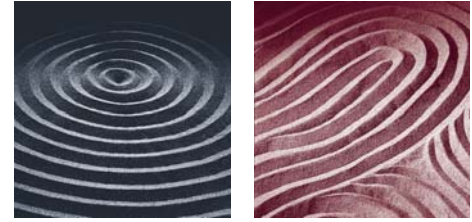


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Case Comment: *1518628*
Ontario Inc. et al v. Tutor Time
Learning Centres, LLC, et al.
[2006] O.J. No. 3011 (S.C.J.),
confirmed on appeal April 12,
2007

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Case Comment: *1518628 Ontario Inc. et al v. Tutor Time Learning Centres, LLC, et al.* [2006] O.J. No. 3011 (S.C.J.), confirmed on appeal April 12, 2007

On July 21, 2006, the Ontario Superior Court of Justice rendered its decision in *1518628 Ontario Inc. et al v. Tutor Time Learning Centres, LLC*, a motion for partial summary judgment which sought to clarify the scope of a franchisor's obligations to disclose material facts to a prospective purchaser of an existing franchise. The plaintiffs had claimed that the franchisor failed to provide statutory disclosure and that they were therefore entitled to rescission under the *Arthur Wishart Act (Franchise Disclosure)* (the "Act"). The motion was ultimately dismissed on the basis that the plaintiffs had released their right of rescission under an earlier settlement agreement with the franchisor. The plaintiffs appealed the decision to the Divisional Court of the Ontario Superior Court of Justice, submitting that the release given by the plaintiffs was ineffective since section 11 of the Act operates to void any release by a franchisee of a franchisor's obligations under the Act. On April 12, 2007, the Divisional Court dismissed the appeal and upheld the findings of the motions court judge. The decision has been subject of great interest and discussion amongst franchise practitioners, franchisors and franchisees, primarily for its important clarification of the effect of releases in favour of franchisors, but also for the interesting discussions of the nature of a franchisor's obligations to provide a disclosure document to a third party purchaser, and the effect of delivering a Uniform Franchise Offering Circular ("UFOC") to the purchaser in lieu of an Ontario disclosure document. The details of the Court's findings are discussed below.

The Facts

Tutor Time Learning Centres, LLC ("Tutor Time") is a Michigan based franchisor of educational day care facilities. On October 29, 2003, the plaintiff 1518628 Ontario Inc. ("151") executed a share purchase agreement to purchase all of the shares of 1557935 Ontario Inc. ("155"), Tutor Time's then existing franchisee in Burlington, Ontario. The vendor's principals sought Tutor Time's consent to the transaction as required under the share purchase and franchise agreements. In compliance with the franchise agreement, Tutor Time delivered to the purchasers its then current UFOC, a disclosure document prepared to comply with U.S. law requirements. Tutor Time acknowledged that the UFOC did not comply with Ontario law and that it was being delivered "for information purposes only" pending completion and delivery of an Ontario disclosure document. The franchisor ultimately consented to the transfer, but only after the individual plaintiffs paid a transfer fee, fulfilled the express conditions of transfer set out in the franchise agreement, and executed personal guarantees and non-disclosure agreements.

The franchisee suffered financial hardship, claiming that the difficulties were due to the franchisor's failure to disclose certain material facts about the operational, financial and regulatory aspects of the business. In June 2004, Tutor Time agreed to give financial concessions to the franchisee in exchange for a broadly worded release in favour of the franchisor discharging all of the franchisee's claims arising out of the franchise relationship (the "Release"). Despite this compromise, the business failed. The plaintiffs delivered a notice of rescission under s. 6(2) of the Act in October of 2004 and filed a statement of claim on July 14, 2005.

Was the transfer effected “by or through” the Franchisor?

The motions court considered whether Tutor Time was required to provide a disclosure document to 151, and therefore whether the plaintiff had any right to rescission from the alleged failure to disclose. Tutor Time contended that the sale was between its franchisee and a third party, and was not being effected “by our through the franchisor”, thereby exempting Tutor Time from any obligation to provide the plaintiff purchaser with a disclosure document. Tutor Time further relied on section 5(8) of the Act which states that a transfer is not effected by or through the franchisor merely because it “has a right exercisable on reasonable grounds, to approve or disapprove the grant.” Cumming J. reviewed the conditions for consent in the franchise agreement and found that by imposing a new obligation on the spouse of the purchaser’s principal to sign a personal guarantee (which condition was not set out in the franchise agreement), the sale of the franchise was in fact effected “by or through” Tutor Time, and that it therefore had an obligation to provide a disclosure document to the prospective franchisee. The Court supported this finding by stating that while Tutor Time may have had the “power” to approve or disapprove the transfer, it did not have a positive “right” to impose the condition of the additional guarantee since it was not prescribed in the franchise agreement. Moreover, the nature of the guarantee *qua* indemnity had the effect of making the additional guarantor a co-franchisee, and the imposition of this condition exceeded the “relatively passive act of approval of the transfer of the franchise as between the parties”.

In addressing this issue, the motions court judge sought to clarify the degree of involvement that a franchisor can exercise in a transfer before “crossing the line” and becoming a participant in the process for the purposes of the Act. When considering the plain language of the disclosure exemption in section 5(7)(a), the nature or degree of involvement which would constitute a transfer “by or through” the franchisor would include: selling the franchise for its account; accepting consideration for the sale directly from the prospective franchisee; brokering the sale as agent on behalf of the vendor; or changing material terms of the franchise agreement, by for example, increasing royalties, shortening the term, or reducing any exclusive territory. Cumming J.’s analysis focused on the qualification in section 5(8) which states that a grant is not effected by or through it merely because the franchisor has a reasonable right to consent to the grant or because a transfer fee needs to be paid. Stated differently, section 5(8) exists to permit a franchisor to weigh the suitability of a prospective franchisee and to be fairly paid for the costs of such analysis, without such actions exposing it to a potentially costly disclosure requirement.

On that note, the writer parts ways with the motions judge on the analysis of section 5(8)(a). In the writer’s view, the existence or absence of a positive contractual right of the franchisor to impose a condition of consent is not determinative of whether the transfer occurred “by or through” the franchisor. Put another way, section 5(8)(a) is not intended, in the writer’s opinion, to state that the introduction by the franchisor of novel conditions to the consent process automatically qualifies the franchisor as a party personally interested in the grant, thereby triggering the disclosure requirement. Rather, one must consider the nature of such novel conditions or grounds upon which the transfer is either accepted or refused. If the grounds are reasonable in that they relate to the franchisor’s function of assessing the suitability of the applicant, and the franchisor’s adjudication on such grounds is reasonable, then the grant is not effected “by or through” the franchisor. In the writer’s view, the “right” referred to in section 5(8) can arise from an express condition, from general language in the franchise agreement, from a change of control or no assignment without consent clause, or from standard commercial

practice. Arguably, there exists an implicit right of the franchisor to consent to any transfer unless specific language in the franchise agreement mandates consent upon fulfilment of specific objective conditions. “Unreasonable” grounds, including for example the changes to material terms of the franchise agreement illustrated above, would constitute additional consideration by the transferee beyond what is merely contemplated by an appraisal of the transferee and would therefore constitute the grant as being effected by or through the franchisor.

In this case, the franchise agreement stipulated “certain conditions” including certain listed conditions. Those conditions included “satisfaction” that the proposed transferee meet all standards, including financial criteria, “customarily” applied to new franchisees at time of transfer. The franchisor was not satisfied with the candidate’s suitability and had the right and the power under the franchise agreement to refuse its consent. In order to accommodate the parties it imposed an additional and arguably reasonable condition to provide it with additional financial and operational comfort in the form of a spousal guarantee. It is submitted that the new condition was, in contractual terms, fresh consideration granted by the existing franchisee in order to obtain a consent which under the existing prescribed conditions would not otherwise have been forthcoming.

Is a UFOC sufficient disclosure?

The motions judge considered whether the act of providing the UFOC constituted delivery of a disclosure document as required by section 5 of the Act. Tutor Time contended that although it was deficient in content, form and delivery, the UFOC substantially satisfied the disclosure requirement under section 5 of the Act and that the 60 day, and not two year rescission window should apply. Section 6(2) of the Act provides that a franchisee may rescind within two years of the date of the franchise agreement if the franchisor “never provided the disclosure document”.

While acknowledging that the UFOC did “provide much of the information required under an Ontario UFOC”, the court focused on the fact that the franchisor did not intend to provide the UFOC for formal disclosure purposes. In addition, the judge noted that the UFOC omitted material facts, was not provided in time and did not contain the required certificate of the officers as to the truth and completeness of the document. Without pronouncing on the degree of adequacy of the UFOC, Cumming J. did find that in the circumstances, Tutor Time “never provided the disclosure document” within the meaning of section 5.

Notwithstanding the outcome, this discussion fans the ongoing debate about whether a disclosure document prepared to satisfy the requirements of another jurisdiction’s laws will be sufficient to satisfy some, if not all, of the Act’s requirements. Had the facts in this case been somewhat different, and had the UFOC been presented to in purported compliance with Ontario law, then the motions judge may have been faced with a formal and substantive comparison of the UFOC format and the Act’s regulations. Moreover court may have been apprised with the issue of what quality or quantity of disclosure constitutes “enough” disclosure to bring one from the realm of “no disclosure” and a two year rescission window, into the realm of “substantial” disclosure which would presumably only trigger the 60 day rescission window. The decision in *1490664 v. Dig this Garden Retailers Ltd.*¹ makes it clear that a franchisor is required to deliver a complete disclosure document at one time containing all material facts and required documents. The Tutor

¹ [2004] O.J. NO. 3008 (S.C.J.), appeal dismissed [2005] O.J. No. 3040, (C.A.)

Time decision strongly suggests that this document should also be in the correct form prescribed by the Ontario Act. The facts for a test case to determine the threshold between disclosure defects tantamount to “no disclosure” and deficiencies only exposing the franchisor to a 60 day rescission window are yet to come.

Can a franchisee release its right of rescission?

Finally, Tutor Time submitted that the Release given by 151 of all claims “arising out of the business/franchise relationship between the parties” was a bar to the action for rescission claimed in the motion for partial summary judgment. The court considered the effect of section 11 of the Act which states that any purported waiver or release by a franchisee of a right or obligation or requirement of the franchisor arising under the Act is void. In its original motion for summary judgment, the plaintiff had taken the position that a release (including a release of its right to rescind) given by it to the franchisor with full knowledge of the franchisor’s failure to make proper disclosure, was ineffective in light of section 11. Justice Cumming disagreed citing that “the policy reasons for enforcing a valid release mirror the policy principles underlying the doctrines of *res judicata* and issue estoppel.” Justice Cummings added that “the settlement of a claim arising from and consequential to an existing statutory right of rescission is not in itself a “waiver or a release” of that statutory right to rescind.” In his finding, he considered that the Release related to those issues which were in the contemplation of the parties at the time the Release was signed. This included in the plaintiff’s case the fact that Tutor Time had not properly complied with its disclosure obligations to the plaintiff franchisee. The judge also found that the plaintiffs were aware of their obligations under the Act at the time of the Release and had signed the settlement agreement releasing Tutor Time on advice of counsel.

The plaintiffs appealed to the Divisional Court on the basis that section 11 of the Act was clear in its wording and intent and that the Release was therefore ineffective. In dismissing the appeal, the panel consisting of Justices Kitley, Himel and Corbett unanimously confirmed that the motions court judge had made no error of law in his treatment of the release issue.

Conclusion

This decision is of great importance as it has provided much needed clarification to the ability of parties to effectively settle issues in the context of franchise disputes. The decision also encourages franchisors to draft into their franchise agreements clear and reasonable conditions of consent to any transfer, or alternatively to provide a correct disclosure document to all prospective transferees as a cautionary practice without seeking to avail itself of the disclosure exemption in the Act. Finally, the decision opens the debate as to the use of U.S. disclosure documents in Canada, and supports the conclusion that foreign franchisors should ensure that their disclosure is prepared to comply with the formal and substantive requirements of the Act and its regulation.

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