's food court location until very late in the term of the franchise

agreement. Even then, it was only by accident that the franchisee discovered that a new location in the shopping complex was being considered by the franchisor. The Courts held that the franchisee was given insufficient notice that its franchise agreement was going to end and was misled into thinking that the relationship was going well and that it would have an opportunity to renew its franchise agreement and sublease agreement.

The sublease agreement in *Timothy's* was unclear as to whether it referred to the entire shopping mall as the "location" or whether it referred only to the specific location in the food court where the plaintiff's business was originally located. The Courts chose to interpret the head lease in favour of the franchisee, finding that the right of renewal was triggered if a head lease was secured anywhere in the shopping complex. In interpreting the franchise agreement, the lower court stated:

*In applying rules of contract interpretation to a franchise agreement, it must be noted that there are significant differences*

*between a franchise agreement and an ordinary commercial contract.*

*A franchise agreement is a contract of adhesion. It involves, in essence, a "take it or leave it" position adopted by the franchisor. Therefore, this type of contract is subject to being interpreted against its author, in this case, the franchisor..."*

The franchisee was also awarded damages which were non-compensatory in nature pursuant to the finding that the franchisor breached its statutory duty to the franchisee. The decision in *Timothy's* signals that renewal expectations and clauses will be interpreted in favour of franchisees where there is any ambiguity. Franchisors are also cautioned to be forthright and unambiguous when communicating with their franchisees.



# “Material Changes” to a Disclosure Document – What do they mean?

By John Yiokaris

For franchisors selling franchises in those provinces with franchise disclosure legislation (Ontario, Alberta, New Brunswick, and Manitoba), the law requires that they must provide all prospective franchisees in those provinces with a disclosure document. In preparing its disclosure document, a franchisor must disclose all “material facts” in its disclosure document. In our experience, franchisors are quite familiar with the definition of “material fact” - but are less familiar with the franchisor’s obligation to disclose a “material change” once they have given out their disclosure document.

## ***What is a “Material Change”?***

The legislation in all of the disclosure provinces defines a “material change” as a change in the business, operations, capital or control of the franchisor or its associate, or a change in the franchise system [New Brunswick and PEI both include any change to the “franchise”], that would reasonably be expected to

have a *significant adverse effect on the value or price of the franchise* to be granted [Alberta uses the term “sold” instead of “granted”] or the *decision to purchase the franchise*, and includes a decision to implement the change made by the board of directors of the franchisor or its associate or by senior management of the franchisor or its associate who believe that confirmation of the decision by the board of directors is probable.

So what does a franchisor do after it has delivered its disclosure document to a prospective franchisee, having ensured that all “material facts” have been disclosed, when it discovers that a “material change” has occurred?

## ***When does a franchisor disclose a “Material Change” to a prospective franchisee?***

A franchisor is required to provide a prospective franchisee with a written statement disclosing any “material change” (known as a statement of material change) to

the information in its disclosure document as soon as practicable after the change occurs and in any event before the 14-day “cooling off” period expires. If a “material change” occurs, a franchisor must provide a prospective franchisee with a statement of material change setting out the relevant information.

## ***How does a franchisor disclose a “Material Change” to a prospective franchisee?***

Although the law doesn’t impose an actual format for the form the statement of material change, both franchisors and prospective franchisees in Ontario should keep in mind the Ontario requirement that disclosure must be “clear and concise”. That is why a statement of material change should either be formatted in the same manner as the disclosure document it modifies, or else it should contain a cross-reference table which points out where the information that is

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being amended may be found in the disclosure document. The idea is that a prospective franchisee should be able to easily understand the affect of the “material change” to the franchisor’s disclosure document.

Since every person who signs the statement of material change may be sued for any misrepresentation that may exist in the document, by necessary implication a statement of material change must have some sort of “Certificate of Disclosure” that is similar to that found at the back of a disclosure document. Since the law doesn’t specify a format for this certificate, a franchisor’s safest bet is to adapt the form of certificate prescribed for its disclosure document.

### ***How does a franchisor deliver its Statement of Material Change to a prospective franchisee?***

To add to all of the confusion, the law does not specify an actual delivery method for a statement of material change by the franchisor to a prospective franchisee. Despite the lack of any guidance from the

legislators, a good way to proceed would be for a franchisor to use one of the delivery methods available for the delivery of a disclosure document.

### ***How much time should a franchisor give to a prospective franchisee to consider the Statement of Material Change?***

Although the law mandates a 14-day “cooling-off” period following the delivery of a disclosure document before the prospective franchisee makes any payment or signs any agreement relating to the franchise, there is no obligation to provide for any “cooling-off period” following the delivery of a statement of material change. So, what does a franchisor and prospective franchisee do? Obviously some sort of “cooling-off” period would be appropriate, but of course there is nothing sacred about 14 days. If a franchisor can wait 14 days then that would be preferable, otherwise a franchisor should simply wait long enough for the prospective franchisee to absorb the new or

modified information presented in the statement of material change and to consider its effect on the intended purchase.

### ***What about negotiated changes?***

There seems to be no purpose in a franchisor being required to disclose to a prospective franchisee the very changes which the prospective franchisee may have negotiated. The purpose of disclosure is to require a franchisor to provide a prospective franchisee with material information which might not otherwise be known, and not to waste a franchisor’s time and money on pointless exercises. It is our general practice to suggest that it is not necessary for a franchisor to disclose negotiated changes requested by the prospective franchisee. Of course, if franchisees regularly succeed in negotiating changes to a franchisor’s standard form agreements, that fact would definitely seem to be material and should be disclosed.... but that’s a topic for another day.

# Re-freshing Your Brand: Legal Considerations

Franchise systems, by their very nature, are evolutionary and subject to change. Change can include a whole variety of modifications; from changes to the colour scheme of your “house” signage and trade-mark to the implementation of major system changes. This article considers the legal implications of making changes.

You first need to consider the governing contract, namely the franchise agreement. You should also be reviewing: (i) your operations manuals, which may also require compliance with franchise system changes; and (ii) various store leases, which may or may not permit a change in the name or permitted use. In almost all cases, however, brand refresh changes are contemplated by the franchise agreement. In a well drafted franchise agreement, a “system change” clause would provide the necessary mechanisms for a franchisor to implement the changes being considered. A “system change” provision essentially provides that a franchisor, in its *sole discretion*, may, upon notice and acting reasonably, change the system, including the adaptation and use of new or modified marks, etc., and that the franchisee will implement the changes at its sole cost. Particular agreements may have specific notice periods that the franchisor has to give or may provide caps on the cost to the franchisee of any system changes.

The legal analysis does not stop there even if the franchise agreement contains a clear and comprehensive system change provision. Evolving case law and franchise specific legislation, particularly in the area of fair dealing, will have an impact on the legality and enforceability of proposed changes. In general, the case law provides that

a franchisor must have regard to the reasonable commercial expectations of its franchisees before implementing re-branding measures. Recent case law (see *MBEC Communications Inc. v. Douglas Gavel et al*, as an example) lends strong support to the conclusion that franchisors who introduce a new trade-mark as an effort at re-branding cannot merely rely on a black letter contractual right to change the appearance of an existing mark. The franchisor must consider the message and meaning conveyed by the change.

Whenever a franchisor exercises discretion which it has reserved for itself in a franchise agreement, such as where it has the discretion to implement system changes, it must act fairly and in good faith. If a franchisor is in fact considering changes that would identify the franchise as something entirely different from that which it authorized its current franchisees to operate, such a change may be deemed far beyond the reasonable expectations of the parties when they entered into the franchise agreement and not be permissible as being unfair.

How does a franchisor act fairly in refreshing its brand? Here are a few tips:

- Work with a well known and qualified market research company to ensure that all the appropriate studies (including focus groups) have been undertaken that would suggest that the changes will have a positive impact on the franchisees.
- Make sure that the changes have been tested in existing stores, preferably a corporate location, well before being mandated as system changes.
- Make sure the franchise advisory

By Allan D. J. Dick and David Gray

council (marketing committee) is involved as early in the process as is reasonable while maintaining confidentiality for obvious reasons.

- Prepare a marketing plan that illustrates and delineates the proposed change.
- Encourage debate among the franchise advisory council and with key members of the franchisee association, if one exists, in order to get feedback, and buy-in, from the franchisees.
- Do not earn a profit or rebate on the construction costs to implement the changes.
- Communicate, communicate, communicate. Give proper notice of changes and make sure that each franchisee understands and appreciates the rationale for changes.
- If the franchise agreement does not contain a system change clause then a franchisor will have to negotiate with its franchisees and come to an agreement on the system changes. In the provinces with franchise legislation, the franchisor in this situation may be required to deliver a disclosure document before such an agreement is signed.

Therefore, careful legal analysis needs to be given of the desired changes and implementation strategy to be adopted to ensure the changes have the best chance of being accepted as permissible. Also keep in mind that once a franchisor is giving serious consideration to possible system changes, that may be a material fact requiring disclosure by that franchisor in those provinces with franchise disclosure legislation.

## Canadian Class Action Update

By Allan D. J. Dick

Since the release of our fall newsletter there have been several important developments in various Canadian franchise class proceedings.

### **Quiznos**

Quiznos and its distributor, Gordon Food Service (“GFS”), were unsuccessful in their bid to have the Supreme Court of Canada entertain an appeal of the Ontario Court of Appeal decision affirming the Divisional Court’s certification of the action as a class action. Certification is now complete and the matter is proceeding to discoveries over the summer months. Our firm represents the franchisee class.

### **Pet Valu**

The Ontario Superior Court of Justice certified an action on behalf of Pet Valu franchisees against their franchisor. The franchisees contend that the franchisor has breached its contractual and statutory obligations to them over the past 7 years by failing to pass on the benefit of the volume rebates which the franchisor has successfully negotiated for the benefit of the entire system by virtue of its tremendous bargaining power. A statement of the common issues certified will be finalized in March, 2011. Our firm represents the franchisee class.

### **Suncor**

The Ontario Court of Appeal will be considering an appeal on behalf of



over 300 former Sunoco dealers in Ontario later this year. The Superior Court of Justice determined that Suncor was entitled to enter into its agreements with the dealers that last preceded the termination of the dealerships without having had to provide a disclosure document within the meaning of the *Arthur Wishart Act (Franchise Disclosure), 2000*, as an exemption to disclose was available to it given the provisions of the agreement relating to its term. This decision determined at first instance the major substantive issue in the intended class proceeding.

The decision has important implications for the franchise industry given the lower court’s interpretation of the exemption. We are not recommending that our franchisor clients immediately seek to avail themselves of the benefits of the decision given the issues which will be decided by the Court of Appeal. Our firm is representing the appellant in the proceeding.

### **GM**

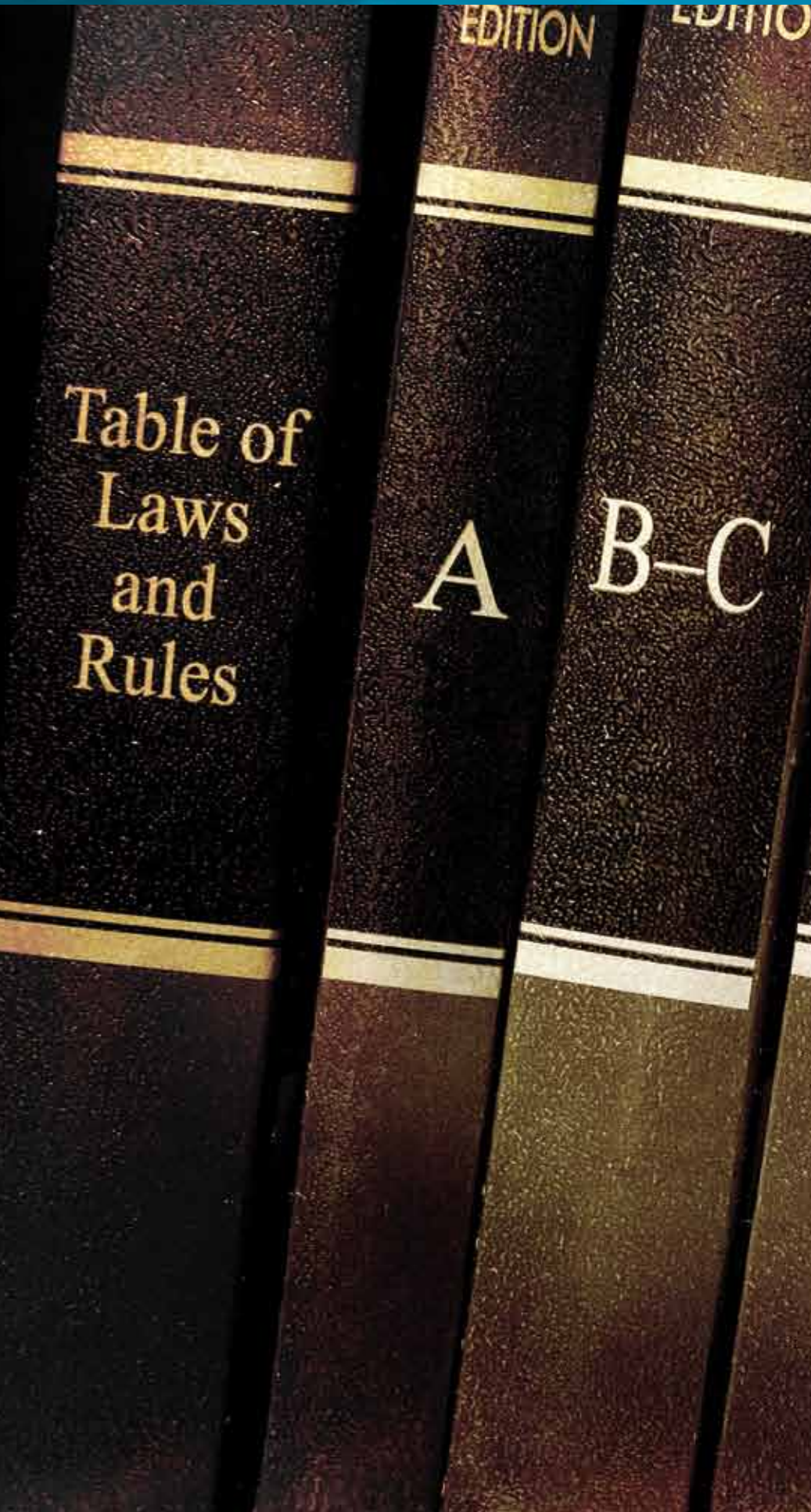
The Ontario Superior Court of Justice heard lengthy argument

in December, 2010 on the motion brought on behalf of over 200 terminated General Motors dealers to have their dispute with GM and the law firm of Cassels Brock & Blackwell certified as a class action relating to the “Wind Down Agreements” which these dealers entered into to close their dealerships when GM was threatening potential insolvency proceedings in the spring of 2009. The class proceedings judge is still considering the matter and no date has been set for the release of the reasons for decision. Our firm together with the Toronto based firm of WeirFoulds LLP is representing the dealers.

### **Sears**

The Ontario Superior Court of Justice also certified a claim brought by a number of Sears home services franchisees relating to the alleged failure by Sears to pass on rebates pursuant to their contracts with Sears and pursuant to Sears’ statutory duties under the *Arthur Wishart Act*. The decision is not under appeal.

We will continue to keep you informed on important developments as these and other class actions wind their way through the courts.



# Forced Releases in Franchise Sales and Transfers

By Vukica Djuric

You will recall from an earlier edition of this Newsletter that the Ontario Court of Appeal in the Midas class action gave effect to Section 11 of the *Arthur Wishart Act (Franchise Disclosure)*, 2000 to severely limit a franchisor's ability to enforce a condition in a franchise agreement requiring a franchisee to deliver a release in favour of the franchisor as a condition of obtaining a renewal or extension. Section 11 states that any release or waiver by a franchisee of rights given by the Act are void.

As stated by the Court of Appeal, a provision in a franchise agreement requiring franchisees to give up potential future claims against the franchisor for purported breaches of the Act in order to renew the franchise agreement "unequivocally runs afoul of the Act".

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Despite the wording of Section 11, the courts have also made it clear that not all releases will automatically be void. Where a franchisee enters into a release with legal advice for the purpose of settling known and existing breaches of the Act and presumably where the settlement is reasonably obtained given the franchisor's duty of fair dealing, the settling franchisee will not be able to subsequently resile from the release. The distinction is therefore made between releases which are forced upon a franchisee and settlement releases which are freely entered into by the franchisee for the purpose of settling known and existing breaches of the Act.

While it had been a common practice for franchisors to make a right of renewal or transfer conditional upon the franchisee providing the franchisor with a general release from any and all claims, the Midas decision marked a clear shift in how franchisors must conduct themselves, both in the drafting of franchise agreements and when considering any situation where they are seeking to obtain a release. The effects of this decision are not restricted to franchisees in Ontario, as the decision applies in situations where the governing law provision of the franchise agreement imports Ontario law into the contract wherever the franchise is situated.

Courts in the other provinces with similar legislative provisions can be expected to consider the Midas case and, as such, franchisors operating in those provinces are wise to treat the Midas decision as being equally applicable in those provinces.

The procuring and drafting of releases in the post-Midas era require special attention and care. It is critical that if the obtaining of a release is an important feature of any transaction, legal advice be sought to give yourself the best opportunity to obtain the benefit you are looking for.



# Non-Competition Covenants: Important Limits on the Freedom to Contract

*By Andy Seretis*

You're a franchisor that has invested significant time, effort, and expense in developing a unique franchise system. In order to successfully franchise the business, you must train your franchisees on the inner workings of the franchise system and show them the standards and specifications of how the system operates. However, you want to ensure that your franchisees do not use that know-how, either during the term of the franchise agreement or afterwards, to run a competing business and damage the goodwill of the franchise system.

A franchisor faces this tough issue before ever signing its first franchise agreement: how does it protect its investment in the franchise system by ensuring that its franchisees do not use what they will learn to compete with the franchise system? The problem is solved by a franchisor requiring its franchisees to give a non-competition covenant whereby each franchisee agrees not to compete directly or indirectly with the franchised business during

the term of the franchise agreement and for a defined period afterwards. If the franchisee is a corporation, the franchisor will ordinarily require the principals of the corporation to give the covenant as well.

A non-competition covenant usually contains three components:

1. a geographic restriction – what area is the franchisee restricted from operating in?
2. a time restriction – what length of time is the franchisee bound for?
3. an activity restriction – what is the franchisee restricted from doing?

While a franchisor may want to draft a broadly worded provision to ensure maximum protection of its goodwill and franchise system, Canadian courts have not been very accommodating in enforcing covenants they consider to be overly broad. The Supreme Court of Canada has long held that non-competition clauses should only be enforced in exceptional

circumstances as such clauses which restrain trade and discourage competition are against the public interest. In balancing the public interest with a franchisor's genuine and legitimate business interests, and recognizing that a franchisee is voluntarily entering the agreement, the court will enforce a restriction only where the clause is reasonable to protect that legitimate business interest.

In enforcing a non-competition covenant, the onus is on the party seeking to enforce the covenant to show that it is reasonable in geographic and temporal scope and limited to activities worthy of protection. As such, a franchisor should be careful to define the geographic, time, and activity restrictions in the narrowest scope that is reasonably necessary to protect its interests. A non-competition covenant will likely be found unenforceable where it is too wide geographically, for too long, and too restrictive in nature.

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It is also important that a non-competition covenant be unambiguous and specific in its terms. If the clause is ambiguous in any material way, courts will find it difficult to determine that the clause is reasonable and it will likely be found unenforceable. For example, for a pizza delivery franchise, stating that the franchisee is prohibited from operating “a similar or competing business” will likely be found unenforceable for its ambiguity. Such a clause may arguably seek to restrict a franchisee from operating another restaurant that may sell pizza as part of a larger menu offering. The fact that the

clause may be interpreted to cover a broader range of businesses than what the franchisee was carrying on will result in the clause being objectionable. Further, Ontario courts will not “read-down” an overly broad non-competition covenant to something that is reasonable, but rather, they will find that the covenant is entirely unenforceable.

Just as a franchisor must define the activity to be protected with care, similarly, the franchisor must be reasonable in selecting the time and distance parameters of the clause. The franchisor should consider the real trading area that needs protecting

and only restrict the activity long enough to allow it to re-establish itself in the trading area.

Given that a non-competition covenant cannot be used to unduly restrict a person’s ability to earn a livelihood but rather must be reasonable to protect the franchisor’s legitimate business interests, a franchisor must take extra precaution when imposing such restrictions upon its franchisees. Counsel familiar with non-competition covenants should be consulted to assist to establish reasonable safeguards to protect those interests to the extent permissible.

# Proposed Law Targets Harassment by Litigation

By David Sterns

*One of the best and worst features of our civil justice system is that basically anyone can sue anyone else, for anything, at any time. Eventually, the bad lawsuits will be thrown out and the winner may collect some of its costs from the other side. But that is cold comfort for people forced to defend frivolous lawsuits. It is even less comfort when the lawsuit is brought by a powerful plaintiff more intent on inflicting costs on the defendant than righting an actual wrong.*



If the recommendations of a panel created by Ontario's Attorney-General are accepted, there may soon be limited relief for people targeted with a specific type of lawsuit known as a Strategic Lawsuit Against Public Participation, or SLAPP.

SLAPPs are typically brought by corporations or powerful individuals against volunteer organizations and ordinary citizens who speak out on public policy issues. A typical example is a defamation suit against an individual who speaks out against a proposed development at a municipal council or zoning hearing. Another example is a suit against an environmental group for opposing a coal-fired generating plant or oil sands mine, or for lobbying for restrictions on the cosmetic use of pesticides.

In each case, the plaintiff's goal is to use the court system to intimidate or punish citizens for speaking

out against the plaintiff's interests. Rarely do these types of cases get to trial. The point is to force the defendant to defend a costly suit or issue a coerced retraction. Most of the time, such actions accomplish their objectives without ever seeing the inside of a courtroom.

The panel, chaired by University of Toronto Law Dean, Mayo Moran, found a need for legal protection against such suits. The panel recognized that the mere threat of a SLAPP can stifle public debate and lessen public participation in the democratic process. The civil justice system is currently ill equipped to identify and weed out SLAPPs quickly. Yes, there are ways to stop a frivolous lawsuit in its tracks by bringing a request to a judge. But, as

most lawyers know, rarely will a court dismiss a case before full evidence is presented. Our system puts a high premium on the plaintiff's right to have its "day in court."

Sophisticated plaintiffs know this. They also know the financial and emotional costs that prolonged litigation can have on a defendant. For a large corporation, the costs of litigation are the costs of doing business. For individuals or community groups, those financial and emotional costs can be crushing. Without assurances of payment, it can even be difficult to find a lawyer willing to take up their defence. All of that will hopefully change if the proposed law is enacted.

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The main feature of the proposed law is a quick and efficient procedure to have a SLAPP dismissed at an early stage. The target of the suit would have the initial onus to show that the lawsuit is directed at its public participation, which includes involvement in the legislative or policy-making process. Once this is shown, the onus shifts. The plaintiff must then show that the claim has substantial merit and the defendant does not have a valid defence.

This is a reversal of the usual test for the dismissal of an action. If the plaintiff cannot satisfy the test, the suit will be tossed out and the plaintiff will be forced to pay the full costs of the defendant.

Anti-SLAPP laws exist in a number of American jurisdictions even though American citizens have constitutional freedom of speech protection from suits by individuals and corporations. In Canada,

though, the Charter of Rights and Freedoms protects citizens only from government intrusions on freedom of speech, not from suits by individuals or corporations.

If the proposed law is passed, Ontario will join Quebec as the only Canadian provinces to have an anti-SLAPP law.

The panel's recommendations strike a delicate balance between preserving a plaintiff's access to the courts, and protecting citizens from the crushing costs of illegitimate lawsuits. The proposed law will deter anyone considering using the legal process to silence legitimate public discourse. It will offer targets of SLAPP suits an effective way to nip the suits in the bud. It will encourage lawyers to represent worthy defendants who might otherwise be unable to pay legal fees. For these reasons, it is a law worth passing.

## Contact List...

John Yiokaris: [jyiokaris@sotosllp.com](mailto:jyiokaris@sotosllp.com)

Allan Dick: [adjick@sotosllp.com](mailto:adjick@sotosllp.com)

Vukica Djuric: [vdjuric@sotosllp.com](mailto:vdjuric@sotosllp.com)

Andy Seretis: [aseretis@sotosllp.com](mailto:aseretis@sotosllp.com)

David Sterns: [dsterns@sotosllp.com](mailto:dsterns@sotosllp.com)