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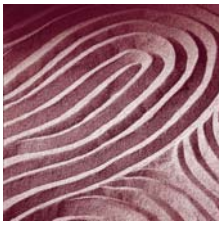

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Disclosure Requirements for Franchisors Clarified by Trial Courts

Craig Mills
October 13, 2006

The Lawyers Weekly

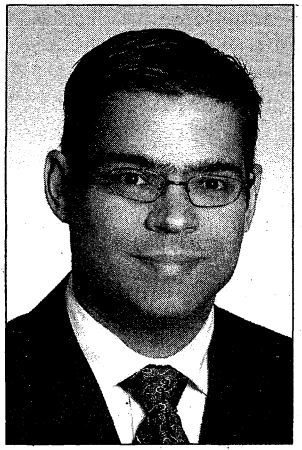
Disclosure requirements for franchisors clarified by trial court

By Craig A. Mills

Ontario franchise law took a step forward with the release of the decision in *1518628 Ontario Inc. v. Tutor Time Learning Centres, LLC* [2006] O.J. No. 3011 (S.C.J.). *Tutor Time* presented Justice Peter Cumming with a novel opportunity to interpret the disclosure obligations under Ontario's *Arthur Wishart Act (Franchise Disclosure)* (the Act).

Prior to this decision, it was unclear as to how a court would apply the disclosure requirements, and the exemptions to those requirements, where a franchise was acquired largely without the franchisor's knowledge or involvement. Justice Cumming's reasons provide some guidance to franchisors and franchisees alike.

The decision was the result of a three-day hearing arising from the plaintiff franchisee's motion for partial summary judgment. The franchisee sought a declaration that it was entitled to rescind the franchise agreement due to the defendant franchisor's alleged breach of its disclosure obligations as set out in the Act. The twist is that the franchisee never changed; rather there was a change in the ownership of the franchisee. The plaintiffs had purchased the shares of the existing franchisee in December 2003. The existing franchise had first been granted by Tutor Time Learning Centres, LLC, the U.S. franchisor, in September 2000, prior to the disclosure requirements in the Act coming into force. The share purchase was negotiated directly between the existing franchisee and the plaintiffs without the franchisor's knowledge. Following the execution of the share purchase agreement, the franchisor's consent was sought. The franchisor consented to the transfer, but only after the purchaser's principal and her spouse executed personal guarantees and non-disclosure agreements.



After a number of months, the franchisee suffered financial hardship. The franchisee began to complain that despite the franchisor's provision of a Uniform Franchise Offering Circular ("UFOC" — a U.S. franchise disclosure document), it had failed to meet the disclosure obligations under the Act. In June 2004, the franchisor agreed to waive existing arrears and grant other financial concessions to the franchisee. The parties entered into a settlement agreement to document the arrangement, which was signed by the franchisee upon the advice of its counsel. The settlement agreement contained a broadly worded release in favour of the franchisor discharging all of the franchisee's claims arising out of the franchise relationship.

Despite this compromise, its business continued to erode. In October 2004, the franchisee delivered a notice of rescission under s. 6(2) of the Act. The plaintiffs then negotiated the sale of the franchisee's assets to a third party and commenced this action against the franchisor for damages.

In response to the claim for rescission, the franchisor argued that the disclosure obligations in the Act only applied to franchise agreements executed after July 1, 2001. Justice Cumming disagreed, holding that the obligation to disclose applied to "prospective franchisees", even ones stepping into the shoes of a continuing franchisee.

The franchisor also argued that as the grant of the franchise was not effected "by or through" the franchisor, it was exempted from the disclosure obligations pursuant to s. 5(7)(a)(iv) of the Act. Justice Cumming dismissed this argument, stating that by requiring the spouse of the franchisee's principal, a non-officer and non-shareholder of the franchisee, to sign a

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Online film distribution will cause radical changes to entertainment law

By David Zitzerman

As anyone with an iPod or a teenager can attest, the distribution of music over the Internet has rapidly moved from an exotic to a mainstream phenomenon. To date, Apple Computer Inc. has sold over 60 million i-Pods and its i-Tunes Music Store, which dominates the legal distribution of online music, has sold over 1.5 billion downloaded songs. The travails of the music industry in first resisting and ultimately adapting to the digital distribution of music have been well documented.

However, more recently, a newer and potentially much larger online market for entertainment products has emerged, namely, the legal distribution of films, television programs and videos over the Internet to computers, television sets, cell phones and other mobile devices. Because it takes much longer to download a feature film than a song, the film and TV industry has had some additional time to study and learn from the mistakes of the music industry in adapting to the new digital world. In fact, two authorized Hollywood services which sell movies online, Movielink LLC and CinemaNow Inc., were launched several years ago, but neither service has gained much traction with consumers because of a combination of limited product selection, pricing and the restrictions placed on consumers when copying and transferring files. But this is all about to change as a multiplicity of new players have launched new initiatives which will dramatically increase the volume and quality of filmed entertainment which is available for the public to legally access online.

David Zitzerman

In the online filmed entertainment world, television shows and videos have led the way with virtually all North American broadcasters and cable services now making available an extensive amount of their television programs for viewing on their respective websites and with both professional and amateur home videos becoming far more widely distributed on the web. This year, for example, NBC Universal announced that it would make its entire fall schedule of new programs available for free (with advertising) online. Popular websites such as YouTube.com and MySpace.com (the latter of which is owned by Rupert Murdoch's News Corp.) encourage the public to upload their favourite video clips and are attracting millions of free downloads every day as well as advertising supported videos and "stealth" ad campaigns.

"Contracts with talent have to anticipate new modes of online distribution and deal with appropriate compensation for films and TV programs that are now being made available over the Internet or on cell phones."

The widespread online distribution of feature films is now following closely behind. Each of AOL, Amazon and Apple has recently announced a new online movie distribution business with various restrictions on use by consumers. Just this month, Apple unveiled a new device, tentatively called i-TV, which will wirelessly transfer downloaded movies, videos and other digital media from a home computer to a television set.

The online market for films, TV shows and videos is exploding for a number of reasons. First, DVD sales (which generate more revenues for the Hollywood studios than box office receipts) have recently been slowing and the introduction of the next generation of high definition DVDs has been delayed by both technical problems and the failure to merge two incompatible high definition formats (i.e. HD-DVD and the rival Blue Ray format). So the studios are very open to new channels of distribution. Meanwhile, in the TV industry, ad revenues for conventional television are flat, but web-based advertising has been increasing at a much faster rate, leading the networks to make their programs available online. Second, recent improvements in online safeguards against piracy and enhanced encryption techniques have made the networks and studios more comfortable distributing their products via the Internet. Third, the electronic distribution of filmed entertainment products is extremely cost efficient as it does not involve physical packaging and shipping and therefore has much higher profit margins. Finally, amateur websites such as YouTube have tapped a tremendous desire by the public to share and exchange their home videos with a wider audience.

From a legal standpoint, this emerging market of online audio-visual products poses a number of significant legal challenges. In the film business, for example, film distributors have traditionally licensed films through a series of successive "windows" of exploitation to licensees such as movie theatres, home video retailers, pay TV services and conventional TV broadcasters in a particular order and subject to geographic limitations. The distribution and often lower pricing of online entertainment products has disrupted this traditional business model and begun to undermine the financial position of various incumbent market participants (i.e. in particular home video stores, such as Blockbuster, whose revenues have begun to decline and TV network affiliates whose "exclusive" rights have been challenged by Internet distribution). Retailers such as

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Victory claimed by both sides

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personal guarantee, the franchisor went beyond passively approving or disapproving the prospective franchisee. As a result, the court held that the franchisor could not rely upon the exemption provisions. Further, Justice Cumming held that the franchisor's delivery of the UFOC failed to satisfy its disclosure requirements under the Act.

Despite finding that the franchisor breached its disclosure obligations, Justice Cumming ultimately dismissed the plaintiffs' motion on the basis of the release contained in the settlement agreement. The plaintiffs argued that the release was not effective as s. 11 of the Act precluded the waiver by a franchisee of the statutory right of rescission. The court held that the non-waiver provision did not apply as the release of a potential claim arising from a breach of the Act was not in itself a waiver of the statutory right.

Both franchisors and franchisees have claimed this decision to be a victory. From the franchisee's perspective, this decision appears to expand the disclosure obligations of a franchisor despite the exemptions set out in the Act. In the wake of this decision, franchisors will need to consider providing a prospective purchaser of an existing franchise with an Ontario disclosure document regardless of the franchisor's possibly minimal involvement in the sale of a franchise.

On the other hand, franchisors should view this decision as a positive clarification of the circumstances in which a release signed by a franchisee will be upheld. Prior to this decision, there had been no cases interpreting the implications of the non-waiver provisions of s. 11 of the Act. *Tutor Time* supports the long held policy that parties who reach a settlement must be held to their bargains, even those arising in a franchise relationship.

Craig A. Mills is a partner at Miller Thomson LLP and specializes in commercial and insolvency litigation.

Canada Pipe will seek leave to the Supreme Court of Canada

PIPE

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FCA held that the correct test for identifying a "substantial prevention or lessening of competition" is whether "the relevant markets – in the past, present or future – [would] be substantially more competitive *but for* the impugned practice of anti-competitive acts" (emphasis added). The FCA stated that the tribunal had erred by focusing on the fact of successful entry by competitors without asking whether there would have been "significantly more" competitive entry "but for" the establishment of the SDP.

Implications

The *Canada Pipe* case is a perfect illustration of the key issue raised by "abuse of dominance". There is obviously nothing wrong in and of itself about a company trying to persuade customers to buy more of its products. The question is: Are there circumstances in which a dominant party should not be allowed to engage in what would otherwise be perfectly legal behaviour?

As to the specific fate of the SDP, Canada Pipe has announced that it will be seeking leave to appeal the FCA's decision to the Supreme Court of Canada. The court is not expected to rule on this application until 2007, where the matter will either proceed to appeal or be sent back to the tribunal for re-determination in accordance with the FCA's decision.

Mark Katz is a partner in the Competition and International Trade Law Group of the Toronto office of Davies Ward Phillips & Vineberg LLP. Davies is representing Canada Pipe in these proceedings.