Positive changes and clarity to Ontario franchise laws

September 29, 2020

Effective September 1, 2020, the Ontario government proclaimed into force certain long awaited amendments to the Ontario franchise legislation, the *Arthur Wishart Act (Franchise Disclosure), 2000* (the *AWA*) and *O. Reg. 581/00* (the *Regulation*) (collectively the *Ontario Act*), which clarified several provisions and better aligned the *Ontario Act* with franchise legislation in the other regulated provinces. Links to the *AWA* and the *Regulation* can be found **here**. The following is a summary of some of the main amendments to the *Ontario Act*.

New carve out for confidentiality, site selection and deposit agreements

Under section 5(1) of the *AWA*, franchisors are obligated to provide prospective franchisees with a franchise disclosure document not less than 14 days before the earlier of, (i) the signing by the prospective franchisee of the franchise agreement *or any other agreement relating to the franchise*; and (ii) *the payment of any consideration* by or on behalf of the prospective franchisee to the franchisor. The scope of agreements potentially captured by the language "any other agreement relating to the franchise", and "the payment of any consideration" was very broad and often did not align with practical business realities which often involved the parties executing or wanting to execute certain preliminary agreements and/or depositing some form of consideration to evidence their interest in the franchise opportunity. The new amendments to section 5(1) seek to clarify and narrow that language by confirming that a franchisor's obligation to provide a disclosure document will no longer be triggered by the following common, preliminary business interactions:

1. Upon the prospective franchisee signing a non-disclosure or confidentiality agreement that only requires that information or material provided to the prospective franchisee to be kept confidential. Note that this exception does not apply when the information or material which the franchisor seeks to keep confidential (i) is already in the public domain (other than as a result of a breach of the agreement); (ii) is disclosed other than as a result of a contravention of the agreement; or (iii) is disclosed with the consent of all the parties to the agreement. Additionally, this exception will not apply if the agreement prohibits the prospective franchisee from disclosing the information to an organization of franchisees, other franchisees in the system, or to its professional advisors;
2. Upon the prospective franchisee signing an agreement that only designates a location, site or territory for the prospective franchisee; and
3. Upon a prospective franchisee paying a deposit that (i) does not exceed 20% of the franchise fee, up to a maximum of $100,000; (ii) is refundable without any deductions; and (iii) is given under an agreement that in no way binds the prospective franchisee to enter into a franchise agreement.

New requirements for statements of material

change

Section 5(5) of the *AWA* requires franchisors to provide prospective franchisees with a written statement of any "material change" to its disclosure document as soon as practicable after the change has occurred and before the earlier of (i) the signing by the prospective franchisee of the franchise agreement or any other agreement relating to the franchise; and (ii) the payment of any consideration by or on behalf of the prospective franchisee to the franchisor.

"Material change" is broadly defined in the *AWA* as any change that would reasonably be expected to have a significant adverse effect on the value or price of the franchise to be granted or on the prospective franchisee's decision to acquire the franchise. Many franchisor's will use a statement of material change to address not only material changes, but, where appropriate, to correct minor deficiencies or omissions in the disclosure document or to supplement new or additional information that comes to light after delivery of the disclosure document. Use of a statement of material change should be done cautiously however, and with the advice of qualified legal counsel, as it is not appropriate in every circumstance.

As with the disclosure document, amendments to section 5(5) now clarify that franchisors will not be required to provide a statement of material change to prospective franchisees if only the types of agreements detailed in bullets (1), (2) and (3) above have been executed.

Additionally, franchisor's issuing a statement of material change pursuant to section 5(5) of the *AWA*, will now be required to include a franchisor's certificate, similar to the one required for disclosure documents, certifying that the statement of material change (i) contains no untrue information, representations or statements; and (ii) includes every material change. Although most well advised franchisors already included such a certificate with their statements of material change as a matter of course, the amendments will now make inclusion of the certified certificate mandatory, with failure to do so potentially constituting a material deficiency and grounds for rescission.

Changes to franchisor disclosure exemptions

Section 5(7) of the *AWA* provides franchisors with certain exemptions to their obligation to provide a disclosure document to prospective franchisees, a number of which have now been amended to provide further clarity.

Director and officer exemption

The first of these amendments can be found in section 5(7)(b), which previously exempted franchisors from their disclosure obligation when granting a franchise to a person for that person's own account if that person was an officer or director of the franchisor or of the franchisor's associate for at least six months. It was not clear if the exemption applied only to active officers and directors or if it could also be extended to former officers and directors and to corporations owned by current or former officers and directors. Amendments to section 5(7)(b) clarify that the exemption will now apply if the grant of a franchise is to a person or a corporation controlled by a person who (i) has been a director or officer of the franchisor or franchisor's associate for at least 6 months and occupies such position at the time of the disclosure obligation; or (ii) was a director or officer for at least 6 months and not more than 4 months have passed since the person held such position.

"Store within store" – The "fractional franchise" exemption

The exemption provided under section 5(7)(e) of the *AWA,* often referred to as the "store within a store" or "fractional franchise" exemption, applied where a grant of a franchise was made to a person who would operate the franchise within an existing business owned by that person, and the total sales generated by the franchise were not anticipated to exceed 20% of the existing business' total combined sales. It was not clear however if the 20% sales cap applied over the life of the fractional franchise or just in the first year of operations. The amendment now clarifies that the applicable period is one year, specifically, the first year of operation. The fractional franchise exemption has been particularly popular and helpful to franchisors and franchisees during the current pandemic, as business owners look to supplement their income by diversifying or expanding their offerings with complementary products and services without incurring the cost and time associated with preparing and reviewing comprehensive disclosure documents. The fractional franchise model is also popular and widely used by retailers who regularly establish boutiques and kiosks within larger retail outlets, such as department stores for example.

Small Investor / Large Investor Exemption

The exemptions provided under sections 5(7)(g)(i) (the Small Investor Exemption) and 5(7)(h) (the Large Investor Exemption) exempt the franchisor from delivering a disclosure document where the amounts invested are below or above the amounts prescribed by the *Regulation*.

Prior to the amendment, the Small Investor Exemption was available if the prospective franchisee's "total annual investment" did not exceed $5,000. The very low investment cap and ambiguity around what expenses should be included when calculating the "total annual investment", resulted in this exemption being seldom applied. Under the new amendments, the investment threshold for the Small Investor Exemption has been increased to $15,000 and the relevant investment period changed from "total annual investment" to "total initial investment".

Conversely, the Large Investor Exemption was available where the prospective franchisee was investing more than $5,000,000 to acquire and operate the franchise over a one year period. As with the Small Investor exemption however, this exemption was also of limited value because of the incredibly high financial threshold, ambiguity around which expenses should be included in the calculation, and the challenge of accurately projecting what those expenses would be over the course of a year. The new amendments reduced the financial threshold to $3,000,000 and more clearly defined and restricted the relevant investment period to the prospective franchisee's "total initial investment".

Amendments to the *Regulation* provide further clarity and assistance with the application of these exemptions by expressly defining "total initial investment" to mean all of the franchisee's costs associated with the establishment of the franchise, including (i) the amount of any deposits or franchise fees; (ii) an estimate of the costs for inventory, leasehold improvements, equipment, leases, rentals and all other tangible and intangible property necessary to establish the franchise; and (iii) any other costs or estimates of costs associated with the establishment of the franchise, including any payment to the franchisor as required by the franchise agreement.

The revised financial thresholds, the narrower investment period and the clarification of the types of expenses to be included in calculating the threshold should increase the use and reliability of the Small and Large Investor Exemptions in the future.

Expanded accounting standards for financial statements

Finally, amendments to the *Regulation* have expanded the scope of permissible audit and review engagement accounting standards for preparation of a franchisor's financial statements to include Canadian, American or

acceptable international standards.

Prior to this amendment, the Regulation provided that a franchisor's financial statements were to be prepared in accordance with generally accepted standards "at least equivalent to" those set out in the Canadian Institute of Chartered Accountants Handbook, with little guidance or consensus on how to assess that equivalency, leaving franchisor's who relied on a foreign accounting standard potentially vulnerable to non-compliance claims.

On balance, the recent amendments to the *Ontario Act* represent positive, long awaited changes that clarified several ambiguities, addressed practical business realities and better synchronized the *Ontario Act* with existing franchise legislation in the other five regulated provinces.

For more information on the recent amendments to the *Ontario Act* and how they may impact your franchise business, please contact Helen Fotinos at Dentons Canada LLP.

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