

Franchise Disputes and Litigation Strategies in the “New World” of the *Arthur Wishart Act: “Duty of Good Faith and Fair Dealing”, franchise associations, and disclosure requirements.*¹

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Introduction

The passing of the *Arthur Wishart Act (Franchise Disclosure) 2000* (the “Wishart Act”) has changed the legal landscape in which I practice franchise litigation by raising new issues which affect the way litigation strategies are implemented. The Wishart Act has established new, detailed disclosure requirements for franchisors as well as franchisee’s rights of association, fair dealing and rescission. Clearly, the Wishart Act has created new pot holes for franchisors to fall into and has armed franchisees with a greater number of tools to promote and protect their interests. So far, the Wishart Act’s greatest impact on my franchise litigation practice has been in the areas of franchisor disclosure requirements and in the imposition of statutory duties of good faith and fair dealing.

While relationships between franchisors and franchisees are generally intended to be long term, there are many aspects of the typical relationship which are not clearly spelled out in a franchise agreement, allowing the parties, and particularly the franchisor, to exercise some level of discretion. Where one party’s exercise of discretion negatively affects another party’s rights or interests, allegations of the breach of good faith and fair dealing provisions of the Wishart Act are now routinely being raised in legal claims for damages. Some of the resulting reported cases are discussed below.

The disclosure provisions of the Wishart Act have had a significant impact on our franchise litigation practice. Since the Wishart Act came into force, we have acted in more than 10 cases in which a franchisee has sought damages and rescission of the franchise agreement (and other, related agreements) because of the franchisor’s failure to provide the disclosure document now mandated by the Wishart Act. These and similar disputes have now produced a number of reported cases, including two of our own, which are discussed below. Although cases of misrepresentation in

¹This paper should be read conjunction with the paper written by Jeffrey Hoffman on *Class Actions in Franchising*.

disclosure documents have not occurred as frequently to date, I expect that we will see a great many such cases in the future, which has been the experience in the United States, where franchise disclosure legislation has been in existence for considerably longer.

As yet, there do not appear to be any reported cases dealing with the Wishart Act provisions regarding franchisee associations. Clearly, however, the legislation supports and protects the rights of franchisees to form associations to increase their co-ordination and bargaining strength in negotiations or contests with franchisors. This statutory right is particularly significant in cases where the franchise system has marked problems and where franchisees and their associations might otherwise feel intimidated by the franchisor.

A. Duty of Fair Dealing and the Duty to Act in Good Faith and in Accordance with Reasonable Commercial Standards

Sections 3, 9 and 11 of the *Wishart Act* state:

Fair dealing

3. (1) Every franchise agreement imposes on each party a duty of fair dealing in its performance and enforcement.

Right of action

(2) A party to a franchise agreement has a right of action for damages against another party to the franchise agreement who breaches the duty of fair dealing in the performance or enforcement of the franchise agreement.

Interpretation

(3) For the purpose of this section, the duty of fair dealing includes the duty to act in good faith and in accordance with reasonable commercial standards.

No derogation of other rights

9. The rights conferred by this Act are in addition to and do not derogate from

any other right or remedy a franchisee or franchisor may have at law.

Rights cannot be waived

11. Any purported waiver or release by a franchisee of a right given under this Act or of an obligation or requirement imposed on a franchisor or franchisor's associate by or under this Act is void.

Prior to the passing of the Wishart Act, Canadian courts had recognized the existence of a common law contractual good faith obligation. However, in Ontario, there was some judicial uncertainty as to when and how the good faith obligation was to be applied, whether the obligation included "fair dealings", and what remedy could be obtained as a result of any breach of the obligation.

For example, prior to the passing of the Wishart Act, in *Amaren Corp v. Cara Operation Ltd.*, [1999] O.J. No. 365, our firm acted for a Harvey's franchise owned by Amaren Corp. After commencing an action against the franchisor, Cara Operations Ltd., the Defendant's counsel brought a motion to strike out portions of our Statement of Claim. In disposing of the motion, the Honourable Mr. Justice Farley struck out a portion of our Statement of Claim in which we had pleaded that the franchisor owed our client a duty of "fair dealing". Justice Farley held, in part, that

There is no independent duty of good faith and fair dealing in Ontario. There is of course a duty to fulfill the contractual obligations of a contract in good faith. Fair dealing so far as I am aware is a statutory obligation in certain U.S. jurisdictions.

The Wishart Act now clearly sets out a duty of "fair dealing", just like the ones which exist in the "certain U.S. jurisdictions" to which Justice Farley referred, and also sets out a specific statutory cause of action for damages for breach of that duty, which hitherto did not exist.

Prior to the Wishart Act, the legal foundation for the existence of contractual obligations of good faith in Canada was established in 1991 in *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1991), 106 NSR (2d) 180 (S.C); affirmed on other grounds (1992), 112 NSR (2d) 180 (CA). *Gateway* has

been cited with approval in several franchising cases, including *Shelanu v. Print Three Franchising Corp.* (2000), 11 BLR (3d) 69 (Ont. SCJ) and at the Court of Appeal (varying the trial judgment on other grounds) (2003), 226 DLR (4th) 577, and in *Mr. Submarine v. Sowdaey*, [2002] O.J. No. 4401 (Ont. SCJ).

In *Gateway*, the Honourable Mr. Justice Kelly held that:

The law requires that parties to a contract exercise their rights under that agreement honestly, fairly and in good faith. This standard is breached when a party acts in a bad faith manner in the performance of its rights and obligations under the contract. “Good faith” conduct is the guide to the manner in which the parties should pursue their mutual contractual objectives. Such conduct is breached when a party acts in “bad faith” - a conduct that is contrary to community standards of honesty, reasonableness or fairness. The insistence on a good faith requirement in discretionary conduct in contractual formation, performance, and enforcement is only the fulfillment of the obligation of the courts to do justice in the resolution of disputes between contending parties.

The statutory provisions of good faith and fair dealing in the Wishart Act clarify the law regarding the duty of good faith in connection with dealings in a franchise relationship and provide an explicit statutory right to claim damages for breach of the duty. This is potentially a powerful new tool in the hands of plaintiffs. As the Honourable Mr. Justice Meehan of the Ontario Superior Court of Justice observed in a 2002 decision, “explicit recognition of the duty of good faith in the performance of a contract simplifies and clarifies the law. Contrary to the views of its detractors...explicitly recognizing the doctrine makes the law more certain, more understandable, and, of course, more fair.”²

The challenge for franchise lawyers is that while the courts may be able to define good faith in general terms, it is much more difficult to determine when the duty is applicable and whether it has been breached in any given factual situation arising out of the provisions of a franchise agreement and resulting franchise relationship.

²*Elite Specialty Nursing Services Inc. v. Ontario*, [2002] O.J. 3009 (SCJ), para. 90

While franchise agreements and resulting franchise relationships are generally not considered fiduciary, franchise contracts possess some fiduciary-like qualities because the inequality of bargaining power between most franchisees (though certainly not all) and franchisors typically renders franchisees vulnerable to and dependent upon the franchisor's exercise of discretion. In most circumstances, the franchisor has significantly greater financial resources and much greater experience in the operation and maintenance of the franchised system, established legal rights to trademarks and processes and access to much more and detailed information about the franchisee, its business and financial resources. The franchisor also typically has the right to inspect the franchisee's business regularly, comment upon or criticize the franchisee's operations and receive detailed and frequent financial reporting. The resulting information asymmetry and bargaining inequality generally permits the franchisor to insist upon a one-sided franchise agreement that heavily favours the franchisor and provides the franchisor with a significantly stronger position during the course of the franchise agreement.

The Ontario Court of Appeal in *Shelanu*³ discussed the circumstances which give rise to a duty of good faith. Citing the decision of the Honourable Mr. Justice Iacobucci, J. in *Wallace v. United Grain Growers*, [1997] 3 SCR 701, the court was prepared to recognize a good faith obligation in employment contracts. Writing for the Supreme Court of Canada, Justice Iacobucci held that employment contracts have unique characteristics that set them apart from ordinary commercial contracts:

(1) the formation of the employment contract is not the result of the exercise of bargaining between two equals;

(2) the power imbalance (caused by such factors as the information asymmetry between employer and employee) results in the person in the weaker position being unable to achieve more favourable contractual terms; and

(3) the power imbalance continues to affect other facets of the relationship after the contract has been entered into.

³*Shelanu v. Print Three Franchising Corp.* (2003), 226 DLR (4th) 577 (C.A.), para.s 64-66

In *Shelanu*, the Court of Appeal held that the same three characteristics discussed by Justice Iacobucci in the context of employment contracts also exist in the typical franchisor-franchisee relationship, as:

(1) most franchisees have much weaker bargaining power than the franchisors with whom they are negotiating and, ultimately, contracting;

(2) as most franchise agreements are contracts of adhesion⁴, franchisees, like employees, are typically unable to negotiate more favourable terms and, much like the situation between employee and employer, the franchisee is dependent on the franchisor for crucial information (such as the merits of the franchise location and its projected cash flow), and the franchisee is typically required to take a training program devised by the franchisor to explain the operation of the franchised system; and

(3) just as in an employment relationship, the franchisee-franchisor relationship continues to be affected by the power imbalance between the parties (most franchise agreements obligate the franchisee to submit to inspections of its premises and audits of its books on demand, to comply with operations bulletins and to buy equipment, services or other products from the franchisor).

Accordingly numerous courts have recognized that a duty of good faith exists at common law in the context of the franchisor-franchisee relationships. For example, in *Shelanu*, the Ontario Court of Appeal held that the duty of good faith and fiduciary duty are closely related and that they and the standard of unconscionability:

...are points on a continuum in which the law acknowledges a limitation on the principle of self-reliance and imposes an obligation to respect the interests of the other. They are defined by P. Finn, “The Fiduciary Principle” in T. Youdan, ed., *Equity, Fiduciaries and Trusts*, (1989), 1 at 4 as follows:

“Unconscionability” accepts that one party is entitled as of course to act self-interestedly in his actions towards the other. Yet in deference to that other’s interests, it then proscribes excessively self-interested or exploitative conduct. “Good faith,” while permitting a party to act self-interestedly, nonetheless qualifies

⁴Contracts of adhesion are contracts in which all or, at least, the essential clauses were not freely negotiated between the parties but were drawn up by one of the parties and imposed on the other.

this by positively requiring that party, in his decision and action, to have regard to the legitimate interests therein of the other. The “fiduciary” standard for its part enjoins one party to act in the interests of the other—to act selflessly and with undivided loyalty. There is, in other words, a progression from the first to the third; from selfish behavior to selfless behavior. Much the most contentious of the trio is the second, “good faith”. It often goes unacknowledged. It does embody characteristics to be found in the other two [footnotes omitted].

The Court of Appeal further explained the nature of the duty of good faith as follows:

If ... A owes a duty of good faith to B, A must give consideration to B’s interests as well as to its own interests before exercising its power. Thus, if A owes a duty of good faith to B, so long as A deals honestly and reasonably with B, B’s interests are not necessarily paramount.⁵

The Court of Appeal held that where a duty of good faith exists, not every breach of contract will be considered a breach of the duty of good faith. Therefore, an honest disagreement concerning the interpretation of a franchise agreement that was ultimately decided in favour of the franchisee could be a breach of contract but need not be a breach of the duty of good faith owed by the franchisor. Denial of payment in order to gain leverage or bargaining advantage in a dispute or out of vindictiveness, was sufficient to support a finding of a breach of the duty of good faith. Furthermore, the fact that the payments were ultimately made does not preclude a finding of a breach of the duty of good faith. Pursuant to the Court of Appeal:

the duty of good faith comprises a time component. That time component requires the party under a duty of good faith to respond promptly to a request from the other party and to make a decision within a reasonable time of receiving that request. Parties under a duty of good faith also have an obligation to make payment of any amounts that are clearly owed to the other party in a timely manner.⁶

Recently, in *Triple 3 Holdings Inc. v. Jan*, [2004] O.J. No. 2749 (Ont. SCJ), the Honourable Mr. Justice Paisley dealt with a situation in which the franchisor had terminated the franchisee in circumstances where it had no right to do so and then subsequently sold the franchise to a third party

⁵*Shelanu*, para. 66 ff.

⁶*Shelanu*, para. 78

despite the franchisee's application for relief from forfeiture and for injunctive relief to prevent the franchisor from taking over the franchise in question. The court described the franchisor's actions as an "arrogant abuse of its contractual powers and overreaching to the nth degree". Having found that the conduct of the franchisor was planned and deliberate, high handed and abusive behavior motivated by profit and akin to 'piracy on the high seas', the court held that circumstances clearly merited an award of punitive damages. Ultimately, the court awarded \$224,457 in damages against the franchisor, together with punitive damages in the amount of \$350,000.

B. Liability of Landlords and Franchisors for Breach of the Duty of Good Faith and Fair Dealing

In *Country Style Foods Services Inc. v. 1304271 Ontario Ltd.* (2003), 7 RPR (4th) 184 (Ont. S.C.J.), the franchisor had previously obtained a judgment against the franchisee permitting the franchisor to reclaim the franchise and for damages for non-payment of certain amounts. However, execution of the Judgment had been stayed pending the trial of specific monetary claims made by the franchisor in the action and by the franchisee in a counterclaim. At trial, the court found that the landlord had made changes to its site plan after it had represented to both the franchisor/tenant and franchisee/sub-tenant that the property would be developed according to the prior site plan. These representations were made before the franchisor entered into the lease and the franchisee entered into the sub-lease. The landlord's subsequent changes to the site plan were found to have had a marked, detrimental effect on the franchisee's business.

At trial, Madam Justice Chapnik held that the landlord had a duty to the franchisee/sub-lessee to make accurate representations regarding the site plan and that the duty existed because of the special relationship of proximity between the landlord and the franchisee. As a result of the landlord's breach of the duty, the franchisee was entitled to rescission of the agreement and damages of \$400,000 were awarded for lost profits. The franchisor was also found to have breached its duty of good faith and fair dealing in its conduct towards the franchisee and was also made liable for the franchisee's damages. The Court was critical of the franchisor for abandoning the franchisee's cause and effectively siding with the landlord and held that the franchisor was also responsible for the

misrepresentations about the site plan.

In *Machias v. Mr. Submarine Ltd.*, [2002] O.J. No. 1261 (S.C.J.), the franchisee, Machias, sought rescission of the franchise agreement, together with damages, and the franchisor sought a declaration terminating the franchise agreement and sub-lease for non-payment of amounts due and permitting it to take the franchise back without compensating Machias. The franchisor also counterclaimed for arrears of rent, royalties and advertising contribution.

Machias had signed a franchise agreement with Mr. Submarine for a franchise location in Montreal. Before signing the agreement, the prospective franchisee requested copies of financial statements for the franchise. However, the only written financial documentation provided was a pro forma financial statement. In addition, the franchisor made oral representations that gross annual income for the franchise would be \$300,000 and that the projected rate of return on an investment of \$150,000 was 26%, so long as Machias was a “good operator”. In actual fact, the sales and profit history for the franchise was significantly below the return suggested in the pro forma financial statement. In addition, following the opening of the franchise, the franchisor refused to fulfil its contractual obligations to renovate the franchise location in a timely manner and to provide bilingual menu boards in accordance with Quebec language laws.

When the action came to trial, Justice Wilson held that the Wishart Act did not apply, as the franchise business had been carried out in Montreal. However, the court went on to hold that the Wishart Act simply codified the common law regarding the duty of good faith in franchisor and franchisee relationships. The court then ruled that, although the parties were not fiduciaries, the nature of their relationship imposed upon them the duties of *utmost good faith*.

In coming to this conclusion, Justice Wilson analyzed various Ontario cases and quoted from the decision of Justice Fleury in the *Perfect Portions* case. In that case, the court confirmed the special nature of the relationship between the parties in a franchise agreement as being one of “utmost good faith”, and concluded that this “special relationship” includes a positive obligation to

disclose accurate financial information and other relevant facts to prospective franchisees before entering into franchise agreements. Justice Fleury also held that misrepresentations may result from silence or omissions of material information.

In *Machias*, Justice Wilson also reviewed Justice Nordheimer's trial decision in *Shelanu* and Justice Dilks's decision in *Country Style Food Services Inc. v. Hotoyan*, [2001] O.J. No. 2889 and agreed that the duty of good faith imposed upon franchisees and franchisors includes community standards of honesty, reasonableness and fairness and decided that the Wishart Act does "little else than codify the common law rule in that regard."

Ultimately, Justice Wilson ruled that rescission was appropriate in the circumstances and that Machias was entitled to the return of his \$150,000 investment, together with the return of an overpayment of \$6,918.65, moving expenses to Montreal of \$3,000 and compensation for business losses experienced in 1999 and 2000. The franchisee was ordered to pay any rent arrears but not royalties or advertising contribution. Machias claim met the test for actionable misrepresentation and satisfied the principles of unconscionability guided by community standards of honesty, reasonableness or fairness.

Justice Wilson also refused to enforce the exclusionary clause contained in the franchise agreement between Mathias and Mr. Submarine. The franchisor had been found to have breached its duty of good faith and fair dealing and to have engaged in a pattern of selective and inaccurate disclosure, creating a grossly misleading picture of the history and financial viability of the franchise. In the light of the findings, Justice Wilson concluded that enforcing the exclusionary clause in the agreement would offend community standards of honesty and fairness.

In *530888 Ontario Ltd. v. Sobeys Inc.*, [2001] O.J. No. 318 (S.C.J.), Sobeys brought a motion to strike out portions of the franchisee's statement of claim, including pleadings alleging breach of the duty of good faith and fair dealing. The duty was pleaded as both an implied term of the franchise agreement and as an independent duty in act in good faith in the performance of the

franchise agreements. Sobey's asserted there was no independent, free standing duty of good faith and fair dealing known in law and that this part of the claim should be struck. In response, the Honourable Madam Justice Lax held that there was controversy as to whether there was an independent good faith doctrine in contract law or a duty of good faith in contractual performance and, therefore, held that it would be wrong to conclude that the claim could not possibly succeed. Accordingly, Sobey's motion was dismissed.

In *Mr. Submarine Ltd. v. Sowdaey*, [2002] O.J. No. 4401 (S.C.J.), the franchisor had commenced an action against 1297300 Ontario Inc. and its guarantor, Sowdaey, for breach of the franchise agreement. 1297300 and Sowdaey counterclaimed for improper termination of the agreement and for breach of the franchisor's duty to deal fairly with 1297300. Sowdaey, through 1297300, had purchased an existing franchise. At trial before the Honourable Madam Justice Hoy, he was shown to have been undercapitalized and to have failed on numerous occasions to comply with the terms of the franchise agreement and with warning letters sent by the franchisor. Many of these failures related to the purchases of equipment and to food safety issues. After numerous warnings, the franchisor purported to terminate the agreement, closed the franchise and claimed for past due royalties and for damages for lost future royalties.

At trial, Justice Hoy allowed Mr. Submarine's action, dismissed the counterclaim, held that there had been no breach of the franchisor's duty of fair dealing and that Mr. Submarine had not acted in bad faith in terminating the franchise agreement. However, while Justice Hoy granted damages for \$2,531.80 in royalty arrears owed by the franchisor at the time of termination, she also held that Mr. Submarine was not entitled to damages for lost future royalties and that a demand for such payments was unfair and unreasonable:

... a breach of [the franchisor's] duty of fair dealing in its enforcement of the Franchise Agreement. This is by no means to suggest that a franchisor cannot usually recover damages from a franchisee for a breach of a franchise agreement. The special factor here is that the franchisor is in essence claiming damages because the franchisee's business failed.

While troubled by some of the franchisor's other actions, such as its demands for payment

of royalties based on unsubstantiated levels of unreported sales, Justice Hoy found that the franchisee's operational non-performance, particularly in the critical areas of food safety, which had been continuing for nearly 2 years, justified termination of the franchise agreement.

The franchisee had argued that, once the franchisor determined that it no longer wanted the franchisee to continue operating the franchise, the fair thing would have been to allow the franchisee a reasonable time in which to endeavor to sell its business to a purchaser acceptable to Mr. Submarine. Sowdaey had invested his life saving in business, was indebted to a bank and was working long hours, seven days a week. At trial, however, 1297300 failed to introduce any evidence that it had ever actually proposed to Mr. Submarine that it be allowed a reasonable time to try to sell the franchise. Had it done so, the merits of the proposal and the franchisor's response might have affected the court's assessment of the franchisor's actions.

C. Relief for Class Action Franchisee Plaintiffs

In *1176560 Ontario Limited v. The Great Atlantic & Pacific Company of Canada Limited* (2002), 62 O.R. (3d) 535 (S.C.J.), the proposed representative plaintiffs for a class proceeding under the *Class Proceedings Act*, 1992 ("CPA") were franchisees of a discount grocery chain operated by The Great Atlantic & Pacific Company of Canada Limited ("A&P"). The proposed representative Plaintiffs moved for certification of their action as a class proceeding and, in a second motion, sought an order restricting A&P's communications with class members and directing A&P not enter into new franchise agreements during the opt out period. The second motion was based on allegations that A&P was attempting to intimidate the class members to sign improvident releases. In particular, it was alleged that:

- (1) A&P was monitoring the franchisee's payments to their lawyers in respect of the proceedings;
- (2) franchisees who refused to sign releases were being subject to unlawful rent increases;
- (3) A&P had delivered copies of the its defence and counterclaim to class members without the plaintiffs' corresponding reply and defence to counterclaim; and

(4) the President of A&P's franchise operations proposed to deliver to each franchisee a new franchise agreement, along with a release from the claims in the proceeding, without regard to the fact that this action was before the courts.

Both motions were granted. In dealing with the claim for extraordinary relief pursuant to sections 12 and 19 of the CPA, the evidence established that A&P intended to defeat the certification process motion by improperly interfering with the class proceeding process. Justice Winkler was deeply critical of A&P's conduct, noting that:

Moreover, the conduct is particularly egregious considering A&P's position as a franchisor. As Nordheimer J. stated in *Shelanu Inc. v. Print Three Franchising Corp.*

... the duty of utmost good faith should apply in terms of the dealing between the franchisor and the franchisees.

Nordheimer, J. then referred to the *Arthur Wishart Act (Franchise Disclosure)* ... which provides in s. 3 that every franchise agreement imposes on each party a duty of fair dealing which is actionable if breached.

... The duty of fair dealing includes the duty to act in good faith and in accordance with reasonable commercial standards.

It is pertinent to the issues on this motion that the existence of the franchisor's duty stems in part from the information imbalance. In this respect, Wilson, J. stated in *Machias v. Mr. Submarines Ltd.* ...:

. . . the franchisee has to continue to rely on the integrity of the franchisor with respect to information privy only to the franchisor. A duty of utmost good faith can be implied in any purchase such as the one described in this case.

Justice Winkler then went on to hold that "apart from any other consideration that may be brought to bear under the CPA, A&P had, and has, an obligation as a franchisor to ensure that its franchisees were properly informed in respect to the decisions they were being asked to make about this proceeding."

Interestingly, the court made no reference to section 4 of the Wishart Act which prohibits a franchisor or franchisor's associate from directly, or indirectly, penalizing, attempting to penalize or threatening to penalize a franchisee for exercising any right of association (which would presumably include a class of franchisees joining together to sue the franchisor).

In a related proceeding, *The Great Atlantic & Pacific Co. of Canada v. 1167970 Ontario Ltd.*, [2002] O.J. 3717 (S.C.J.), A&P commenced an application to appoint an interim receiver over the defendant franchisee pursuant to the terms of a financing agreement between the parties. One of the defences raised by the franchisee was that A&P was not dealing in good faith as required by section 3 of the Wishart Act and, therefore, the financing agreement should not be enforced pending the determination of the class action suit against the franchisor. Although financing agreements are included in the expansive meaning given to "Franchise Agreement" in section 1(1) of the Wishart Act, the Honourable Mr. Justice Farley held that, pursuant to section 3 of the Wishart Act, damages were the only remedy available to the franchisee for the franchisor's breach of the statutory duty of fair dealing. In other words, A&P's breach of the duty of fair dealing did not entitle the franchisee to injunctive relief to prevent the enforcement of the financing agreement and the appointment of an interim receiver.

D. Effects of the Franchisor's Failure to Provide a Disclosure Document

Perhaps the Wishart Act's most significant affect on our franchise litigation practice is the statutory requirement that franchisors deliver a disclosure document to prospective franchisees in accordance with section 6 of the Wishart Act. Since the Act came into force, our firm has represented ten different franchisees who were not provided with disclosure documents and who were entitled to rescind their franchise agreements as a result. One defence that franchisors have raised is to argue that the particular business relationship involved was not actually a franchise.

In **Narbeh Khachikian and 1521514 Ontario Limited vs. Patrice Williams et al.**, [2003] O.J. No. 5876 (S.C.), our clients, Narbeh Khachikian and 1521514 Ontario Limited, had acquired a karate

dojo franchise in the beaches area of Toronto under the name Classical Martial Arts Canada Beaches. Shortly thereafter, Mr. Khachikian, who was a second degree black belt, had a falling out with Patrice Williams, the sensei who controlled the chain of Classical Martial Arts' dojos. While the plaintiff had entered into an oral agreement to open up a Classical Martial Arts franchise, there was no written franchise agreement. After the plaintiff had found the space, paid for and built the leasehold improvements, and obtained paying students, he had a falling out with his sensei who then physically threw the plaintiff out of his dojo. We took the position that the business agreement between the plaintiff and his sensei (and the company the sensei controlled) was a franchise within the meaning of the Wishart Act and we sought rescission of the franchise agreement and damages on the grounds that no disclosure document had been provided pursuant to section 6 of the Act. We also claimed for punitive damages against Patrice Williams personally as a result of his conduct.

A number of issues were raised in the lawsuit, including whether the business relationship was a franchise within the meaning of the Act and whether the fact that there was no written franchise agreement precluded application of the Wishart Act. The Wishart Act exempts certain types of business relationships which are set out in sub-section 2(3) of the Act, including relationships or arrangements arising out of an oral agreement where there is no writing which evidences any material term or aspect of the relationship or arrangement. In this case, our client was able to produce certain documents evidencing certain material terms of the franchise relationship, including a cancelled cheque for \$10,000.00 paid by the plaintiff as a "License Fee" and a business plan which had been prepared by the plaintiff and approved by the defendant and which referred to the operation as a franchise.

At trial, the Honourable Mr. Justice Matlow granted judgment for rescission in favour of our client the Plaintiff. Justice Matlow found that the parties had entered into a franchise agreement within the definition of subsection 1(1) of the Wishart Act and that the defendant had failed to provide a disclosure document. He also held that the plaintiff's cheque in the amount of \$10,000 given in payment of a "licence fee" constituted evidence of "a material term or aspect of the relationship or arrangement" between the parties within the meaning of subsections 2(3) and section

7 of the Wishart Act. He also awarded punitive damages of \$10,000.00 against our client's former sensei, Patrice Williams, based upon the principles laid out in the Supreme Court of Canada's decision in **Whiten v. Pilot Insurance Co.** 209 DLR (4th) 257 (S.C.C.):

“The Defendant deliberately took advantage of the plaintiff's vulnerability as his student and in violation of the Act induced him to enter into a franchise agreement without providing him with the required disclosure notice. As well, the defendant likely made sure that the agreement would not be reduced to writing so that no clear evidence would be created that could reflect its true terms and provisions. This type of conduct requires that my judgment include a provision that reflects this court's denunciation of what the defendant did and will serve as a deterrent to others who might also be inclined to use the concept of franchising as a means of taking undue and improper advantage of another person.”

In *1490664 Ontario Limited vs. Dig This Garden Retailers Ltd., Roger Harper and Robyn Burton* (unreported) (Court file: 03-CV-246185CM1), a recent decision of the Honourable Madam Justice Horkins, released June 11, 2004, my partner, Scott Rosen, obtained rescission against the defendant franchisor for its failure to provide the disclosure document mandated by the Wishart Act. In this case, the franchisor was based in British Columbia and sold our client a Dig This Garden franchise in Toronto, Ontario. The franchisor did not know that the Wishart Act existed and was similarly ignorant about the statutory disclosure requirements. Likewise, the solicitor whom the applicant had previously retained to provide legal advice concerning the franchise agreement did not advise the applicant of the disclosure requirements of the Act.

The applicant franchisee signed the franchise agreement on September 21, 2001. The business was a failure. In late November, 2002, the applicant retained me and discovered, for the first time, that the franchisor had been required to provide her and her franchisee company with a disclosure document pursuant to the Wishart Act. On December 5, 2002, we delivered a letter to the franchisor rescinding the franchise agreement pursuant to subsection 6(2) of the Act based upon the franchisor's failure to deliver a disclosure document. This rescission notice was addressed to both the franchisor company and to that company's the principals as the franchisor's associates and we refunds, purchase money and damages in accordance with subsection 6(6) of the Act. When the application was heard by the Honourable Mr. Justice Gans, he ordered that it proceed by way of trial

of issues. The trial was heard by Justice Horkins, who noted that the title of the Wishart Act states that its goals are “to require fair dealing between parties to the franchise agreements, to ensure that franchisees have the right to associate and to impose disclosure obligations on franchisors”.

The franchisor argued that, although it had not provided the franchisee with a single franchise disclosure document, it had satisfied the disclosure requirements of the Wishart Act by providing the franchisee with information, both orally and in written documents, both before and after the deadline for disclosure set out in subsection 5(1) of the Act. Justice Horkins rejected this argument and held that subsection 5(3) specifically stated that “a disclosure document must be one document delivered, as required under subsections (1) and (2), as one document at one time.” The disclosure requirement cannot be met by providing information orally or in several different documents delivered at different times.

Justice Horkins went on to hold that the two individuals who were the principals of the franchisor company were also franchisor’s associates as defined by subsection 1(1) of the Wishart Act. As equal co-owners of the company, they controlled the franchisor and they were involved in the “grant of the franchise”. At trial, they were found to have traveled to Ontario to meet with the franchisee on several occasions, visited possible franchise sites, showed the franchisee other store locations, accompanied the franchisee to a lawyer and provided the franchisee with training in Victoria, B.C. They had also made representations to the franchisee on the franchisor’s behalf about financial issues and other matters relating to the operation of the franchise. Accordingly, Justice Horkins found that the respondent franchisor and the franchisor’s associates were jointly and severally liable pursuant to subsection 8(3) of the Wishart Act.

E. Statutory Protection of Franchisee Associations

Section 4 of the Wishart Act states that:

Right to associate

(1) A franchisee may associate with other franchisees and may form or join an organization of franchisees.

Franchisor may not prohibit association

(2) A franchisor and a franchisor's associate shall not interfere with, prohibit or restrict, by contract or otherwise, a franchisee from forming or joining an organization of franchisees or from associating with other franchisees.

Same

(3) A franchisor and franchisor's associate shall not, directly or indirectly, penalize, attempt to penalize or threaten to penalize a franchisee for exercising any right under this section.

Provisions void

(4) Any provision in a franchise agreement or other agreement relating to a franchise which purports to interfere with, prohibit or restrict a franchisee from exercising any right under this section is void.

Right of action

(5) If a franchisor or franchisor's associate contravenes this section, the franchisee has a right of action for damages against the franchisor or franchisor's associate, as the case may be.

Our review of the case law did not disclose a single case involving section 4 of the Wishart Act. However, the existence of these provisions are having an impact on the way franchise associations are being treated by franchisors. Franchise associations now have greater confidence

in dealing with franchisors where there is conflict. Conversely, it is my impression that franchisors are taking greater care to listen to the concerns of these associations.

F. Do Franchisee Associations have Standing to Assert Claims in Court?

The Wishart Act stops short of providing a franchisee association with the right to commence an action in court on behalf of its member franchisees. Group actions can be commenced in Ontario under the Class Proceedings Act, provided that the requirements of a class action are met. As well, pursuant to Rule 12.08 of the Ontario *Rules of Civil Procedure*:

where numerous persons are members of an unincorporated association or trade union and a proceeding under the Class Proceedings Act, 1992 would be an unduly expensive or inconvenient means for determining their claims, one or more of them may be authorized by the court to bring a proceeding on behalf of or for the benefit of all.

Rule 13.01 of the Ontario *Rules of Civil Procedure* also provides that a “person” (which would include a corporation) may move for leave to intervene and be added as a party to any litigation, if the person claims,

- (a) an interest in the subject matter of the proceeding;
- (b) that the person may be adversely affected by a judgment in the proceeding; or
- (c) that there exists between the person and one or more of the parties to the proceeding a question of law or fact in common with one or more of the questions in issue in the proceeding.

Conclusion

The Wishart Act has dynamically changed the relationship between franchisors and franchisees in ways that are continuing to have repercussions in franchise litigation. Though any breach of the franchisor’s disclosure obligations established by the Act permit the affected franchisee

to rescind the franchise agreement and claim for damages, the disclosure requirements are relatively easy to comprehend and comply with. Before the franchise agreement is executed, the franchisor must provide the prospective franchisee with a single disclosure document providing financial information, contact details for existing franchisees and the other information required by the Wishart Act and listed in the regulations made pursuant to the Act. While there have yet to be many decided cases dealing with damages for misrepresentation or omissions in the disclosure documents themselves, such cases can be expected in the future.

By contrast, the application of the franchisors' and franchisees' statutory duties of good faith and fair dealing is still uncertain. While it is clear that franchisors are entitled to act to terminate franchises and to take other steps to protect their contractual rights and interests, which tactics will be considered a breach of the duties of good faith will be determined on a case by case basis. In practice, if not in name, many courts appear to holding franchising parties to equitable standards of conduct. Accordingly, before appearing in court, each side would be well advised to construct and argument as to why their treatment of the other side has been "fair" as well as in accordance with contractual provisions. Finally, although the scope and effect of the franchisee's statutory right to associate has yet to receive judicial consideration, it is likely that this provision of the Act will receive consideration in the near future, as franchisors and franchisees struggle to redefine their relationship in the wake of the other changes mandated by the Wishart Act.

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