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Disclosing without fear: tips and strategies for effective disclosure to prospective franchisees

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Disclosing without Fear: Tips and Strategies for Effective Disclosure to Prospective Franchisees

by Richard D. Leblanc[1]

1. Introduction

The relatively recent introduction of the *Arthur Wishart Act (Franchise Disclosure)*, 2000[2] (the '"Act) in Ontario has had a significant impact upon the manner in which active franchise opportunities are promoted and sold in the Province. Initially, franchisors with good track records and successful franchise systems resented the legislative imposition of a compliance cost which they deemed unnecessary. In addition, many viewed the disclosure requirements of the Act to be intrusive, overbroad, and in some cases immaterial given the specific nature of their franchise proposal. The market, it was argued, would perform its function of natural selection and would weed out the good franchisors from the bad without the need for regulation. In the end, only the best and strongest would survive.

All opposition notwithstanding, the Act is now an entrenched fixture of Ontario's franchising landscape and a handful of lawsuits have provided some guidance in defining the precise scope of the disclosure requirements of the Act. Nonetheless, lawyers and franchisors alike continue to struggle with the emerging "art" of franchise disclosure drafting, that is the attempt to find a working compromise between the hard sell and the "warts and all" disclosure required by the Act.

2. Theory and Scope of Disclosure: Telling the Good News

Franchise legislation saw its origin in the United States whose economy and demographics made it fertile ground for the establishment and proliferation of the franchise concept. This early growth, and the abuses of unscrupulous franchisors,

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[2] S.O. 2000, c.3.

underlined the need to protect would-be franchisees from unfair practices and unethical and fraudulent franchisors. In the early 1970's the Grange Commission proposed the implementation in Ontario of disclosure legislation modeled upon the securities laws based, prospectus-style disclosure systems of California and Alberta.[3] While Alberta replaced its cumbersome original statute with the *Franchises Act*[4] in 1995, its Ontario counterpart did not fully become law in the Province until 2001.

The substance and core of the Act are the disclosure requirements, which are referred to and are embodied in the regulations[5]. Under the Act, the franchisor must deliver a disclosure document[6] to the prospective franchisee not less than 14 days before the earlier of (i) the signing of any franchise agreement or any other agreement relating to the franchise; and (ii) the payment of any consideration by or on behalf of the prospective franchisor[7]. The Act states that the disclosure document must contain all "material facts", financial statements, franchise agreements, and all other statements, documents and facts as prescribed in the legislation and regulations. [8]

Given these broadly-defined representations and disclosures, some may consider that branding the disclosure document as a selling tool is an oxymoron to say the least. It has even been suggested, somewhat ironically, that perhaps the best way to ensure compliance with the Act is to insist upon including in the document everything that the sales people are begging to have removed as harming their chances to close the deal. The truth lies somewhere in between, and while it is clear that every franchisor must strictly comply with the Act and regulations, the disclosure document should be viewed first and foremost as a selling tool, and secondly as a disclosure vehicle.

Disclosure Document as a Sales Tool

Franchisors should view the disclosure document in the same manner as any other piece of promotional or business communication: its purpose is to assist in making a sale and not in deterring it. Accordingly, the same principles that underlie the preparation of any effective sales materials are also relevant in the drafting and

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[3] In the United States, the Federal Trade Commission enacted the FTC Franchise Rule in 1979 which has federal application.

[4] R.S.A. 1980 c.F-17.

[5] Ontario Regulation 581/00, amended to Regulation 611/00 (the "Regulations").

[6] "Disclosure document" is defined in s.1(1) of the Act as "the disclosure document required by section 5."

[7] Section 5(1)(a) and (b) of the Act.

[8] Section 5(4)(a) of the Act.

production of the disclosure document. In this respect, the following points should be considered when drafting a disclosure document:

a) Tell Your Story: The Act sets a minimum disclosure threshold to ensure that the franchisor provides to the prospect enough salient information to enable the prospect to make an informed choice about the purchase of the franchise. There is however no upper limit upon the amount of information which may be provided, as long as such information is presented in an accurate, clear and concise manner[9]. Accordingly, while you may believe that certain disclosed facts are less attractive than others, be sure to tell your success story. The disclosure document, in addition to the requirement to disclose business background, provides a franchisor with the opportunity elaborate upon the origins of the franchise system, the business strategy of the franchisor, and the franchisor's ideal conception of its franchise system. Coupled with the required caveats and provisos, this type of disclosure, to the extent that it is factual and not misrepresentative, will provide prospective franchisees with insight into the broader vision of the franchisor and will, if well drafted, dispose the franchisee very favourably to the proposed franchise opportunity.

   This exhortation should not be construed as a licence to provide overblown, irrelevant or redundant information however. It is simply a statement that the disclosure document should not adhere only to the regulatory requirements at the expense of the whole story. For example, if a franchisor has an unattractive history of terminations which must be disclosed, it may be that disclosure of the specific reasons for the terminations will play favourably to the franchisor. Alternatively, the franchisor may wish to present certain facts which indicates that it has "owned up" to certain past difficulties and that it has taken concrete steps to rectify such problems.

b) Organization, Drafting Style and Clarity: While it may seem trite to say, a document which is clear and easy to read will, simply put, leave a much more positive impression upon a reader than a poorly drafted, confusing and misleading document[10]. Organization can be achieved by typing in a clear and legible font and by liberally using numbered headings and subheadings. Disclosure documents should include an index and the use of tabs to separate documents is highly recommended. A disclosure document should be proof-read to ensure that it is free of spelling and grammatical errors and that it reads clearly without raising questions as to the meanings of certain elements of disclosure. A

[9] See Section 5(6) of the Act.

[10] Note that Section 5(6) of the Act requires that "all information in a disclosure document and a statement of material change shall be accurately, clearly and concisely set out."

document which honestly and plainly discloses a fact which may not be perfectly attractive will, in the writer's view, generate more goodwill and trust than a document which, through sharp drafting leaves the reader wondering about the true meaning of a passage.

c) Format of Materials: As discussed above, the disclosure document is a selling tool and should therefore be drafted and printed with this in mind. A franchisor who views the disclosure document as a resented cost of doing business, includes in the document only the bare minimum information required by statute, and presents the document in the same manner, will be telegraphing to the prospect a fairly distinct message about the type of business that he, she or it is running. As stipulated above, the disclosure document should help make the sale, not deter it, and should be packaged and presented accordingly.

d) Earnings Projections: Section 6(3) of the Regulations provides that a franchisor may provide an earnings projection in addition to a statement specifying the reasonable basis for the projection, the assumptions underlying the projection and a location where information is available for inspection that substantiates the projection. The ability to provide earnings forecasts can be both a blessing and a curse for obvious reasons. There is arguably no data more material to a prospective franchisor in assessing the cost/benefit of an investment than the estimate of revenues which the franchisee is entitled to reasonably expect. The ability to provide evidence of attractive revenues would undoubtedly be a very persuasive sales tool. On the flip side, it is manifest that the provision of forecast data is most likely to be a source of liability for actionable misrepresentation in the event that actual revenues are significantly below those set out in a projection.

   Nonetheless, certain franchisees may not even consider investing in a particular franchise without some disclosure of earnings or earnings estimates and as such, franchisors may be increasingly compelled to including this type of information in the disclosure package. A franchisor who wishes to include some earnings information without having to undergo the expense of determining the format of the projections, establishing a reasonable basis and properly qualifying the projections in order to allay potential liability, may simply decide to include historical earnings. Where earnings are attractive, this may become a useful element of the disclosure materials, and to the extent that the source of the earnings data is reliable, will likely attract little liability to the extent that the document states that historical data provides no assurance of future performance. In the event that a forecast is deemed worthwhile, much more effort will be required to ensure that the analysis is produced using reliable methods on the basis of reliable data and assumptions. Any forecasts should be significantly qualified by geographic, demographic, seasonal, market and technical factors as appropriate.

Note that some commentators[11] are of the strong view that historical earnings fall under the rubric of "material fact" which the franchisor is therefore obligated to disclose in its disclosure document pursuant to section 5(4)(a) of the Act. While this is a compelling argument, as it is unobjectionable that revenue data is a critical variable in a prospect's risk and viability assessment, there has not yet been any judicial support for this interpretation. We may expect to see a test case before long which considers a franchisor's obligation to include historical earnings data in its disclosure package where such non-disclosure resulted in prejudice or damages to an aggrieved franchisee.

e) Advertising: The Regulations require certain minimum information be provided respecting expenditures made relating to local and national advertising. In addition to fulfilling the statutory requirement, the franchisor may at its option describe the nature and extent of its advertising strategy and tactics, which will serve to distinguish it from its competitors.

3. Timing of Disclosure: The Law and Practice

As earlier noted, a franchisor must provide the disclosure document 14 days prior to the prospective franchisee signing any franchise agreement or any other agreement relating to the franchise and prior to the payment of any consideration relating to the franchise. While somewhat arbitrary, the legislators considered that 14 days was a sufficient period of time for a prospective franchisee to obtain professional advice if necessary and to assess the merits of a potential investment in franchise.

Interestingly, the legislator does not define the meaning of "days" in the legislation. However, the *Interpretation Act* (Ontario)[12] states that "where the time limited by an Act for a proceeding or for the doing of any thing under its provisions expires or falls upon a holiday, the time so limited extends to and the thing may be done on the day next following that is not a holiday. A "holiday" includes Sunday all other statutory or other public holidays. When any holiday, except Remembrance Day, falls on a Sunday, the day next following is deemed to be a holiday.

It would appear that the 14 day period is calculated on a calendar day basis, subject to the aforementioned provisions of the *Interpretation Act* (Ontario).

a) Confidentiality: Section 5(1)(a) of the Act states that disclosure must be made 14 days before the signing of the franchise agreement or "any other agreement"

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[11] (and notably my colleague Paul Jones of Miller Thomson LLP)

[12] R.S.O. 1990, CHAPTER I.11 (Section 28(g)).

relating to the franchise. Since section 1.1(1) of the Act defines "franchise agreement" to include "any agreement that relates to a franchise" between a franchisor and a franchisee, including presumably development agreements, signage agreements and licensing agreements, the scope accorded to the words "any other agreement" in 5.(1)(a) would, according to the principle of economy in statutory interpretation, appear to refer to agreements outside of the purview of "franchise agreement". Accordingly, a confidentiality or non-disclosure agreement would, upon a strict interpretation of the relevant provision, be included in the definition of "any other agreement".

This interpretation creates practical concerns for the franchisor. In particular, a franchisor who has a prospect execute a confidentiality agreement as a prelude to the pre-sale screening process may find itself in technical violation of the Act for failure to produce the disclosure document at least 14 days prior to obtaining such signature. This result is somewhat absurd, given the necessity of each party to make a preliminary and confidential assessment of suitability and synergy, prior to taking the process to the next level. A franchisor will not be inclined to distribute the highly detailed and confidential disclosure document and take the risk that such information will be leaked to its competitors until a qualified prospect has been screened beyond the preliminary stages and has made the "A" list.

In practice, it would appear that the disclosure requirements of the Act are having the desired effect of making the franchise selection process more transparent. Accordingly, the facts contained in disclosure documents are not shrouded in the same secrecy as they might have been in pre-Act days, and franchisors faced with the ultimate duty of disclosure may realistically decline from insisting upon the absolute confidentiality of the contents of a disclosure package. Where a franchisor is insistent upon obtaining confidentiality, it may arguably do so by obtaining an oral agreement from the prospect to sign such an agreement on the 15th day following receipt of the disclosure document whether or not a franchise agreement is signed on such date. While this oral agreement may be difficult to prove, it will not be in violation of the Act and will provide some moral suasion for later insisting upon a written confidentiality agreement.

By way of comparison, the Alberta *Franchises Act* provides that a confidentiality agreement is not a franchise agreement, and no cooling off period needs to expire prior to the signing of such an agreement.[13] The Study Group on Franchising of the International Institute for the Unification of Private Law ("UNIDROIT") has also recommended in its Model Franchise Disclosure Law

[13] Section 7(b).

adopted on September 25, 2002 (the "Model Law") that the execution of confidentiality agreements not trigger the 14 day cooling off period.[14]

With respect to timing generally, it is a matter to be determined in each individual circumstance. It is usually not advisable to tender the disclosure document too early, as this will often result in an unnecessary cost to the franchisor and may have the undesired result of disseminating information to "tire-kickers" who are not particularly serious about pursuing the franchise opportunity. Franchisors acting on poor advice or fearful of exposing themselves to rescission may tender too early. It is generally recommended to tender the disclosure document after the first or second meeting, once the pre-sale process is well underway, and after each party has expressed a serious interest in one another. In such manner, each party's due diligence process can proceed more or less in tandem, with the result that the each party can be reasonably assured that it is working toward the same goal notwithstanding that neither may be in a position to sign on the 15th day following disclosure. Tactics such as waiting until the last possible moment to disclose and pressuring competing candidates to sign on the 15th day are not highly recommended, and may arguably offend the fair dealing principles of the Act[15].

b) Refundable Deposits or other Consideration: The erstwhile practice of obtaining a refundable deposit from the prospective franchisee as a form of "security deposit" to accompany delivery of the highly confidential disclosure document is no longer appropriate under the Act. Specifically, the Act states that the disclosure document must be delivered and received 14 days before "the payment of any consideration" by or on behalf of the prospective franchisee. The phrase "any consideration" is expansive enough to include a deposit, whether refundable or not. Broadly construed, the deposit would be paid in consideration for the delivery and review of the confidential information, the failure to return which and to abide by any confidentiality covenants would entail forfeiture of such deposit. Given the express wording of the Act, no such deposits are permitted.

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[14] Section 1A of Article 3 of the Model Law states as follows:

"(1) A franchisor must give every prospective franchisor a disclosure document, to which the proposed franchise agreement must be attached, at least fourteen days before the earlier of

> (A) the signing by the prospective franchisee of any agreement relating to the franchise, <u>with the exception of agreements relating to confidentiality of information delivered or to be delivered by the franchisor</u>...." [Emphasis mine.]

[15] Section 3 of the Act.

Once again, I would note that the Model Law (which to be precise is not a law but a guide) prescribes in Section 1B thereof that no payments may be made by the franchisor to the franchisee of "any fees relating to the acquisition of a franchise that are not refundable or the refunding of which is subject to such conditions as to render them non-refundable, with the exception of a security (bond or deposit) given on the conclusion of a confidentiality agreement." [Emphasis mine.] This approach is consistent with section 4(6) of the Alberta *Franchises Act* which does permits the payment of refundable deposits prior to delivery of the disclosure document.

Under the current Act, no payment of any kind, including by way of deposit, may made until the 14 day cooling off period has expired after the delivery and receipt of the disclosure document.

4. Mechanics of Disclosure

a) Receipt: The Act specifies that the disclosure document shall be provided and the prospective franchisee "shall receive" the document not less than 14 days prior to the execution of any agreement or the receipt of any payment. Therefore, the receipt, and not the delivery of the disclosure document is the moment which triggers the cooling off period. In order to confirm that the period is running, a franchisor must obtain a written receipt from the franchisee acknowledging that it has received a complete copy of the relevant disclosure document together with all attachments.

b) One Document: The disclosure document and all of its attachments may be delivered personally, by registered mail or by any other prescribed method[16], and must be one document.[17] This is to prevent inaccurate or incomplete disclosure, and to avoid the omission of a material fact by referring to another document which does not form part of the package or which the franchisor promises to produce at a later date. The disclosure document and all of its components should be solidly bound together, and the franchisor must absolutely retain an exact copy of the document sent to the prospective franchisee, for the purposes of later reference.

c) Certificate and Signature: The disclosure document must include a certificate stating that the document contains no untrue information, representations or statements and includes every material fact, financial statement, statement and other required information. The document must be signed and dated by the

[16] Section 5(2) of the Act.

[17] Section 5(3) of the Act.

franchisor where the franchisor is not incorporated, by the sole director or officer of the franchisor, or where the franchisor has more than one officer or director, by at least two persons who are officers or directors.[18]

5. Remedies for Improper Disclosure

Section 6(1) of the Act permits an aggrieved franchisee to rescind the franchise agreement without penalty or obligation, 60 days from the date the disclosure document was received, where the document was not provided within the time required by section 5 or where the contents of the disclosure document did not meet the requirements of section 5. Practically, this means that a franchisee may terminate where it has paid consideration or signed an agreement prior to the lapse of 14 days from the date of receipt of the disclosure document, or where any of the information required pursuant to section 5(1) and the Regulations is false or omitted.

Where the disclosure document not provided at all, the franchisee may rescind the agreement without penalty or obligation within two years of entering into the franchise agreement.[19]

In the event of rescission, the franchisor must within 60 days of the date of rescission, repay to the franchisee all amounts paid by way of franchise fees, purchase from the franchisee all inventory, supplies and equipment and further compensate the franchisee for any losses that the franchisee incurred in acquiring, setting up and operating the franchise.[20]

The aforementioned remedies underscore the requirement to take the disclosure process very seriously and to understand not only the specific regulatory requirements of compliance, but also the potential ramifications of non-compliance. A well-founded rescission can be a very costly exercise for a franchisor, and one which it will likely not wish to endure again, especially if it can be avoided by make proper disclosure in accordance with the Act and Regulations.

Late, deficient, or failure of disclosure relating to an existing franchise agreement may possibly be cured by providing updated disclosure in a disclosure document and by signing a new franchise agreement after the cooling-off period has elapsed. Once the period relating to the initial disclosure has expired, then the franchisor's exposure to rescission will be determined under the original agreement.

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[18] Sections 7(1) and 7(2) of the Regulations.

[19] Section 5(2) of the Act.

[20] Section 6(d) of the Act.

Franchisees must also be mindful of section 7(1) of the Act which provides that a franchisee has a right of action for damages against the franchisor, its associate, its broker and every person who signed the disclosure document, where the franchisee suffers a loss because of a misrepresentation therein. Franchisors should be aware that a franchisee who suffers loss in the face of such a misrepresentation will be statutorily deemed to have relied upon the misrepresentation[21] and will not be required to prove such reliance before a court.

6. Conclusion

While franchisors must ensure that the terms of the *Arthur Wishart Act (Franchise Disclosure)* are complied with in letter and in spirit, the disclosure document need not maintain the negative perception that it has thus far garnered. When properly drafted, organized and presented, the disclosure document can and should be an effective selling tool which succeeds in painting a positive image of a franchisor's system, practices, and vision.

[21] Section 7(2) of the Act.