Litigation Bulletin

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"Wannabe" Franchisees are Entitled to Protection Under the *Franchise Act*

Those of you involved in the franchising industry are likely aware that Ontario enacted franchise-specific legislation in July, 2000. The *Arthur Wishart Act (Franchise Disclosure), 2000* (the "Act") created significant obligations and new standards of conduct for parties to a franchise relationship.

The Act defines "franchisee" as "a person to whom a franchise is granted…". As described below, franchisors owe certain duties to their "franchisees" under the Act. What about prospective or "wannabe" franchisees? Do they have rights under the Act? A recently reported decision of the Ontario Superior Court of Justice has just considered this issue. Franchisors beware – the answer to this question is yes.

Brief Overview of the Act

The Act provides, among other things, that every party to a franchise agreement owes the other a duty of fair dealing in performing and enforcing the terms of the agreement. Fair dealing is defined to include the duty to "act in good faith" and in accordance with "reasonable commercial standards". The Act also imposes some fairly onerous disclosure obligations on franchisors. Franchisors must provide prospective franchisees with a disclosure statement containing all material facts, financial statements, and other information required to assist the prospective franchisee make an informed investment decision. The disclosure document must be provided to the prospective franchisee at least fourteen days before the franchisee signs any franchise agreement or makes any payment. The Act provides harsh consequences for the failure to make full and accurate disclosure.

The Act entitles "franchisees" to sue franchisors, as well as their brokers, agents and associates, and anyone who signed the disclosure document, for misrepresentation or failure to disclose. Basically, a franchisee may rescind the agreement and recoup from the franchisor all money the franchisee invested in the enterprise.

What if a person agrees to buy a franchise business but then changes his or her mind and wants to get out before the deal actually closes? Are such persons (who are technically only "prospective franchisees") entitled to the right of rescission given to "franchisees" under the Act?

The Act Protects Someone Who is Not Yet a Franchisee

In *Bekah* v. *Three for One Pizza* the Ontario Superior Court of Justice considered whether a purchaser of a franchise in a transaction that has not yet closed is a "franchisee" within the meaning of the Act and therefore entitled to the right of rescission. The facts of the *Bekah* case are simple.

The plaintiff in *Bekah* signed an agreement to purchase the assets of a pizzeria, including the right to sublease a facility and operate a pizza business under the defendant's franchise. The plaintiff provided a deposit of $25,000. The defendant did not provide the financial disclosure required by the Act, however, and before the transaction closed, the plaintiff notified the defendant that it would not be proceeding. The plaintiff delivered a formal notice of rescission and asked for a return of its deposit. The defendant refused to refund the plaintiff's $25,000 deposit and took the position that the plaintiff was not entitled to rescind the transaction.

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Essentially, the defendant argued that the remedy of rescission under section 6 of the Act (which states that a "franchisee may rescind the franchise agreement" where the franchisor fails to provide the requisite disclosure) is only available to a "franchisee". The defendant asserted that the plaintiff was only a *prospective* franchisee because the transaction never closed. The plaintiff, by contrast, argued that it was a franchisee because it had entered into a binding "franchise agreement" within the meaning of the Act. The plaintiff claimed that it should therefore be entitled to rescind the franchise agreement and have its deposit refunded based on the defendant's failure to comply with the disclosure obligations imposed by the Act.

The court found in favour of the plaintiff and, in doing so, rescinded the franchise agreement and ordered the defendant to return the $25,000 deposit. The court noted that to "insist that a franchisee must have concluded the franchise transaction is not required by the language [of the Act] and would illogically leave a gap in the protection of the statute". In finding for the plaintiff, the court relied upon the facts that: the parties had signed a binding agreement for the purchase and the sale of a franchise business; monies were paid under that agreement; and the plaintiff was obligated to enter into a franchise relationship as a result of the agreement.

The court concluded that the plaintiff was a party, as a "franchisee", to a "franchise agreement" as that term is defined in the Act. The court held that the plaintiff is therefore entitled to protection under the Act. The court ordered that the franchise agreement be rescinded and that the defendant must return the plaintiff's deposit.

Conclusion

The logic of the *Bekah* decision is intuitively appealing. As the court itself observed, to hold that the plaintiff is not a "franchisee" simply because the transaction had not fully closed would "run counter to the scheme of the Act, the definitions of franchise agreement and prospective franchisee and would deprive the plaintiff of a remedy for the breach of a franchisor's obligation to give full disclosure".

The *Bekah* case should put franchisors on notice that, in certain circumstances, wannabe franchisees are entitled to protection under the Act. It also underscores the importance of complying with the Act's significant disclosure obligations.

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