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DRAFTING FRANCHISE AGREEMENTS IN THE 21ST CENTURY

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1. INTRODUCTION

To draft a franchise agreement requires more than simple expertise and a good understanding of the franchisor's existing business operations and objectives. Lawyers drafting franchise agreements continuously face the daunting challenge of attempting to anticipate specific business and legal issues that might one day in the future confront their clients, which issues have not yet been contemplated at the time that the agreements are drafted.

While the problem of anticipating change in contractual matters is not unique to the discipline of franchise law as it is clearly pervasive in every area of the law, it is exacerbated by the fact that the length of the terms of many franchise agreements are much longer than in most other commercial agreements. Some franchise agreements are 25 years or more in duration, so anticipating every possible change and scenario when originally drafting such agreements is virtually impossible. Yet, the success of the system to some extent depends upon the franchisor's ability to address such possible changes in the franchise documentation.

Before discussing the major challenges confronting the drafting of franchise agreements today, it is important to recognize that not all matters must or should be considered within the franchise agreement *per se*. The inability of franchisors and their counsel to predict the future is compounded by the objective shared by many that the agreement not be unduly complicated and that it be drafted in an accurate, clear and concise manner for the benefit of prospective franchisees. This is particularly the case, as mentioned above, when one is confronted with a long-term agreement. To provide franchisors with a measure of flexibility, therefore, franchisors have relied upon the operations manual and policy statements for the issuance of standards and policies affecting the franchise system. This is legally accomplished by the incorporation of the operations manual by reference into the franchise agreement and by general distribution of such policies.

2. MAJOR DEVELOPMENTS

When drafting franchise agreements, it is important to first consider some of the major developments confronting franchising in the Province of Ontario in the 21st century. Some of these developments include the following:

(a) The *Arthur Wishart Act (Franchise Disclosure), 2000* (Ontario) (the "Act") and the disclosure requirements arising out of the Act have considerably altered the franchising landscape in this Province. Since the advent of the Act, franchisors must be mindful of the statutory duty of fair dealing (which arguably does not differ from the common law duty of good faith and fair dealing), the pre-existing

right of franchisees to form or join franchisee organizations and the new disclosure obligations imposed by the Act and the Regulations to the Act.

In addition, franchisors must draft their franchise agreements in a manner consistent with their disclosure documents and the agreements must be amended to reflect and address the obligations imposed by the Act. For example, franchisors may no longer interfere, prohibit or restrict, by contract or otherwise, a franchisee from forming or joining a franchisee organization or otherwise prevent them from associating from other franchisees. Any such prohibition or restriction in the franchise agreement will be rendered void and ineffective by virtue of Section 10 of the Act.

(b) The emergence of the new economy, i.e., the Internet and e-commerce, has presented a whole host of issues that franchisors must address in their documentation, from protecting trade secrets and other intellectual property on the Internet, to domain name and website control and protection, to website terms of use and online privacy issues.

(c) The growing popularity of alternative forms of franchise expansion such as co-branding, drive-thrus and licensing arrangements has raised a number of issues for franchisors with respect to drafting their franchise agreements and disclosure documents.

(d) The heightened activism and sophistication of franchisees and the associated growth and popularity of franchise associations and councils. Franchisees are increasingly becoming more active and vocal as they pursue various means of protecting their investment and take steps to ensure that constraints are placed upon their franchisors. Prospective franchisees are also seeking franchise systems that are more collaborative in nature and that do not exemplify the command-and-control management techniques typically associated with most franchise systems.

(e) Franchise counsel are increasingly being asked by their clients to draft their franchise documentation in as plain language as possible and to reduce the amount of legalese present in the documentation. Franchisors not only want to be legally protected from their franchisees, suppliers and other third parties, but they also desire user-friendly franchise agreements that may be used as marketing tools themselves and that do not unnecessarily confuse or intimidate their prospective franchisees. The Act furthermore specifically requires that the disclosure document and the franchise agreement, which is an important element of the disclosure package, be drafted in a "clear, concise and accurate" manner. Traditionally lengthy franchise agreements may not therefore satisfy the requirements of the Act nor will it meet the requirements of more demanding franchisors.

3. GOALS IN DRAFTING

There are several sometimes competing and overlapping objectives that require attention when drafting franchise documentation. The most important objective in drafting a sound franchise agreement is to "bullet-proof" your franchisor client. One does so by clearly setting out the applicable legal rights, obligations and remedies of the franchisor, franchisee and guarantors, if any. For example, franchise agreements will inevitably deal with the sale, transfer and termination of franchises, and establish the payment obligations of the franchisees and the manner by which the franchisee is to conduct its business operations. Protecting the value of the brand, trade-marks, trade secrets and confidential and proprietary information is another objective which deserves serious attention by franchisors and their counsel.

Since the advent of the Act, furthermore, the proposed franchise agreement and all other related documentation to be signed by the prospective franchisee must be included in the disclosure document (Section 5(4) of the Act) to be disclosed to prospective franchisees in accordance with Section 5(1) of the Act. Franchise counsel must now therefore take steps to ensure consistency between the terms and conditions of the franchise agreement (and other agreements) and the disclosure document when preparing the franchise documentation. Internal inconsistencies between the franchise agreement, for example, and the disclosure document not only reflects poorly upon the franchisor, but also exposes the franchisor to a possible claim of misrepresentation under the Act.

Other goals to be achieved when drafting the franchise agreement include the following:

(a) The process of drafting the franchise agreement helps to solidify the franchisor's understanding of its own system and confirms that understanding with both prospective and existing franchisees.

(b) Ensuring that the agreement does not contain provisions that are unduly abusive, unconscionable or otherwise unfair. Such provisions dissuade prospective franchisees from purchasing the franchise or cause franchisees and their counsel to request amendments to the agreement, thereby increasing the cost of selling the franchise. Furthermore, such onerous provisions could possibly generate dissension amongst existing franchisees and the franchisor.

(c) Adopting a more collaborative approach to relations as between franchisor and franchisee and otherwise minimizing disputes with franchisees. For example, franchisors might consider including language that would institutionalize the creation of a franchisee association or advisory council to better co-ordinate their affairs with their franchisees and to encourage franchisees to participate in the growth and the development of the franchise system.

(d) Providing the framework within which additional investments are to be made by the franchisee over the course of the term of the franchise agreement.

(e) Addressing issues surrounding franchise growth and development and the length in years of the franchise agreement. For example, will the franchisee be offered a right of first refusal over any of the surrounding territories should they later

become available? Is the franchisee granted a right of renewal to extend the term of the agreement and if so, what conditions must it satisfy to ensure the renewal term?

(f) Providing stability and a measure of predictability over the course of the franchise term by institutionalizing methodologies to ensure system adherence.

(g) To the extent possible, anticipating changes within the system over the term of the franchise agreement. One approach to anticipate such changes would be to build enough flexibility within the franchise agreement so as to allow the franchisor with sufficient latitude to respond to new challenges over time. Franchise counsel traditionally do so by drafting largely generic agreements and leaving the specifics to the operations manuals. The operations manuals are then used by franchisors to institute new policies from time to time which, while not necessarily contemplated by the franchise agreement, are legally "sanctioned" by the franchise agreements since the manuals are incorporated by reference into the franchise agreement.

4. SIGNIFICANT ISSUES IN FRANCHISING TODAY

The balance of this paper will specifically address what are likely the most significant issues that require attention when drafting a franchise agreement in the 21st Century. They include the following: the obligation of good faith and fair dealing; the impact of the Internet on franchising in general and the related issue of the Internet and the possibility of encroachment in particular; system standards, manuals and policies; privacy, earnings projections, alternative dispute resolution and class actions, force majeure and terrorism and the recent popularity of franchisee associations and councils.

5. GOOD FAITH AND FAIR DEALING

Issues

In considering the duty of good faith and fair dealing in franchise law and how it impacts upon the drafting of franchise agreements, it is necessary to review exactly what the duty is and how it arises.

(a) The Statutory Duty

Section 3 of the *Arthur Wishart Act (Franchise Disclosure), 2000* (the "Act") deals with the duty of fair dealing. It is provided in subsection 3(1) that every franchise agreement (which term is defined to mean any agreement that relates to a franchise) imposes on each party a duty of fair dealing in its performance and enforcement. The remedy for a breach of the duty of fair dealing is the right to bring an action for damages pursuant to subsection 3(2). However, Section 9 of the Act states that the rights conferred by the Act are in addition to and do not derogate from any right or remedy available at law (which would include equitable relief). Subsection 3(3) states that the duty of fair dealing includes (note that this provision is inclusive) the duty to act in good faith and in accordance with reasonable commercial standards.

Accordingly, pursuant to section 3 of the Act, a franchisor has a duty of fair dealing to its franchisees in respect of the performance and enforcement of the Agreement. The duty of fair dealing means that the franchisor must act in fact in good faith and in accordance with reasonable commercial standards.

(b) **Cases**

The term "good faith" has generally been interpreted in recent case law to mean the opposite of bad faith. It is a subjective concept, interpreted in respect of individual franchise relationships between a franchisor and a franchisee, as opposed to the relationship between a franchisor and its franchisees as a whole. Those cases which have considered the concept of good faith have essentially determined whether a franchisor has acted in bad faith in respect of a particular franchisee in the sense of discriminatory action, action taken against a franchisee which departs from the normal course of action taken against other franchisees in similar circumstances, and the like. The concept of reasonable commercial standards is an objective standard which generally must be determined by reference to the competitive market place at large.

In the case of *Shelanu Inc. v. Print Three Franchising Corp.* [2002] O.J. No. 4129 (Ont. S.C.J.), the trial judge found that the franchisor had failed in its common law duty to act in good faith in its dealings with its franchisee. In this case the court stated that the Act did little else than codify the common law rule imposed upon a franchisor to act in good faith in its dealings with the franchisee and that the duty of "utmost good faith" must come from the dealings of the parties with one another.

In the recent case of *Machias v. Mr. Submarine Ltd.* [2002] O.J. No. 1261 (Ont. S.C.J.), a Mr. Submarine franchisee claimed that representatives of the franchisor misrepresented the material facts with respect to a Mr. Sub franchise location in Montreal, thereby inducing the franchisee to enter into a franchise agreement. A number of important statements were made by the trial judge concerning the duty of good faith and fair dealing, and in particular with respect to the duty of fair dealing in the Act.

In reviewing recent cases involving presale misrepresentation, Wilson, J. stated as follows:

> "These cases are also part of a recent trend to define duties of good faith between bargaining parties to prevent abuse or obvious unfairness in the context of the franchise relationship. A recurrent theme in these cases is the inherent inequality of bargaining power between an established franchisor and an individual franchisee as well as the unique interdependent relationship between franchisor and franchisee".

The judge also remarked on the enactment of the Act although it did not apply in the case since the franchise was located in Montreal, Quebec:

> "The recurring problem with respect to inequality of bargaining position and in particular the accuracy of financial disclosure in the context of acquiring a franchise has now been recognized and rectified by statute… The Act responds to the recurring situation such as this one where inadequate or misleading disclosure is made by the franchisor… Counsel for the defence acknowledges, however, that the good faith requirements

> of common law apply to define the duties and obligations between franchisee and franchisor in this case. From a practical point of view, the Act simply codifies the common law".

In considering the rights, duties and obligations between the parties, Wilson, J. stated as follows:

> "It appears clear from the case law, that although the parties to a franchise agreement are not in a fiduciary relationship, they are in a relationship that imposes upon the parties the duties of utmost good faith.
>
> Franchisors are not required to act selflessly placing the interests of the franchisee ahead of their own. However, it appears clear from the case law that a franchisor is subject to the duty to act in utmost good faith towards the franchisee."

In citing a similar consideration of the duty of good faith and fair dealing from the *Shelanu* case, the judge confirmed that the duty of good faith imposed upon the parties includes "community standards of honesty, reasonableness and fairness".

(c) Application

Applying these recent pronouncements with respect to the common law and statutory duties of good faith and fair dealing, it is important to recognize that the duty is to be interpreted in connection with the "performance" and "enforcement" of the agreement. The Act itself does not suggest that a franchise agreement must be a "fair" agreement between the parties. To the contrary, a number of court decisions have recognized that the balance of power in a franchise relationship rests with the franchisor, and that franchisees must appreciate that there are certain inherent risks and subjective issues which will affect the ultimate success or failure of the franchisee.

In the case of *Country Style Food Services Inc. v. Hotoyan* [2001] O.J. No. 2889 (Ont. S.C.J.), the trial judge made the following observations with respect to the state of franchising:

> "To say that franchising is a risky business is, if anything, an understatement for there is risk not only for the franchisee but also for the franchisor. Many events and circumstances, a few inevitable, but for the most part unforeseen, will affect the life of a franchise. Some franchising schemes will prosper; others will fail. Some of those that fail will do so despite the success of one or more of the franchisees. Some individual franchisees will fail despite the success of the overall franchising scheme…The rest who fail do so for other reasons, including undue competition or mismanagement."

These developments indicate that the duty of fair dealing, as it is defined in the Act to pertain to the enforcement and performance of a franchise agreement, will be assessed by the courts based on the conduct of the parties in performing and enforcing the agreement. If in the course of performance or enforcement a franchisor does not deal fairly (i.e. in good faith in accordance with reasonable commercial standards), a court will find against the franchisor. Further, as suggested in the *Machias* case and previous decisions, franchisors are subject to the duty to act in

"utmost" good faith towards their franchisees, a stricter requirement than the statutory duty in the Act. Therefore, in order for a franchisor to ensure that it does not breach the duty of fair dealing in respect of the enforcement of a franchise agreement, the franchisor must act in good faith in accordance with "community standards of honesty, reasonableness and fairness", as the courts have construed the duty, and in accordance with reasonable commercial standards as specified in the Act.

It is therefore critical to appreciate that a franchise agreement by itself cannot contravene the statutory or common law duty of fair dealing. To the contrary, the duty of fair dealing may be contravened by a franchisor depending upon the manner in which the franchisor chooses to perform and enforce the agreement in a particular situation.

Recommendations

(d) **Agreement Changes**

In view of the comments above with respect to the duty of good faith and fair dealing, it is important for franchisors to ensure that there are no unnecessary provisions in their franchise agreements which could colour the agreements in respect of the duty of fair dealing. Franchisors should consider making the following changes to their agreements to accomplish this purpose:

- Eliminate such concepts as "sole" or "unfettered" discretion, since, in any event, discretion will have to be exercised in good faith and in accordance with reasonable commercial standards.

- Ensure that there are adequate notice periods to franchisees for defaults, remedial action and termination.

- Whenever possible, the franchise agreement or an operations manual should contain policy statements or defined parameters for the determination of critical items which are only dealt with in a general manner in the franchise agreement as, for example, determination of prices, formulas, buyout amounts, and rights to additional franchises and the like.

- Ensure that obligations of franchisees are not written in such an onerous manner that they are virtually impossible to be complied with.

- Ensure, by way of confirming provisions, that areas of possible dispute will be avoided by clear and unambiguous language (e.g. if there is no renewal, the agreement should specifically confirm same).

- Wherever action is required to be taken by a franchisor, particularly in response to requests from the franchisee, the agreement should outline the mechanics for such action, and specific timelines for responses.

- Consider adding a "reasonableness" provision defining the franchisor's conduct in respect of consents, approvals and actions to be taken by the franchisor.

- Carefully consider whether rights of the franchisor which typically are considered to be onerous can be modified to be more reasonable in nature but at the same time to provide the franchisor with the rights which are necessary for enforcement of the agreement (e.g. inspection and audit rights, default and termination clauses, non-competition covenants, disclaimer of rebates and allowances, use of advertising funds, purchasing and supply restrictions, and financial and other reporting).

- Consider alternate dispute resolution methods (e.g. mediation).

6. INTERNET AND ENCROACHMENT

To paraphrase Mark Twain, reports of the demise of the Internet revolution are greatly exaggerated. Despite the recent downturn in Internet-related industries and investment, the Internet and e-commerce have had a significant impact on the way that franchisors and franchisees conduct business to date and, to a lesser extent, the manner by which the ultimate customers interact with franchise systems. Franchisors are encouraged to revisit their franchise documentation to ensure that they have addressed the new realties posed by the Internet and e-commerce. Below, are some of the issues that have arisen with respect to the Internet and e-commerce as they pertain to the drafting of franchise agreements.

Issues

- Do certain of the definitions set out in the franchise agreement require amendment to broaden them to include references to the Internet and other recent technologies?

- What kinds of mechanisms are in place to protect the franchisor's trade-marks and copyrights from possible infringement by either franchisees or third parties and, conversely, to shield the trade-marks and copyrights of third parties from the franchisees?

- Does the franchise agreement permit the franchisor to update its operations manual on its Intranet for its franchisees?

- Has the franchisor reserved a right to implement a website usage policy in its franchise agreement should it decide to implement one sometime in the future?

- Does the franchise agreement permit the franchisor to require its franchisees to upgrade their computer hardware and software from time to time, as system requirements might change considerably over the course of the term of the franchise agreement?

- Is the franchisee clearly obligated to shut down any websites operated by it and to transfer all domain names/web addresses used by it to the franchisor upon the franchisee's termination? What remedies does the franchisor have if the franchisee refuses to do so upon termination?

Recommendations

- Definitions. Various definitions throughout the franchise agreement may require amendment to update the agreement for the beginning of the 21st Century, including the definitions of "Proprietary Information", "System" and "Operations Manual". For example, the definition of "Proprietary Information" should include all information transmitted electronically, including emails and any information posted on the franchisor's or the franchisees' websites. This definition is a critical one, as it appears several times throughout a typical franchise agreement and many obligations imposed upon the franchisees will relate to that definition.

- License. The granting section should include a non-exclusive license by the franchisor to the franchisee to use the franchisor's copyrighted material and proprietary information that may be disclosed online or transmitted through email. In addition, should the franchisor wish to distribute its product or services over the Internet, it should reserve a right to do so in the granting section of the franchise agreement. Finally, if the franchisor does not specifically reserve for itself the right to distribute its goods or services over the Internet, it runs the risk of triggering a claim of encroachment by its franchisees.

- Personal Property Security Interest. Franchisors are advised to take a security interest in the domain names and websites belonging to their franchisees if they accustomed to taking a security interest in the assets of their franchisees.

- Website usage policy. The franchise agreement should either be amended, or should specifically allow the franchisor to issue a website usage policy (as an operations manual policy statement), which may include granting the franchisor the right to do any or all of the following:

    - Manage, control and approve Internet advertisements placed by its franchisees on any websites associated with the franchise system and to implement any online ordering or other e-commerce systems;

    - Prohibit or restrict the franchisee's ownership and usage of any websites, links or frames and the content thereon, including those belonging to the franchisor or any third parties. To convey the content of the websites to the franchisor, franchisees may be required to either transfer the title or issue an irrevocable license to the franchisor so that the franchisor may use the said content;

    - Prohibit the franchisee from uploading any viruses, worms, trojan horses or links to its website that may be illegal, inappropriate or offensive in nature;

    - Implement a privacy policy with respect to the franchisee's use of the Internet and the franchisor's ability to monitor the franchisee's use;

    - Require the franchisee to acknowledge that the franchisor has ownership over all information posted on the franchisor's and the franchisee's website and that the

franchisor may alter any aspect of its website at its own discretion at any time and from time to time;

- Prohibit the franchisee from having its own domain on the web, instead permitting the franchisee to simply utilizing the inner links associated with the franchisor's principal site. For example, if the franchisor's site were called "www.nameoffranchisor.com", its franchise store located in downtown Toronto might have a sub-domain name appropriately entitled "www.nameoffranchisor.com/downtowntoronto". By so doing, the franchisor is better positioned to exert control over the franchisee's website should it decide to terminate the franchise some time in the future;

- Require the franchisee to transfer any domain names and email addresses associated with the franchise system to the franchisor upon termination of the franchise and prohibit the franchisee from suggesting that it is in any way associated by way of links or other electronic means with the franchise system post-termination. Franchisees should also be required to grant a power of attorney to their franchisors to effect all of the forgoing;

- Require the franchisee to indemnify the franchisor from any loss occasioned by the franchisee's failure to abide by the website usage policy; and

- Disclaim the functionality of the franchisor's website, and otherwise limit the liability of the franchisor which may arise in connection with the franchisee's or any third party's usage of the franchisor's website.

The above represents a cursory summary of some of the issues raised by the Internet and its interaction with franchising. It therefore becomes patently clear why the Internet has become one of the most significant developments to affect the drafting of franchise agreements in recent times.

7. SYSTEM STANDARDS, MANUALS AND POLICIES

Issues

Franchise systems are unique by reason of their standards, procedures, techniques, methods and specifications (the "standards"). The standards of the franchisor will undoubtedly change over the life of a franchise. In fact, if the standards do not change, one might expect that the franchise system has become stagnant and non-competitive. It is obviously impossible for a franchise agreement to contain details of each and every standard or the agreement will not only become hundreds of pages long, but it will be subject to amendment on almost a daily basis. Therefore, franchise agreements must adopt a manner in which standards can be dealt with on a going forward basis.

Recommendations

(a) **Definitions**

The first element of dealing with standards in a franchise agreement is to define the "franchise system". A typical definition will include the following elements:

- The "franchise system" means the uniform standards, procedures, techniques, methods and specifications formulated and developed by or on behalf of the franchisor.
- These may be added to, changed, modified, withdrawn or otherwise revised by the franchisor from time to time.
- The standards relate to the sale and distribution of products or services (depending upon the franchise system) by the franchisee.

A second element necessary to encapsulate the concept of standards within the franchise agreement is to reference a manual which contains the mandatory and suggested standards applicable to the operation of the franchise system and the franchisee's operation as a franchisee. In order to do this, a "manual" must be defined. The definition of the manual must be contemporary in nature to incorporate different forms of communication of the standards and the fact that the same may be changed from time to time. A typical definition of the "Manual" would include the following elements.

- The "manual" includes any specifically named manuals, together with all other manuals, books, pamphlets, bulletins, memoranda, directives, instructions and other materials.
- These items may in written, machine readable, electronic or other form.
- These items will set out the standards, procedures, methods, techniques and specifications of the franchise system.
- These items may be amended, revised, withdrawn or replaced from time to time.

(b) **Manual Compliance**

The manual compliance provision is key to the proper enforcement by a franchisor of the franchise system and the standards referable to the franchise system. Therefore, the provision must state that the manual, as revised from time to time and the mandatory standards, methods, procedures and specifications applicable to the franchise system and the franchisee's operation as a franchisee, and such revisions made from to time, constitute provisions of the franchise agreement and the franchisee must comply with same as if fully set forth in the franchise agreement.

The franchisor must reserve the right to add to, modify, withdraw from or otherwise revise the provisions of a manual from time to time as provided for in the agreement or to maintain the goodwill associated with the franchise system and the franchisor's trade-marks. However, it is essential that the franchisor not attempt to contract through the manual in a manner which might

otherwise be considered to be an amendment to the franchise agreement or the imposition of new fundamental provisions to the agreement. Therefore, the manual provisions should state that no revision to the manual will alter unreasonably the franchisee's fundamental rights under the agreement.

In order to assure the effective utilization of the manual throughout the term of the agreement, the manual provision should also include the following concept:

- The franchisor shall lend to the franchisee during the term of the agreement a copy of the manual.

- At all times the manual shall remain the exclusive property of the franchisor and shall be returned to the franchisor promptly upon request by the franchisor and, in any event, upon termination or expiration of the agreement for any reason whatsoever.

- The franchisee shall not at any time copy, duplicate, record or otherwise reproduce or transcribe the manual or any part thereof, including on disc, CD-rom or other electronic means.

- The franchisor may transmit a copy of the manual and any revisions by electronic mail, internet, intranet or other electronic means or post the manual and any revisions on its website.

- If there are any differences between the franchisor's and franchisee's copies of the manual, the terms of the master copy of the manual maintained by the franchisor will be controlling in all respects.

(c) **Policies**

Somewhat analogous to, but incidental to, the concept of a manual, is the establishment by a franchisor of policies. While not all franchise systems operate with policies, the use of policies is becoming more prevalent in mature franchise systems due to the complexity of both business and legal concepts applicable to a franchise system.

For example, when dealing with difficult or complex formulas or valuation procedures, policies may be invoked by the franchisor. Some franchise systems use policies to outline the practice for granting of additional franchises. It has long been a practice in hospitality franchise agreements for franchisors to refer to policies for determining the effect, if any, of encroachment on a franchisee's existing business or the establishment of a competing franchise unit in proximity to the franchisor's unit. Policies may change from time to time depending upon experience, competition, market factors, different formulations and another considerations. In order to allow for such changes, it is essential that the franchise agreement, the manual or the policies themselves establish a mechanism whereby such policies may be implemented, communicated and changed from time to time. Of course, it must always be recalled that the manner in which a franchisor performs and enforces such policies will be relevant to a consideration as to whether the franchisor, in such circumstances, may be considered to have breached the duty of fair dealing contained in the Act.

8. PRIVACY

Issues

Recent developments in privacy law will affect virtually every aspect of doing business in Canada and, in particular, will require franchisors and franchisees to obtain consent from individuals to collect, use and disclose their information for marketing and other purposes. As discussed below, these developments may also require amendments to franchise agreements, manuals and related documents and policies governing franchise systems.

(a) Legislation

On January 1, 2001, the federal government enacted new privacy legislation, the *Personal Information Protection and Electronic Documents Act* S.C. 2000, c.5 ("PIPEDA"), which regulates the collection, use and disclosure of personal information by private sector organizations. Currently, the legislation only applies to "federal works" (such as banks, telecommunications carriers and airlines) and other organizations that sell or trade in personal information across a federal or provincial border. However, beginning January 1, 2004, PIPEDA will drop down to the provincial level and will apply to the commercial activities of *all* organizations in Canada, except to the extent an organization is collecting, using or disclosing personal information within a province that has adopted "substantially similar" legislation.

To date, none of the provincial or territorial governments has introduced legislation in response to the federal government's call for "substantially similar" private sector privacy legislation. The province of Quebec is the only province that currently has private sector privacy legislation in place. Quebec's *Act for the Protection of Personal Information in the Private Sector*, R.S.Q. c. P-39.1 came into effect on January 1, 1994, well before the enactment of PIPEDA and regulates the collection, use and disclosure of personal information in the private sector. Although the Ontario government released a consultation draft privacy bill in early 2002, it failed to introduce privacy legislation before recessing for the Winter break. Given that the Ontario legislature will not resume until mid-March 2003 and the likelihood of a Spring or Fall provincial election, time is running out for the government to introduce "made in Ontario" privacy legislation prior to the January 1, 2004 deadline. It is likely, therefore, that the federal privacy legislation will extend to cover all commercial activities in Canada as of January 1, 2004. As a result, franchisors have less than one year to assess their current practices with respect to the collection, use and disclosure of personal information and to review and revise their franchise agreements and related documents and policies.

The basic premise of the federal privacy legislation is that each individual owns his or her personal information and is entitled to control the collection, use or disclosure of that information. *PIPEDA* has enshrined into law the Canadian Standards Association *Model Code on the Protection of Personal Information* ("CSA Code"). The CSA Code imposes certain obligations upon organizations with respect to personal information collection, use, disclosure, retention, security and access.

The principle of consent is one of the cornerstones of the legislation. Specifically, organizations must identify the purposes for which personal information is collected at or before the time of

collection and obtain the individual's consent to such collection, use or disclosure. When personal information is to be used for a new purpose, organizations must identify the new purpose and obtain the individual's consent prior to the new use.

In determining the most appropriate form of consent, the CSA Code guides organizations to take into account the circumstances surrounding the collection, the type of personal information collected and the reasonable expectations of the individual. Express consent should generally be used whenever the personal information being collected is likely to be considered sensitive. Implied consent should generally only be used when the information is less sensitive.

Interestingly, while the CSA Code specifically contemplates the use of opt-out consent, recent high profile decisions of the Privacy Commissioner of Canada appear to have significantly narrowed the use of opt-out consent as an acceptable means of obtaining consent for marketing purposes. Should the trend toward express opt-in consent continue, the operation of loyalty and customer research programs could be jeopardized. In addition, the marketing programs of many franchise systems would have to be restructured and reworded, since they are typically implemented by contractually requiring that franchisees collect customers' personal information and share this information with the franchisor and/or other franchisees.

Recommendations

The following is a list of action-items franchisors should consider as part of an overall privacy compliance strategy:

- Franchise agreements, manuals and policies should be reviewed and revised as necessary to require franchisees to obtain the appropriate form of consent from customers for the collection, use and disclosure of their personal information (even where such information will be shared within the franchise system).

- Franchisors should develop a comprehensive external privacy statement and internal guidelines and policies governing the collection, use and disclosure of personal information by the franchisor and its franchisees. These guidelines and policies should be incorporated into the manual and may be posted on the franchisor's website.

- Invoices and sales forms, customer application or membership forms, on-site application or registration forms or documents, product or service warranties and personal data records may require specific acknowledgements or consents.

- Franchisee websites should contain a franchisor-approved or created online privacy policy.

Franchisors should be aware that there is no grandfathering provision in the federal legislation. In other words, once the legislation does apply, the restrictions on use and disclosure will also apply to personal information collected by franchisors and franchisees *before* the legislation comes into force. Therefore, franchisors should prepare for compliance in advance and consider the benefits of ensuring that information collected *now* by the franchisor and its franchisees is collected in compliance with PIPEDA. This preparation will require a thorough review and likely

redrafting of all relevant agreements, forms and other documents used by franchisors and their franchisees with customers of the franchise system.

9. RELATIONSHIP AND DISCLAIMER CLAUSES

Issues

(a) Disclaimer Clauses

Every well drafted franchise agreement contains a number of relationship and disclaimer provisions. While franchisors and their legal counsel often consider such clauses to be "boiler plate" in nature, and repeat the same clauses which they have been using for years, it is important to examine such clauses to ensure that they do not overstep what is reasonable or necessary.

The types of clauses in question generally consist of the following:

- Independent parties or relationship.
- Entire agreement.
- Disclaimer provisions.
- Franchisee investigation.
- Franchisee review of agreements.

No matter how well drafted the entire agreement, relationship clauses and disclosure provisions are in a franchise agreement, there is always the overriding consideration that such clauses may be declared unenforceable by reason of the conduct of a franchisor. In particular, should a franchisor's conduct be considered to be unconscionable, or should a franchisor act in such a manner that it will have committed a fundamental breach of the agreement, the clauses may be declared unenforceable. It is therefore necessary to consider the relevant case law in respect of both unconscionability and fundamental breach to understand when either may arise.

(b) Unconscionability

In a number of franchise decisions disgruntled franchisees have alleged that their franchise agreements were unconscionable, and accordingly should be declared unenforceable. It is important, in this respect, to review how the concept of unconscionability arises and whether or not it would have application in a dispute between a franchisor and a franchisee with respect to a franchise agreement.

A leading franchise decision involving the concept of unconscionability is the case of *Atlas Supply Company of Canada v. Yarmouth Equipment Ltd.* (1991), 37 C.P.R. (3d) 38 (N.S.C.A.). The *Atlas Supply* case has been cited and considered in a number of recent Ontario franchise decisions involving allegations of unconscionability. Most of these cases also involved pre-sale disclosure issues. The effect of a finding of unconscionability in franchise law is to negate the usual exclusionary or entire agreement clauses found in a franchise agreement. In the *Atlas*

Supply case, the Nova Scotia Court of Appeal made the following remarks regarding the exclusionary clause:

> "Exclusionary clauses are often fair and necessary. However, when evidence discloses otherwise, courts have devised various methods to avoid injustice. For example, the *contra proferentum* principle, collateral warranty, fundamental breach and unconscionability... Concerns of unconscionability and inequality of bargaining power must be considered in order to determine the force to be given to the relevant clauses in the agreement… The contract may be found to be unconscionable where there is unequal bargaining power between the parties. However, unequal bargaining power is not the only situation where unconscionability may arise. The task of determining whether acts are unconscionable is at times difficult because the meaning of the word is far from precise... The answer must be found within the particular facts of the case: the results will differ as to the facts.
>
> Business people entering into a contract must have some certainty that its provisions will be applied and the courts will refrain from rewriting the contract. That proposition, however, is subject to the important caveat: the court will intervene and properly so when the party desiring to enforce its exclusionary clause has engaged in unconscionable conduct."

The determination of what is unconscionable must be reviewed in the context of the leading decision, *Mundinger v. Mundinger*, (1968) 3 D.L.R. (3d) 338, affirmed (1971) 14 D.L.R. (3d) 256 n.(S.C.C.). In that case the Ontario Court of Appeal adopted the following passage as an accurate statement of the law of unconscionability:

> "If the bargain is fair the fact that the parties were not equally vigilant of their interest is immaterial. Likewise if one was not preyed upon by the other improvident and even grossly inadequate consideration is no ground upon which to set aside a contract freely entered into. It is the combination of inequality and improvidence which alone may invoke this jurisdiction. Then the onus is placed upon the party seeking to uphold the contract to show that his conduct throughout was scrupulously considerate of the other's interests".

The *Mundinger* decision was applied in the case of *Ellis v. Subway Franchise Systems of Canada Ltd*. (2000), 8 B.L.R. (3d) 55 (Ont. S.C.J.). The court in the *Ellis* case emphasized that before a claim of unconscionability can proceed, one must have evidence of fraud, duress or some abuse of inequality of bargaining power. The following remarks were made by the court in the *Ellis* case:

> "The advantage in such a franchise agreement is thus mutual, rather than unilateral, unequal or undue. Equally part of the consideration for the franchise agreement is the element of mutual advantage. The onerous terms of the franchise agreement are not necessarily in order to ensure that the franchisee does not erode the franchisor's goodwill. The contract's terms provide the franchisee with certainty and

> predictability…Therefore, the defence of unconscionability must fail and the franchise agreement must stand".

Although the court in the *Ellis* case noted that the applicant was only a small business person and the franchisor was a large international corporation, and the franchise agreement contained onerous terms for the franchisee, the court confirmed that such is the nature of the franchise relationship.

In the *Machias v. Mr. Submarine* case, however, the court found that the *Atlas Supply* case principles should be applied to declare the disclaimer clauses unenforceable on the basis of unconscionable behaviour. The court determined that the franchisor, if not having acted fraudulently, acted recklessly by creating "a grossly misleading picture of the financial viability of the franchise". Elements of fraudulent misrepresentation were present in the case, and as a result the court determined that the plaintiff's claim for misrepresentation must succeed whether the analysis derived from principles of unconscionability guided by community standards of honesty, reasonableness or fairness as discussed in the *Atlas Supply* case, or based on a separate tort of misrepresentation. In the case an inequality of bargaining position existed on the facts, and to enforce the exclusionary clauses in the agreement would therefore be unconscionable in light of the facts.

As can be seen from the above cases, unconscionability will be determined by the conduct of a franchisor. However, the wording of a franchise agreement may influence a court considering a claim of unconscionability, particularly when the court is influenced by the inequality of bargaining power between the parties as reflected in an agreement. It is therefore necessary for franchisors to appreciate that the manner in which they act, including the relevant provisions of a franchise agreement, may influence a court to determine that the conduct of a franchisor would be considered to be contrary to "community standards of honesty, reasonableness and fairness" and therefore result in a determination of unconscionability. A determination of unconscionability, in turn, will lead to a finding that the entire agreement and disclaimer provisions of the franchise agreement are ineffective.

(c) Fundamental Breach

The concept of fundamental breach has been raised in a number of franchise cases. A declaration of fundamental breach allows a franchisee to treat the agreement as null and void, thereby requiring a franchisor to make financial compensation to the franchisee to the extent that would be necessary to place the franchisee in the same position as the franchisee was in prior to entering into the arrangement.

Generally fundamental breach will not be allowed as a remedy by a court where there has been performance by a franchisor of the essential terms of the agreement. Where a franchisor does not perform the essential terms, fundamental breach may be available as a remedy.

An example of a recent case in which the concept of fundamental breach was pleaded by the franchisee but not allowed by the court is the case of *Chung v. LiteWay Subs & Deli Inc.*, [2001] O.J. 3746 (Ont. S.C.J.). In this case, the franchisee claimed against the franchisor for fraudulent misrepresentations made in connection with the acquisition of a franchise.

The franchisee further alleged that the franchisor changed its practice of selling low fat meats to meats with a higher fat content after a reliable supplier could not be obtained, and that this change represented a fundamental breach of the franchise agreement. The trial judge held that the move towards a higher fat food product was not a departure from the franchisor's low fat business concept. In order to constitute a fundamental breach of contract, according to the court, the "breach had to be of such a degree or such a nature as to make it unconscionable for the franchisee to be obliged to carry through with the bargain".

Once a franchisee has opened a franchised business, and has operated the business for a period of time, assuming that the franchisor has performed its obligations, it is highly unlikely that fundamental breach could be successfully claimed by the franchisee.

(d) **Earnings Projections**

According to a study conducted in 1999 by two leading franchise attorneys and a franchise consulting firm in the United States (*Effectively Structuring Earnings Disclosures: What to Disclose, And how to Disclose it Without Creating Additional Liability for the Franchisor,* by Charles Modell, Gary Davidson and Jeff Kolton, May 24, 1999 IFA Legal Symposium), approximately 20% of all US franchisors are estimated to provide prospective franchisees with earnings claims as part of their Uniform Franchise Offering Circulars. Unfortunately, there have not been any comparable studies conducted in the Provinces of Ontario or Alberta, the two provinces in Canada which require that disclosure be provided to prospective franchisees. Nonetheless, given the strong similarities in franchising trends between Canada and the United States, one can assume that roughly a similar percentage of franchisors in Canada offer their prospective franchisees some sort of earning claims or projections with their disclosure documents.

Earnings claims are used by franchisors to entice prospective franchisees to purchase their franchises. Franchisees are understandably eager to obtain as much information as possible regarding the franchise system under consideration to make a more informed decision and to better determine the likelihood of success. Franchisees will regularly arrive at their decisions in part by examining the earnings claims or projections made by franchisors, often without truly appreciating the possible pitfalls of basing their decision on historical or prospective financial data and results.

Franchisors, on the other hand, run the risk of being sued by their franchisees if the claims or projections do not accurately reflect the financial results of the franchisees or in the event that the earnings claims or projections were made negligently by the franchisors or without verification as to the basis for such claims or projections. It is because of this risk of litigation, that many franchisors typically include exculpatory language in their franchise agreements (and now disclosure documents) so that they can insulate themselves from any possible liability in this regard.

The benefit of including exculpatory language with earnings claims and projections in a franchise agreement has been seriously challenged, however, in light of a string of cases which have held that exclusionary clauses are not determinative in the context of franchise agreements: *Machias* v. *Mr. Submarine Ltd.*, [2002] O.J. No. 1261, *Zippy Print Enterprises Ltd.* v. *Pawliuk*,

[1994] B.C.J. No. 2778 (C.A.), *Atlas Supply Co. of Canada Ltd.* v. *Yarmounth Equipment Ltd. et. al.* (1991), 37 C.P.R. (3d) 38 (N.S.C.A.), *Perfect Portions Holding Co.*v. *New Futures Ltd.*, [1995] O.J. No. 2113 (Gen. Div.) and *Shelanu Inc.* v. *Print Three Franchising Corp*., [2000] O.J. No. 4129 (S.C.J.). In each of the foregoing cases, the Courts refused to apply the entire agreement, independent investigation or disclaimer clauses. Instead, the courts either upheld the franchisee's claim of misrepresentation on the part of the franchisor or refused to enforce the agreement on the grounds that to do so would be unconscionable, notwithstanding the presence of exculpatory language.

Nevertheless, while the courts have looked beyond the language of the franchise agreement to ensure that justice is served as between the franchisor and the franchisee, there certainly will be occasions where the exculpatory language will benefit the franchisor. Disclaimers and exculpatory language may well serve the franchisor who does not make an intentional oral misrepresentation, unlike the misrepresentations made by the franchisor in the *Zippy Print* decision, for example. In other words, there will be occasions when the earnings claims or projections are in fact made by the franchisor in good faith and with no intent to deceive, yet the figures may not be objectively accurate. In such circumstances, the inclusion of appropriate language into the franchise agreement may assist the franchisor in defending any claim of misrepresentation or preventing a finding of unconscionability.

Before identifying some of the associated issues surrounding earnings claims and projections, it is important to note the distinction in terminology used by the U.S. regulators at Item 19 of the UFOC Rules, which employs the term "earnings claim", versus the Ontario usage of the term "earnings projection" (Section 6(1)3 of the Regulations to the Act). (Interestingly, the Regulations to the *Alberta Franchises Act* refer to "earnings claims" at the heading of Section 16 but the body of the Section itself cites both "actual or potential sales" etc.) While the terms "claims" and "projections" are often used interchangeably by franchise lawyers and the franchise industry as a whole, one could argue that the term "earnings claims" refers to past, historical and actual financial performance by franchisees, unlike the term "earnings projections" which seemingly points to the potential and future sales volumes of a prospective franchisee. If one can make such a distinction between the terminology, Section 6(1)3 of the Regulations to the Act, for example, would not apply to any earnings claims that solely refer to the past historical financial results. The need to comply with the Regulations by setting out the underlying assumptions and the basis for the results would not necessarily apply in that case and accordingly, the disclaimer language should be tailored in both the disclosure document and the franchise agreement to reflect this distinction.

In addition, disclaimer language would seem even more appropriate and necessary for inclusion into a franchise agreement where the franchisor provides earnings projections rather than simply making earnings claims, as claims based on historical system-wide sales are more easily verifiable than projections of future performance. There are several possible variables that might affect the earnings projections to be provided to prospective franchisees (such as management, location, advertising and promotional activities, local economic conditions, area demographic factors, store type and size etc.), unlike earnings claims which simply summarize the accumulated historical data of the franchisor. Notwithstanding the foregoing, it is good practice to insert exculpatory language in the franchise agreement and disclosure document whenever

earnings claims or projections are made so as to highlight the potential usefulness of the information to the franchisee.

The following considerations apply:

- If earnings claims or projections are provided by the franchisor to the prospective franchisee in the disclosure document, does the exculpatory or disclaimer provisions set out in the franchise agreement make reference to the fact that such claims or projections were in fact made in the disclosure document?

- Is there an exclusion of express or implied warranties regarding the potential for profits or success?

- Is the section providing the earnings claims or projections identified clearly as the only authorized analysis provided by the franchisor in this regard?

Recommendations

(e) **Franchisee Acknowledgements**

The above discussion has particular application to earnings claims. One manner in which a franchisor may minimize a finding of unconscionability is to ensure that a franchisee has been afforded a proper opportunity to obtain legal advice and has in fact done so. Franchise agreements should contain disclaimer provisions from franchisees which include the following items:

- The franchisee has had ample time to read the agreement.

- The franchisee acknowledges to have had an adequate opportunity to be advised by advisors of the franchisee's own choosing including a lawyer and a financial advisor regarding all pertinent aspects of the franchised business and the franchisor.

- The franchisee has received such advice prior to executing the agreement.

In order to support these acknowledgements, a franchisor should require that a franchisee deliver a certificate of independent legal advice (which may be executed by the franchisee or by the franchisee's legal counsel).

It is equally necessary that a franchisee execute an entire agreement clause to minimize the likelihood of successful claims for misrepresentation. However, in appropriate circumstances a franchisee may be successful in pursuing a claim for negligent or fraudulent misrepresentation, which will usually negate a typical entire agreement provision.

A well drafted entire agreement clause will contain the following acknowledgements:

- The agreement and any document incorporated by reference therein constitute the entire agreement between the parties pertaining to the subject matter of the franchise and

supersede all prior agreements, understandings, negotiations and discussions with respect to the subject matter of the agreement, whether oral or written.

- There are no conditions, representations, warranties, undertakings, promises, inducements or agreements, whether direct, indirect, collateral, express or implied, made by the franchisor to the franchisee, except as provided for in the agreement.

- No supplement, modification, amendment or waiver of the agreement shall be binding unless executed in writing by both parties.

- No field representative of the franchisor has the right or authority to make any oral or written amendment or modification to the agreement.

In addition to an entire agreement provision and a franchisee review of agreement provision, it is extremely important for a well-drafted agreement to contain acknowledgements from the franchisee with respect to the franchisee's investigation of the business opportunity. These acknowledgements would include the following:

- The franchisee has conducted an independent investigation of the operations of the franchise and the franchisor.

- The franchisee recognizes that the business venture contemplated by the franchise agreement involves business risks and that the franchisee's success will be largely dependent upon the business ability of the franchisee.

- The franchisee acknowledges that the franchisee has not received any warranty, condition, representation or guarantee, express, implied or collateral, as to the potential volume, profits or success of the franchisee's operation as a franchise [except as set out in the disclosure document].

Despite all of the disclaimers, acknowledgements of independent investigation, entire agreement provisions and the like, the fundamental overriding consideration to the effectiveness of all of these provisions will be the conduct of the franchisor in respect of pre-sale disclosure, pre-sale representations and post-sale conduct, as well as negligent and fraudulent misrepresentations.

(f) **Relationship Clauses**

It is possible for a court in certain circumstances to attempt to redefine the independent nature of the franchise relationship by dealing with concepts of fiduciary duty and trust. It is therefore important that a franchise agreement contain a well drafted relationship provision confirming the nature of the relationship and negating other types of relationships. Despite the finding in *Jirna Ltd. v. Mr. Donut of Canada Ltd.* [1975] 1 S.C.R. 2 (S.C.C.) that the franchise relationship is not one of a fiduciary nature, attempts have been made in recent years in significant cases to convince a court that certain aspects of the franchise relationship may be of a fiduciary nature including, in particular, issues pertaining to advertising funds, product sourcing and product pricing. Therefore, a modern form of relationship clause will contain the following aspects:

- The parties are independent contractors.

- The franchisee will not represent himself or herself to be agent, joint venturer, partner or employee of the franchisor or related to the franchisor other than as its independent franchisee.

- The franchisee will not make any representations or take any acts which could establish any apparent or actual fiduciary relationship or any relationship of agency, trust, joint venture, partnership or employment.

- The franchisee will not establish any bank account, make any purchase, apply for any loan or credit or incur or permit any obligation to be incurred in the name or in the credit of the franchisor.

No acts of assistance given by the franchisor to the franchisee shall be construed so as to alter the relationship of independent contractors.

(g) **Earnings Claim Disclaimers**

Typically, the earnings disclaimer will confirm that there are no statements or representations pertaining to the subject matter of the franchise agreement except as set out in the franchise agreement. If earnings claims or projections are made in the disclosure document, however, such a statement in the franchise agreement would be inaccurate and would therefore require amendment. Specifically, reference should be made in any such disclaimer provision to any statements or representations set out in the disclosure document or in any other document.

- Sales staff, personnel, employees and officers should be instructed that they are not permitted to make claims or statements as to earnings, sales, prospects or chances of success, nor that they are not authorized to represent or estimate dollar figures as to any particular franchise. A provision in the franchise agreement to that effect would help to convey this information to the prospective franchisee.

- The disclaimer language in the franchise agreement should highlight to prospective franchisees that no other disclosure from any other source should be accepted or relied upon by the franchisees, other than what is already contained in the franchise agreement and the disclosure document.

- Prospective franchisees should be obligated by the franchise agreement to immediately report any claims or projections that are unauthorized and that have been provided to it in addition to what franchisor has disclosed to franchisee in the franchise agreement or disclosure document.

- Even where claims or projections are provided to the franchisee, the franchise agreement should stipulate that no specific earnings claims, projections or predictions are made with respect to the franchise being offered and that the franchisee should not rely upon the claims or projections as “results may vary”. Instead, prospective franchisees should be

encouraged to conduct an independent investigation as to whether to purchase the subject franchise.

- Prospective franchisees should be warned in the franchise agreement that any projections or cashflow pro-formas are merely projections/forecasts of the sales, cost of sales, operating expenses, and cashflow before debt service and are not based on actual performance. Alternatively, if they are in fact based on actual performance, the franchisor should clearly identify the reasonable basis for the projections in the disclosure document.

- Franchisors should inform prospective franchisees orally, in the franchise agreement and the disclosure document that the cashflow figures may fluctuate dramatically depending on several factors, including, without limitation, the management, aptitude, expertise and time spent, the store type and size, the location, access, visibility of the store, the advertising and promotional activities of the franchisee, the cost of advertising, the local economic factors and area demographic factors.

- Franchisors should identify the location where information is available for inspection by the prospective franchisees that substantiate the earnings projections (Section 6 (1) 3. of the Regulations to the Act). Franchisors presumably may "substantiate" the projections by providing the reasonable basis for the projections and the assumptions underlying the projections in accordance with Section 6 (1) 3. of the Regulations.

It is also prudent to have the prospective franchisee acknowledge some or all of the following assumptions in the franchise agreement when a franchisor provides earning claims or projections:

- That the gross sales figures provided in the earnings projections are before or after tax, as the case may be, and that they refer to franchise sales *targets* and are not indicative of any year's sales projections.

- That the costs are calculated as a percentage of gross sales and are based on the franchisor's suggested retail prices, that the cost percentage may fluctuate as a result of external variables beyond the control of the franchisor and that the cost percentage is based on the weighted-average cost of all items.

- That store hours differ by location and will inevitably impact the franchisee's gross sales. Prospective franchisees should also acknowledge in their franchise agreements that the wages and benefits (i.e., vacation pay, Canada pension plan, employment insurance, workers safety insurance board) paid by them will also have an impact on the total operating expenses of the franchisees.

- That many different variables go into determining the rent to be payable by the franchisee, including, location (urban, rural, food court), square footage, state of the economy, and surrounding tenants.

- That the utilities may include gas, electricity and water, that the projections assume a certain constant monthly rate of [stated amount] dollars and that the cost of utilities will fluctuate according to geography, the locations' square footage and the franchisee's usage.

- That it is the franchisee's responsibility to maintain all accurate books and records, that federal and provincial income tax returns and financial statements will be required to be prepared by a qualified professional and that, as such, accounting and bookkeeping fees will vary according to the franchisee's participation and skills in such matters.

10. ALTERNATE DISPUTE RESOLUTION AND CLASS ACTIONS

Issues

Franchisee actions have become more complex, highly publicized and protracted in recent years. Further, several actions have recently been certified as the appropriate subject matter of a class proceeding under the *Class Proceedings Act*, 1992, S.O. 1992 C.6. For example, in the case of *Rosedale Motors v. Petro Canada Inc.*, (2001) O.J. No. 5368, (Ont. S.C.J.), the court stated that the law with respect to class proceedings, in light of recent pronouncements by the Supreme Court of Canada, has evolved since the original decision of the motions judge and that the class action should be certified. More recently, in the case of *1176560 Ontario Limited et al v. The Great Atlantic & Pacific Company of Canada Limited*, Court File No. 02-CV-2277 CP, the Ontario Superior Court of Justice, in a decision dated December 9, 2002, certified as a class proceeding an action commenced by certain franchisees of Food Basics, a discount grocery chain operated by the defendant, A&P. While the certification decision is under appeal, nevertheless it appears to be a virtual certainty that franchisee class proceedings will be on the increase in the future.

For these reasons, not to mention reasons of efficiency, costs, management time and other relevant considerations, franchisors should be considering whether it might be more beneficial for them to utilize other alternate dispute resolution methods.

Typical alternate dispute resolution methods include the following:

- Communications between the parties.

- Advisory councils or franchise associations.

- Mediation.

- Arbitration.

There are obviously a number of means of dealing with each of these types of alternate dispute resolutions. However, the discussion below will outline more common provisions dealing with each of these types of alternate dispute resolution methods.

Recommendations

(a) **Communications Between the Parties**

Prior to the initiation of any formal means of alternate dispute resolution, it may be a useful technique for the parties to agree that disputes will be attempted to be resolved by direct communication between the franchisee and a high level executive officer of the franchisor. The representative chosen by the franchisor should be independent of direct involvement with the franchisee, like as a specific franchise relations officer. In some more developed franchise systems an independent ombudsman whose role is simply to deal with disputes and misunderstandings, will be utilized for this purpose.

(b) **Advisory Councils or Franchise Associations**

Where franchisors have established an advisory council or where an independent franchise association has been formed, and relations between the franchisor and the advisory council or the franchise association, as the case may be, have proven to be progressive and beneficial, the franchise agreement may provide for certain dispute matters to be referred to a panel consisting of representatives of the franchisor and the advisory council or the franchise association. The panel will hear the positions of the parties and make recommendations for resolution, although not binding upon the parties.

In another respect, where the franchise agreement reserves the right of the franchisor to make major changes to terms of the franchise agreement or to franchise or policies, as in the case of increased fees or changes to buyout formulas, the franchise agreement may provide a mechanism whereby the franchisor will engage in consultation with the advisory council or the franchise association prior to initiating such changes. While the franchisor will undertake to consult, the franchise agreement nevertheless should specifically state that the franchisor is not required to obtain the consent or approval of the advisory council or the franchise association in order for the franchisor to implement such changes or to invoke proposals or policies relating to the matter being considered in the course of consultation. The franchise agreement should specifically outline the items for which there will be a consultation process.

(c) **Mediation**

A mediation provision in a franchise agreement must cover the following elements:

- Matters accepted for mediation.
- Mediation is to proceed prior to the matter being brought before a court, other tribunal or arbitrator.
- Mechanics for appointing the mediator including reference to a mediation services organization.
- Special experience factors for the mediator.
- Place of mediation.

- Confidentiality.
- Costs and expenses of mediation.
- Inability to resolve the matter.
- Procedures for mediation.

(d) **Arbitration**

There are many variations for an arbitration provision in a franchise agreement. However, the following fundamental issues should be considered:

- Exceptions from arbitration.
- Methods for selecting arbitrator.
- Governing rules for arbitration.
- Special characteristics or experience of arbitrator.
- Costs of arbitration.
- Governing law of arbitration.
- Venue of arbitration.
- Binding effect and non-appealable decision.
- Confidentiality.
- Arbitration to be commenced on an individual and not-class basis.

(e) **Disputes Generally**

Finally, the following items should be considered in respect of disputes generally in order to protect the interests of a franchisor:

- Costs to be recovered on a solicitor and its own client basis.
- Waiver of jury trials.
- Waiver of consequential and punitive damages.
- Limitation period for commencing actions.

11. FORCE MAJEURE & TERRORISM

It has been over a year since the horrific events of September 11, 2001 and we are still feeling the political and economic impact of that dreadful day. The United States and its allies are threatening war against the Iraqi regime and Canada and many other countries throughout the World are fearful of a repeat terrorist attack. Legal counsel in general are encouraged to re-examine their boilerplate "force majeure" provision in light of the events of 9/11 so to ensure that they are adequately protecting their clients' interests. Franchise counsel in particular should do so as well, particularly as it may inadvertently provide the franchisee with an opportunity to escape from its contractual obligations.

Issues

- What are the triggering events that would constitute an event of force majeure that will excuse timely performance? Is a terrorist act an act of "War"?
- Who should bear the risk of loss during the period of non-performance, the franchisor or the franchisee?
- What are the implications, if any, for the type and amounts of insurance coverage obtained by the franchisor and the franchisee?
- What will the effect of the uncontrollable event be? Will it excuse the affected party from performing its obligations entirely, or more likely, will the affected party's performance be delayed for so long as the event continues? Alternatively, will the franchise agreement be terminable after a certain period of time?
- If there are alternative consequences (e.g., termination of the agreement without further liability versus delay), which party is entitled to choose the result?
- Does the affected party have an obligation to mitigate the affect of the event of force majeure so as to lessen the impact?
- Will the term of the agreement be extended for a period of time equal to the time lost due to the delay or will no extension of the term be permitted?

Recommendations

The parties to any agreement should evaluate the risks associated with the force majeure provision, as it is all a matter of risk allocation. This provision should be drafted with specific reference to the nature of the actions required under the particular contract. In the franchising scenario, therefore, franchisor counsel should specifically address the respective obligations of the franchisee and the franchisor when drafting the force majeure provisions in the franchise agreement. An event of force majeure could potentially excuse the franchisee's payment of royalties, advertising fees and other payments and the fulfillment of the franchisee's numerous non-financial obligations. On the other hand, a force majeure provision could provide the escape hatch for the franchisor's contractual obligation to construct and model the store, train and

support the franchisee and deliver uniforms, signs and other promotional material and product to the franchisee. Nevertheless, franchisees are the most likely beneficiaries of a poorly drafted force majeure clause as most of the obligations under a franchise agreement are to be performed by the franchisee.

A franchisor may therefore wish to include the following exceptions to the force majeure provision to ensure that the franchisee is not inadvertently released form its obligations under the franchise agreement:

- No release of the franchisee's obligation to fulfil its commitments under the franchise agreement should be permitted where the affected franchisee assumed or should have assumed the risk in the first place. For instance, the franchisee may have opted to source its own supplies pursuant to its option to do so under the franchise agreement and then an event occurs which makes it impossible for the franchisee to continue to source such product from its original source. In such event, the force majeure clause should prohibit the franchisee from relying upon the provision.

- Similarly, where the affected franchisee through its fault or negligence caused the event itself or, for example, it failed to use commercially reasonable efforts to avoid or remove the cause of non-performance or delay, the franchisee should not be permitted to avail itself of the force majeure provision.

- Where the franchisee cannot perform its obligations under the franchise agreement due to a lack of funds, it should not be permitted to rely upon the force majeure provision as an excuse for non-performance.

Where the franchisor finds it in its best interests to rely upon a force majeure provision, the word "terrorism" should be included in the clause as there is now an increased risk that terrorism would be considered a foreseeable event (given the heightened risk of a terrorist attack) and therefore non-excusable unless specifically included in the force majeure provision. An act of terror may not arguably meet the definition of "War" and, as such, it should be added as another event of force majeure.

Consider not even including a force majeure clause altogether by simply buttressing the "events of default", "representations and warranties" and "condition precedent" provisions of your franchise agreements. In other words, the events that would specifically excuse performance could be identified and then inserted in the main body of the franchise agreement, without resorting to the presence of a force majeure provision. If you insist on including a force majeure clause, spell out the nature and scope of the factors that will excuse timely performance as indicated above.

If delays are permissible, the provision should stipulate that a delay beyond a specified period would nonetheless result in termination of the agreement, either automatically or at the option of the franchisor.

The following additional points are relevant:

- Consider the Supreme Court of Canada's decision of *Atlantic Paper Stock Ltd. et al. v. St. Anne-Nackawic Pulp & Paper Co. Ltd.* (1975), 56 D.L.R. (3d) 409 (S.C.C.) as it exemplifies the courts' general proclivity to narrowly read the force majeure provision, particularly when the clause utilizes archaic boilerplate language.

- Identify any additional insurance coverage requirements that may be necessary to address the consequences of a narrowly drafted force majeure provision.

- As an aside, consider including a statement in the disclosure document warning of the possible adverse impact that 9/11 and the events since then may have had and may have on your clients' businesses. (Almost all SEC filings in the United States have done so). Furthermore, franchisors should also ensure that force majeure provisions are inserted in their agreements with their major suppliers and customers.

12. FRANCHISE ASSOCIATIONS AND ADVISORY COUNCILS

Issues

Section 4 of the Act deals with the ability of franchisees to associate. Subsection 4(2) provides that a franchisor shall not interfere with, prohibit or restrict by contract or otherwise, a franchisee from forming or joining an organization of franchisees or from associating with other franchisees. Further, pursuant to subsection 4(3), a franchisor shall not, directly or indirectly, penalize or attempt to penalize or threaten to penalize a franchisee for exercising any right under section 4 of the Act.

Pursuant to subsection 4(4), any provision in a franchise agreement or other agreement relating to a franchise which purports to interfere with, prohibit or restrict a franchisee from exercising any right under section 4 is void, and if a franchisor contravenes section 4, the franchisee has a right of action for damages.

It is important to not that section 4 of the Act is not mandatory. In other words, there is nothing contained in section 4 of the Act which requires a franchisor to acknowledge or deal with a franchise association. To the contrary, however, the section is restrictive in the sense that it prevents a franchisor from interfering with the right of franchisees to associate.

In some franchise systems, particularly more developed and mature systems, and systems with many franchisors, franchisors have developed means of communicating with and dealing with franchisees on a representative basis. In particular, franchisors may establish advisory councils, or may deal with independent franchise associations. The advantage of so doing is to allow participation by franchisees in the decision making process and to utilize the advisory council or franchise association to endorse those matters on behalf of the franchisor to all franchisees.

Recommendations

It is not generally recommended that a franchisor enshrine the right of an advisory council or a franchise association in its agreement in the sense that certain decisions must be approved by

either body in order for them to be effective. However, consultation with a franchise advisory council or association may be a useful means of communication and obtaining endorsement with either group prior to implementing new matters with the franchisees at large will be of significant benefit.

A provision in a franchise agreement requiring consultation with an advisory council may be included to provide franchisees with the comfort that certain items will be discussed with the advisory council on a consultative basis prior to their implementation. Such a provision should include or at least consider the following issues:

- Formation of advisory council.
- Structure of advisory council and appointment of members.
- Mandatory or voluntary participation by franchisee in franchise association.
- Ability of franchisor to discontinue advisory council.
- Terms of reference of advisory council (may be in manual)
- Consultation process with advisory council.
- Disclaimer with respect to consent or approval of advisory council in order for franchisor to implement changes or to invoke proposals or policies.
- Ensure that franchise agreement specifically refers to matters to be dealt with on the basis of consultation with advisory council.

13. **CONCLUSION**

The growth of franchising in Canada has been truly phenomenal. It is estimated that 40% of all retail sales revenue in Canada is represented by sales at or from franchised systems. Further, the development of franchise systems has become more complex, particularly with the advent of electronic commerce. In addition, with the maturation and saturation of established systems, franchisors are turning to alternate means to distribute their products and services, often resulting in methods previously unheard of and certainly not contemplated in existing franchise documents.

Disputes among franchisees and franchisors appear to be increasing, at least proportionate to the growth of franchising and the sale of franchises. When such actions are certified as class proceedings, the exposure to franchisors becomes extremely significant, not only in potential monetary damages, but in respect of costs, fees and utilization of management time.

Franchise lawyers need to be well versed in many aspects of commercial law in order to effectively advise franchisors and to draft franchise documentation for their clients. This paper has touched only on some of the more critical elements of franchise agreement drafting in the early 21st Century. It does not include many other subjects which could rightfully be dealt with as well. It is fairly certain, however, that franchise law will continue to evolve as a sophisticated

and unique area of legal expertise, and franchise documents will require careful and continuing scrutiny, originality and revision in order to properly protect the interests and rights of both parties to the agreement.

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APPENDIX

1. INTERNET & ENCROACHMENT

- **Advertising**. Franchisee may advertise and promote the Franchised Business on the World Wide Web or any comparable electronic network of computers only as specified in the Operations Manuals.

- **Franchisor's Reservation of Rights**. Franchisee acknowledges that Franchise granted hereunder is non-exclusive and that Franchisor and its Affiliates retain the exclusive right, among others:

  (a) to use, and to license others to use, the Marks and System for the operation of < > franchises at any location other than in the Territory. Except as otherwise specifically provided in this Agreement, this Agreement shall not restrict Franchisor or its Affiliates, or grant any rights to Franchisee, with respect to the pursuit of any business concept other than < > franchises or the distribution of approved and recommended equipment and supplies to wholesalers or other distribution outlets (other than < > franchises), or by Internet commerce (e-commerce), mail order or otherwise, whether inside or outside the Territory.

  (b) to use the Marks and the System in connection with the provision of other services and products or in alternative channels of distribution, without regard to location;

  (c) to use and license the use of other proprietary marks or methods of doing business which are not the same as, or confusingly similar to, the Marks, whether in alternative channels of distribution or in the operation of a < > service, at any location (including within the Territory), which may be the same as, similar to or different from the < > franchises;

  (d) to any websites utilizing a domain name incorporating one or more of the words "< >" or "< >", and Franchisee shall not establish a website on the Internet using any domain name containing one or more of the words "< >.com", "< >.ca", "< >.net", "< >.org", "< >.bus", "< >.edu", "< >.tv", "< >.us", or any variation thereof. Franchisor retains the sole right to advertise on the Internet and create a website including the name < >, or any variation thereof. Franchisee acknowledges that Franchisor is the owner of all right, title and interest in and to such domain names as Franchisor shall designate in the Manual. Franchisor retains the right to pre-approve Franchisee's use of linking and framing between Franchisee's web pages and all other websites. Franchisee shall, within five (5) days, dismantle any frames and links between Franchisee's web pages and any other websites, if and as requested by Franchisor.

- **Modifications to the System.** Franchisor shall have the right to add to, and otherwise modify, the Manual from time to time to reflect changes in authorized Products and Services, business image or the operation of the < > Franchise; provided, however, no

such addition or modification shall alter Franchisee's fundamental status and rights under this Agreement. Some of the revisions to the Manual presently contemplated include changes with respect to …. **web and e-commerce-related advancements**.

- **Website Policy.** Franchisee acknowledges that Franchisor has issued a website usage policy in the form attached hereto as Schedule "< >" and that it agrees to comply with the said policy and any amendments made thereto by Franchisor from time to time. Without limiting the generality of the foregoing, Franchisee agrees as follows:

  (a) Franchisee shall not establish a website on the Internet using any domain name containing the words "< >" "< >", or related domain names.

  (b) Franchisee acknowledges that Franchisor is the owner of all right, title and interest in and to such domain names as Franchisor shall designate in the Manual.

  (c) Franchisor retains the right to pre-approve in writing Franchisee's use of linking and framing between Franchisee's web pages and all other websites.

  (d) Franchisee shall, within five (5) days, dismantle any frames and links between Franchisee's web pages and any other websites, if and as requested by Franchisor.

- **Acknowledgment re: Ownership.** Franchisee acknowledges as between Franchisor and Franchisee, Franchisor has the sole rights to, and interest in, all telephone numbers, directory listings, and web addresses used by Franchisee to promote the < > Franchise and/or associated with the Marks. Franchisee hereby irrevocably appoints Franchisor, with full power of substitution, as its true and lawful attorney-in-fact, which appointment is coupled with an interest, to execute such directions and authorizations as may be necessary or prudent to accomplish the foregoing.

- **Termination.** In addition, Franchisee shall upon termination immediately shut down any website operated by Franchisee to promote the < > Franchise and assign and transfer all web addresses used by Franchisee for the same purpose.

DRAFT NOTE: Assignment Schedule. Consider requiring that the franchisee execute an "Assignment of Telephone Numbers, Telephone Listings, and Internet Addresses Schedule" whereby the franchisee would assign to the franchisor those certain Internet Website Addresses ("URLs") associated with franchisor's trade-marks and used from time to time in connection with the operation of the franchised business in addition to the standard assignment of telephone numbers and regular, classified or other telephone directory listings.

2. EARNINGS PROJECTIONS

<u>WHERE NO "EARNINGS PROJECTIONS" ARE PROVIDED</u>:

EXAMPLE 1. Franchisee agrees and acknowledges that it has not been induced to enter into this Agreement in reliance upon, nor as a result of, any statements, representations, warranties, conditions, covenants, promises or inducements, whatsoever, whether oral or written, and

whether directly related to the contents hereof or collateral thereto, made by Franchisor, its officers, directors, agents, employees or contractors except as provided herein. Franchisee acknowledges that the Franchise has been granted in reliance upon the information supplied to Franchisor in Franchisee's application for a Franchise. Except as provided herein, Franchisee acknowledges and agrees that there are no warranties, representations, statements, promises or inducements, express or implied or collateral, whether oral or written, about this Agreement by Franchisor, or its officers, directors, shareholders, employees or agents, that are contrary to the terms of this Agreement or the documents referred to herein.

EXAMPLE 2. Franchisee acknowledges that Franchisee has conducted an independent investigation of the business contemplated by this Agreement, and recognizes that it involves business risks making the success of the venture largely dependent upon the business abilities of Franchisee. **Franchisor expressly disclaims the making of, and Franchisee acknowledges that Franchisee has not received or relied upon, any warranty, representation, statement, promise or inducement, express, implied or collateral, whether oral or written, as to the potential volume, profits or success of the business venture contemplated by this Agreement.**

WHERE "EARNINGS PROJECTIONS" HAVE BEEN PROVIDED:

EXAMPLE 3. Franchisee acknowledges that:

(a) the success of the business venture contemplated herein involves **substantial risks** and depends upon Franchisee's ability as an independent business person and its active participation in the daily affairs of the business, and

(b) no assurance or warranty, express or implied, has been given as to the potential success of such business venture or the earnings likely to be achieved, and

(c) no statement, representation or other act, event or communication, **except as set out in this Agreement, and in any disclosure document supplied to the Franchisee**, is binding on Franchisor in connection with the subject matter of this Agreement, and

(d) Franchisee acknowledges that Franchisee has conducted an independent investigation of the System and recognizes that the success of the business venture contemplated by this Agreement will be largely dependent upon the ability of Franchisee as an independent business person. **Franchisor expressly disclaims the making of, and Franchisee acknowledges that it has not received, any warranty or guarantee, expressed or implied, as to the potential volume, profits, or success of the business venture contemplated by this Agreement**.

3. FORCE MAJEURE

Example 1: In the event that any party hereto is delayed or hindered in the performance of any act required herein by reason of strike, lock-outs, labour troubles, inability to procure materials, failure of power, restrictive governmental laws or regulations, riots, insurrection, war or other

reasons of a like nature **not the fault of such party**, then performance of such act shall be excused for the period of the delay and the period for performance of any such act shall be extended for a period equivalent to the period of such delay, up to a maximum of three (3) months. The provisions of this section **shall not operate to excuse the Franchisee from the prompt payment of any fee or other payment** due OBA Article pursuant to the provisions of this Agreement.

Example 2: If the Franchisee is unable to operate due to damage or loss to the Franchisee's premises caused or created by a casualty, act of God, condemnation, or other condition over which the Franchisee has no control, **then the Franchisor, in its sole discretion, may elect to waive the Royalty Fee** for a period no greater than one hundred twenty (120) days commencing with the month in which the Franchisee gives the Franchisor notice of the damage or loss.

Example 3: No party (the "Affected Party") shall be in breach of any of its obligations under this Agreement where failure to perform or delay in performing any obligation is due, wholly or in part, directly or indirectly, to the occurrence of an act of God, act of public enemy, act of a governmental body or agency, foreign or domestic, sabotage, riot, fire, flood, typhoon, explosion or other catastrophe, epidemic or quarantine restriction, labour unrest or labour shortage, accident, freight embargo, delay occasioned by carriers or delay of a supplier of the Affected Party or because of any other similar event (a "Force Majeure Event"), **for the period of time occasioned by any such occurrence**, **so long as the event is beyond the reasonable control of, does not result from the fault of, and cannot be overcome by the exercise of reasonable due diligence by the Affected Party**, and provided that:

(a) **the Affected Party forthwith gives the other parties hereto written notice of the Force Majeure Event**, which notice shall include an estimate of the duration and the likely impact of the Force Majeure Event;

(b) **the suspension or delay of performance shall be of no greater scope and of no longer duration than in reasonably required by the Force Majeure Event**; and

the Affected Party will use its best efforts to correct, cure or overcome the Force Majeure Event.

Example 4:

Events of Force Majeure: "Force Majeure" will mean any cause which is beyond the reasonable control of the affected Party, provided such event is not due to the affected party's sole negligence and may include, but not be limited to:

causes such as flood, earthquake, storm, lightening, fire, epidemic, war, terrorism, explosion, riot, act of public enemy, act of civil or military authority, civil disturbance or disobedience;

(a) accidents, sabotage and vandalism;

(b) inability to obtain or curtailment of supplies _____ or of services;

(c) inability to obtain or curtailment of supplies of any materials or equipment; and

(d) restraint by court order, or the action or inaction of, or inability to obtain maintain or renew Regulatory Approvals from any Governmental Authority unless such inability was caused by the violation of the terms thereof by the Party holding the Regulatory Approval

provided that _____ shall be deemed to be events of Force Majeure; and provided further the lack of finances will not be considered an event or occurrence outside of a Party's control.

Effect of Force Majeure and Notice: If by reason of Force Majeure either Party to this Agreement is unable, wholly or partially, to perform or comply with its covenants and obligations hereunder, then the party so affected by Force Majeure shall be relieved of its obligations or liability and shall suffer no prejudice for failing to perform or comply during the continuance and to the extent of the inability so caused from and after the happening of the event of Force Majeure, provided that the Party invoking Force Majeure gives to the other Party prompt notice, written or oral (but if oral, promptly confirmed in writing) of such inability and reasonable full particulars of the cause thereof. If notice is not promptly given, then the Party suffering the Force Majeure shall only be relieved from such performance or compliance from and after the giving of such notice. The Party invoking Force Majeure shall use all reasonably efforts to remedy the situation and remove so far as possible and with reasonable dispatch, the cause of its inability to perform or comply, provided that settlement of strikes and other labour disputes shall be wholly within the discretion of the Party involved and such Party shall not be required to accede to demands of its opponents in any such strike or labour dispute. The Party invoking Force Majeure shall give prompt notice of the cessation of the event of Force Majeure. Nothing in this Section shall relieve a Party of its obligations to make payments of any amounts accruing due, due or owing by the Party invoking Force Majeure prior to the time of the occurrence of the Force Majeure.

Extension of Supply Period: The Supply Period shall be extended for twice the duration of any periods of Force Majeure from which a Party claims relief and during which the supply hereunder is wholly or partially interrupted as a result of the event of Force Majeure; provided that, except in the case of total or partial destruction of the Supplier's Facilities, the maximum allowable extension will be two (2) years; and provided further that the length of the term of this Agreement shall not exceed the length of the lease term during which Supplier's Facilities may be operated pursuant to the leases between the Supplier and each of _____ and _____.

Duration: If any single event of Force Majeure from which a Party claims relief lasts longer than 2 years, or if any multiple events of Force Majeure from which a Party claims relief result in a continuous period of Force Majeure which is longer than two (2) years, either Party may, except in the case of total or partial destruction of the Supplier's Facilities, terminate this Agreement.

4. INDEPENDENT PARTIES

The Franchisee is and will at all times remain an independent contractor and is not and shall not represent himself or herself to be the agent, joint venturer, partner or employee of the Franchisor, or to be related to the Franchisor other than as its independent franchisee. No representations will be made or acts taken by the Franchisor or the Franchisee which could establish any apparent or actual fiduciary relationship or any relationship of agency, trust, joint venture, partnership or employment, and the Franchisor shall not be bound in any manner whatsoever by any agreements, warranties, representations or undertakings made by the Franchisee to any other person nor with respect to any other action of the Franchisee. The Franchisee shall not establish any bank account, make any purchase, apply for any loan or credit, or incur or permit any obligation to be incurred in the name or on the credit of the Franchisor. No acts of assistance given by the Franchisor to the Franchisee shall be construed so as to alter this relationship.

5. ADVISORY COUNCIL

Formation of Advisory Council: In order to provide a forum to exchange ideas and information between the Franchisor and Tirekicker Franchisees, the Franchisor may establish an advisory council (the "Advisory Council"), the terms of reference of which shall be contained in the Manual. The Franchisor may, in its discretion, discontinue the Advisory Council on Notice to the Franchisee and to all other Tirekicker Franchisees. The Franchisee may be eligible to participate on the Advisory Council only if the Franchisee is not in default of any of the Franchisee's obligations contained in this Agreement, or in any other agreement entered into or made with the Franchisor or its Affiliates, whether relating to the Franchised Business or any other Tirekicker Franchise System business.

Consultation with the Advisory Council: Wherever in this Agreement it is provided that the Franchisor shall engage in Consultation with the Advisory Council, the Franchisor shall take the following steps:

(a) provide Notice to the Advisory Council outlining in a summary manner the matter to be reviewed and, if applicable, the Franchisor's proposal respecting such matter;

(b) convene a meeting of the Advisory Council as soon as reasonably practicable to discuss such matter and the Franchisor's proposal, if applicable;

(c) provide to the Advisory Council at or, if reasonably possible, within five (5) days prior to, the meeting, a summary of the relevant information available to the Franchisor with respect to the matter and the Franchisor's proposal, if applicable;

(d) engage in a consultative process at the meeting whereby the suggestions and views of the Advisory Council are made known to the Franchisor and taken into account by the Franchisor; and

(e) as soon as reasonably practicable following the meeting, provide Notice to the Advisory Council of the Franchisor's final decision regarding the matter.

It is hereby understood and acknowledged by the parties that Consultation with the Advisory Council does not, under any circumstances, require the Franchisor to obtain the consent or approval of the Advisory Council in order for the Franchisor to implement any changes to or to invoke any proposals or policies relating to any matter considered in the course of Consultation with the Advisory Council as provided for in this Agreement or in the Manual.

6. DISPUTE RESOLUTION BY THE PARTIES

The parties will attempt in good faith to resolve any dispute arising out of or relating to this Agreement through the Franchisor's voluntary dispute resolution program as the same shall be described in the Manual from time to time or otherwise communicated to the Franchisee. To initiate the process, the Franchisee shall deliver a written summary of the dispute to the Franchisor's Franchise Manager or such other person as may be designated from time to time by the Franchisor. The Franchise Manager or such other person shall determine the appropriate manner to resolve the dispute including working directly with the Franchisee; facilitating a meeting between the Franchisee and the Regional Sales Manager; or convening a meeting of representatives of the Franchisor and Tirekicker Franchisees to consider the dispute and propose a non-binding resolution. The use of the dispute resolution program and the discussions that arise are without prejudice to either party pursuing alternative legal remedies should, in the opinion of either party, efforts fail to resolve the dispute. The parties agree that all correspondence, discussions and settlement shall remain confidential and shall not be disclosed to any third party.

7. DISPUTE RESOLUTION: ARBITRATION AND LEGAL PROCEEDINGS

Disputes: Franchisor and Operator acknowledge that disputes or disagreements may arise during the term of this Agreement and any renewals thereto. Franchisor and Operator have elected to resolve such disputes or disagreements in a non-judicial alternative dispute resolution format ("ADR"). An ADR format minimizes the expense of dispute resolution and generally can be accomplished in a more expeditious and effective manner. By agreeing to an ADR format, both Operator and Franchisor are also waiving a number of rights, remedies and privileges which may arise in a judicial resolution format. In view, however, of the continuing relationship between Operator and Franchisor over the original and renewal terms of this Agreement, both Operator and Franchisor agree that an ADR format is the most economical, efficient and practical way to resolve disputes and disagreements.

Arbitration: Accordingly, except as otherwise provided in this Agreement, in the event of any dispute or disagreement between Franchisor and Operator with respect to any issue arising out of or relating to this Agreement, its breach, its interpretation or any other disagreement between Operator and Franchisor, such dispute or disagreement shall be resolved by arbitration. In the event of any dispute or disagreement, Operator and Franchisor both agree to submit the dispute to arbitration in accordance with the least expensive procedure of the American Arbitration Association ("AAA"), and the application for such arbitration shall be filed in the AAA's New York City office. Franchisor and Operator agree that the hearing(s) shall be held in the City of Toronto, Ontario before one Arbitrator. This paragraph shall not apply to any monetary defaults of Operator including its obligations to pay franchise and advertising fees to Franchisor, and Franchisor shall be free to utilize any right or remedy it may have at law or equity.

Limitation Period: It is agreed that any claim of the parties concerning the Franchise, the Franchised Business, this Agreement, or any related agreement will be barred unless an arbitration or an action for a claim that cannot be the subject of arbitration, is commenced within 1 year from the date on which Operator knew or should have known, in the exercise of reasonable diligence, of the facts giving rise to the claim.

Depositions: Franchisor and Operator agree that unless otherwise agreed to by the parties, prehearing discovery shall be limited to requests for, and the exchange of, documents relevant to the dispute and two (2) depositions per side, including expert and opinion witnesses. No deposition may exceed eight (8) hours without agreement of the parties or order of the arbitrator.

Motions: Parties shall have the right to file prehearing motions to dispose of some or all of the claims or to obtain rulings on the admissibility of evidence prior to an evidentiary hearing. Such motions shall be filed sufficiently in advance of the hearing date to permit the arbitrator to rule on the motion prior to the hearing date.

Damages and costs: It is agreed that as to any arbitrated matter between them, Franchisor and Operator shall equally share arbitration costs that are part of the arbitrator(s) award. Otherwise, each party shall bear its own legal fees, expert witness fees and other court or arbitration costs incurred in connection with any arbitration or other legal action between Franchisor and Operator. Punitive or exemplary damages or legal fees may not be awarded by the arbitrator(s), and any such award shall not be enforceable or enforced in any court. If the waiver of punitive or exemplary damages are in violation of the laws of the province where the Operator's System Restaurant is located, such claims may be awarded by the arbitrator(s), and any such award shall be enforceable or enforced in any court of appropriate jurisdiction. This Agreement shall be strictly construed in the arbitration hearing. In no event can the material provisions of this Agreement including, but not limited to the method of operation, Authorized Product line or monetary obligations specified in this Agreement, amendments to this Agreement or in the Manual be modified or changed by the arbitrator at the arbitration hearing.

Governing Law: Franchisor and Operator agree that all laws governing jurisdiction, choice of laws, conflict of laws, interpretations, arbitrations or any other issue relating to a dispute between the parties shall be governed by and construed in accordance with the laws of the Province of Ontario and laws of Canada applicable therein.

Survival: The terms of this article shall survive termination, expiration or cancellation of this Agreement.