

## Read All About It: Franchisor Loses Second Claim for Disclosure Exemption

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### INTRODUCTION

The disclosure obligations under the *Arthur Wishart Act (Franchise Disclosure)*, 2000 (the “*Wishart Act*”), as well as under franchise legislation in various other provinces across Canada<sup>1</sup>, form a cornerstone of franchise law and a significant source of potential liability for franchisors and those who are deemed to be franchisor’s associates.

The *Wishart Act* imposes an obligation on the part of the franchisor to make detailed disclosure about itself and the franchise opportunity to the prospective franchisee by delivery of a disclosure document, coupled with a right on the part of the franchisee to rescind the franchise agreement if proper disclosure is not made; and sue for: (i) if payment for the rescission damages pursuant to ss. 6(6) of the *Wishart Act* is not made, and/or (ii) damages for a failure to comply with the disclosure obligation or a misrepresentation<sup>2</sup>. Pursuant to s. 6(2) of the *Wishart Act*, a franchisor’s failure to provide adequate disclosure permits a franchisee to rescind the franchise agreement without penalty within the two (2) years of the signing of the franchise agreement.

To prevent individuals from hiding behind corporate structures, the *Wishart Act* expands the scope of liability to influential parties in the franchising process who failed to ensure compliance with the *Wishart Act*. Specifically, “franchisor’s associates”, who are defined under s. 1(1) of the *Wishart Act* as any individual or entity who:

- (a) is directly or indirectly controlled by the franchisor;
- (b) is directly involved in the granting of the franchise by exercising significant operational control over the franchisee; and
- (c) is owed a continuing financial obligation by the franchisee in respect of the franchise;

are jointly liable, with the franchisor, for the damages.

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<sup>1</sup> Presently, this includes British Columbia, Alberta, Manitoba, New Brunswick, and Prince Edward Island. Saskatchewan is also considering its own franchise legislation with the introduction of Bill, 149, *The Franchise Disclosure Act*.

<sup>2</sup> Defined as (a) an untrue statement of a material fact; or (b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

Ss. 5(7)(a) and s. 5(8) of the *Wishart Act* provides an exemption (the “**Resale Exemption**”) to a franchisor from the obligation to provide a disclosure document, if:

- (a) the grant of a franchise by a franchisee if,
  - (i) the franchisee is not the franchisor, an associate of the franchisor or a director, officer, or employee of the franchisor or of the franchisor’s associate,
  - (ii) the grant of the franchise is for the franchisee’s own account,
  - (iii) in the case of a master franchise, the entire franchise is granted, and
  - (iv) the grant of the franchise is not effected by or through the franchisor;

Section 5(8) states that that a grant is not effected by or through a franchisor merely because,

- (a) the franchisor has a right, exercisable on reasonable grounds, to approve or disapprove the grant; or
- (b) a transfer fee must be paid to the franchisor in an amount set out in the franchise agreement or in an amount that does not exceed the reasonable actual costs incurred by the franchisor to process the grant.

In the recent decision of *1901709 Ontario Inc. et al. v. Dakin News Systems Inc.*<sup>3</sup>, the court considered how the level of involvement of a franchisor in franchisee-franchisee transactions may preclude a franchisor from relying on the Resale Exemption thus triggering the disclosure obligations set forth in the *Wishart Act*<sup>4</sup>. The *Dakin News* decision is another illustration of how courts narrowly interpret exemptions from the disclosure obligations to ensure that the overarching objectives of the *Wishart Act*, which is fundamentally a consumer protection legislation, are met.

## BACKGROUND

In 2013, Bingyang Tan and 1901709 Ontario Inc. (collectively, the “**Franchisee**”) entered into a purchase agreement for an operating “International News” franchise. Consistent with the provisions of most franchise agreements, the purchase required the approval of Dakin News Systems Inc. (the “**Franchisor**”). Although the Franchisor did not have any direct contact with the Franchisee, the Franchisor required the Franchisee to:

- (a) complete a “six-step procedure” (though in the authors’ view there was nothing out of the ordinary in this “six-step procedure” which should have resulted in the Franchisor being unable to rely on the Resale Exemption, except for the payment of the \$20,000.00 inventory fee referenced in (b) below);
- (b) pay a \$20,000.00 inventory fee over and above the amount the Franchisee paid to the selling franchisee for inventory; and

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<sup>3</sup> [2022 ONSC 6008](#) (Ont. S.C.J.) [*Dakin News*].

<sup>4</sup> Also see [2256306 Ontario Inc. and Ali Reda v. Dakin News Systems Inc. et al.](#) (“*Dakin 1*”) in which the same franchisor was denied the use of the exemption but under different circumstances.

(c) execute a new franchise agreement and sublease agreement.

Shortly thereafter, the Franchisor informed the Franchisee that if he wished to renew the franchise agreement, which would otherwise expire in one (1) year, he was required to: (a) pay \$75,000 for a rebranding initiative; and (b) make a prepayment to refurbish the premises.

The Franchisee served a Notice of Rescission on the Franchisor, stating that he didn't receive disclosure from the Franchisor as required by the *Wishart Act*. In addition to suing the Franchisor, the Franchisee also sued Dakin West Inc., who was the sublandlord under the sublease, Samuel Davis, the principal of the Franchisor and sublandlord, and an employee of the Franchisor, as "franchisor's associates". The Franchisor argued that it was exempt from its disclosure obligations pursuant to the Resale Exemption.

## THE DECISION

### (A) Availability of Exemption

In determining whether the Franchisor "effected" the transfer or not, the Court recalled Karakatsanis J.'s holding in *2189205 Ontario Inc. v. Springdale Pizza Depot Ltd.*<sup>5</sup>, where it was determined that the Resale Exemption only applies where the franchisor is:

"not an active participant in bringing about the grant and does nothing more than 'merely' exercise its rights to consent to the transfer. In such circumstances, the power imbalance does not bear upon the decision to become a franchisee and plays no role in effecting the grant."

Considering the actions taken by the Franchisor, the court held that they went far beyond the mere exercising of the right to consent. Rather, the Franchisor guided and controlled the entire transaction, including requiring the Franchisee to enter into a new franchise agreement and sublease and pay a new \$20,000 inventory fee. The existing agreements and inventory were not simply co-opted by the Franchisee, but an entire new franchisor-franchisee transaction occurred in disguise. As such, the court held that the exemption from disclosure was unavailable to the Franchisor, and the failure to provide said disclosure entitled the Franchisee to rescission under section 6(2) of the *Wishart Act*.

### (B) Determination of a Franchisor's Associate

The court held that Dakin West, as a completely controlled subsidiary, and Mr. Davis, as the source and directing mind of the grant process and ultimate authority over who is approved as a franchisee, were both franchisor associates and therefore jointly liable.

On the other hand, the Court held that employees of the Franchisor (including one person who was not named in the litigation but was very much involved in the franchise approval process) who by virtue of their positions are required to implement a process over which they have no control, were held to be not "controlled" by the Franchisor, nor able to exercise sufficient operational control over the approval process. The Court mentioned that had they been

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<sup>5</sup> [2011 ONCA 467](#).

independent contractors, the result may be different, but their status as employees effectively shielded them from liability.

## CONCLUSION

Given the potential liability, franchisors must be scrupulous about relying on the Resale Exemption. The franchisor's role in the transfer of a franchise should be clearly defined and restricted solely to activities necessary to reasonably assess whether to approve the transfer, as well as to the costs that are reasonably incurred in executing the transfer. Above all, franchisors with compliant disclosure documents for new franchisees will almost always assume less risk by delivering a disclosure document to a transfer franchisee<sup>6</sup> than in attempting to rely on the Resale Exemption.

Though the *Dakin News* decision appears to provide some clarity on which persons are deemed to be franchisor's associates, and thus held jointly liable, in our view this aspect of the decision is wrongly decided, and that Mr. Smagaran (and Ms Yelisyeyenko who was not named in the litigation but referenced in the decision) are exactly the types of persons who should be jointly and severally liable as franchisor's associates.

Finally, lawyers must be careful to ensure that they provide the correct advice to either their franchisor or transfer franchisee clients, failing which they could be liable for a claim of post-rescission damages if:

- (A) The franchisor's lawyer failed to:
  - (i) advise the franchisor of its disclosure obligation under the *Wishart Act*, or its ability to use the Resale Exemption, resulting in a franchisee exercising its right to rescind; or
  - (ii) prepare a compliant disclosure document to be used by its franchisor client in the context of a transfer, resulting again in the transfer franchisee exercising its right to rescind;
- (B) The transfer franchisee's lawyer fails to advise their client of its rights arising from the franchisee not receiving a compliant disclosure prior to purchasing the franchise, and the franchisee misses out on the opportunity to rescind its franchise agreement within the time provided for under the *Wishart Act*.

In each of these scenarios, the lawyer may be found to be liable for the post-rescission damages awarded to the transferee franchisee. Furthermore, the errors made by the lawyer in these scenarios cannot be rectified. Accordingly, it is imperative that a lawyer advising a franchisor, or that were failed to be claimed by a transferee franchisee, be familiar with the *Wishart Act*, and particularly the disclosure obligation imposed upon franchisors.

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<sup>6</sup> Provided that the franchisor includes all material facts and agreements in the disclosure document given to the transfer franchisee, which necessarily must be site specific.