Exit Strategies: Dealing with Franchise Reorganizations, Unforeseen Changes and Succession Planning

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Franchising, as with many other areas of commercial law, involves parties working together for a mutually-beneficial financial goal. The laws concerning franchising are often focused on the franchise parties coming together, rather than the conclusion of the parties' relationship. For example, the *Arthur Wishart Act (Franchise Disclosure), 2000* and other provincial franchise legislation largely deal with the parties entering into franchise agreements and the quality of the information that has to be provided in relation to that transaction. In contrast, there are a myriad of different ways in which franchisees exit franchise systems that are generally not discussed in legislation and are of secondary importance in jurisprudence due to the predominance of discussions of termination resulting from operational breaches of contract or misrepresentations. However, franchisee departures are an important subject to understand in respect of the operation of a successful franchise system. Although franchises are commonly operated by corporations, there are individuals behind these corporations who are often parties to the franchise agreements as principals, operators, or guarantors. These individuals have families, get older, have disagreements with each other, and have lives and experiences that necessarily impact on the operations and continuation of their franchises. As such, they may have to exit the franchise system, either by choice or by being compelled to so. Initially unforeseen circumstances or changes within a franchise may necessitate a restructuring or termination of the franchise relationship. Franchisors should ensure that their agreements

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have the necessary tools to plan for and deal with these departures. Further, franchisors should be aware of how courts approach contentious issues that arise out of these departures.

Although there are a significant number of ways by which a franchisee can exit a system, this paper focuses on five “exit strategies” – some voluntary, and some the product of the franchisee’s behavior, conduct or circumstances. The five are as follows:

- Criminal conduct;
- Succession planning/retirement;
- Franchisee incapacity;
- Franchisee divorce/separation; and
- Dissolution of franchisee corporations and partnerships.

The causes and consequences of these franchise relationship exits are wide-ranging but understanding how to legally address them is essential skill for franchise system operators.

A. Criminal Conduct

When addressing potential grounds for terminating a franchise agreement, it is important to consider the impact of franchisee behaviour on the reputation of the franchise system. Protecting the brand or system is an integral component of maintaining a strong and effective system. This is why franchisors take significant steps to ensure that their trade-marks are not being infringed or misused by franchisees or other parties. The appearance of the brand matters, as consumers do not distinguish between franchisees or between franchisor and franchisee. Instead, consumers see them as one brand, a single entity, and therefore the actions of one impact the success of others. This concept was succinctly stated by Justice Tingley in the *Bertico Inc. v. Dunkin’ Brands Canada Ltd*. decision: “A successful brand is crucial to the maintenance of healthy franchises. However, when the brand falls out of bed, collapses, so too do those who rely upon it."[2]

The importance of protecting a brand's reputation is arguably most pronounced when a franchisor is dealing with a franchisee who has been charged and/or convicted of criminal conduct. The last thing a franchisor wants is for its brand to be associated with the criminal acts of a franchisee. As such, franchise agreements often contain protections that permit franchisors to terminate the franchise agreement as a result of this criminal (or in some instances, allegedly criminal) conduct. These protections can take a variety of forms. First, many franchise agreement contain express provisions that set out a right to terminate if the franchisee is convicted of a criminal offence. These provisions are often drafted broadly and do not limit the termination to certain types of criminal offences. Second, many franchise agreements contain broad rights to terminate the franchise agreement if the franchisee commits acts that impair the goodwill of the franchisee, the franchisor, or the franchise systems. These are generally wide-reaching catch-all provisions that franchisors often attempt to rely on for the purposes of terminations, and are based on the conceptual presumption that a franchisee's criminal conviction would indeed impair goodwill. These provisions frequently give rise to a controversy as to the connection between the franchisor conduct and the business, whether the conduct actually injures the franchisor, and the evidentiary standard to be met. Lastly, franchisors will often rely on provisions which positively dictate the franchisee's obligation to abide by the law. This is generally called an "obey all laws" provision, and can be a broad, effective tool to provide an exit strategy in respect of a franchisee whose conduct is impugned.

In respect of the specific category of termination right upon conviction for a criminal offence, such provisions are usually not curable by the franchisee and are grounds for immediate termination without notice. Including an opportunity to cure may be fundamentally

[2] *Bertico inc. c. Dunkin' Brands Canada Ltd.*, 2012 QCCS 2809 (CanLII), at para. 57.

impractical, as there is nothing that can be done to cure the default (conviction) once it occurs. Moreover, franchisors likely do not want to provide a potential cure period during which there is a franchisee who has committed a criminal offence continuing to operate the franchise.

In the case of criminal charges without conviction, franchisors are often in a difficult position. Criminal charges laid by police against a franchisee may result in significant adverse publicity, but given the possibility of the franchisee being innocent of the charges, it may be difficult for a franchisor to terminate the franchise based on the charges alone. In this instance, a franchisor may attempt to rely on the broader "goodwill impairment" termination provision instead of the narrower "criminal conviction" termination provision. However, a franchisee could potentially seek injunctive relief to prevent such a termination in those circumstances, citing the harm that could arise out of the termination.

A criminal charge may inadvertently cause other breaches of the franchise agreement. If the franchisee is jailed as a result of an arrest and is unable to operate the franchise location or business, there is the possibility of either an abandonment of the franchise or the breach of a contractual obligation to devote full time and effort to the business. Depending on the specific terms of the franchise agreement, this could also lead to termination.

There is extremely limited Canadian case law in respect of the termination of franchise agreements due to a franchisee's criminal conviction. American jurisprudence suggests that there is a presumption that criminal convictions will harm the franchisor's goodwill and, as such, the general validity of criminal conviction termination provisions has been upheld.[3] This line of reasoning was adopted by the British Columbia Supreme Court in *Boston Pizza International Inc. v 395047 B.C. Ltd* (*"Boston Pizza"*), albeit in a slightly different context.[4] In *Boston Pizza*, the defendant franchisee and its principals were convicted of numerous GST tax offenses.

[3] *Palombi v. Getty Oil Co*., 501 F. Supp. 158 (U.S. Dist. Ct. E.D. Penn. 1980) ("*Palombi*")
[4] *Boston Pizza International Inc. v. 395047 B.C. Ltd*, 2008 BCSC 1016 ("*Boston Pizza*").

Following the sentencing of the defendants, which consisted of substantial fines, the franchisor, Boston Pizza, advised the defendants that it would not permit the renewal of the parties' franchise agreement upon its expiration. The defendants contested the non-renewal, and Boston Pizza brought an application for a declaration that the franchise agreement was at an end.

The renewal provision in the franchise agreement permitted Boston Pizza to deny a renewal if the franchisee was "convicted of a crime which substantially impairs the goodwill associated with the Franchisor's trade mark, service mark, trade name, logo type, advertising or commercial symbol." Further, the franchisee was considered to be in default of the franchise agreement if it or the principals were convicted of any offence under any statute which, in the opinion of Boston Pizza, significantly detracted from the good reputation of Boston Pizza. The existence of a default was also grounds to deny renewal.

The decision in *Boston Pizza* examined whether Boston Pizza had good cause to refuse to renew the agreement given the convictions. The defendants attempted to introduce evidence from the community to establish that the franchise's reputation was not damaged. The evidence was rejected as hearsay. Justice Butler held that the question of impairment of goodwill is not a subjective inquiry but an objective one:

> [T]he proper approach to determining whether there has been a substantial impairment of goodwill is for the court to consider the issue on an objective basis. This means that I must consider the nature of the offence, its relationship to the franchisor's business and goodwill, policy concerns, and any other relevant factors brought to the attention of the court.[5]

As such, not only was no proof required to establish evidence of reputational damage, evidence to the contrary was excluded. This approach differs from some recent American jurisprudence, such as *International House of Pancakes, LLC v. Parsippany Pancake House*

[5] *Boston Pizza* at para 28.

Inc. (Parsippany 1),[6] a case that involved the termination of a franchisee due to the principal's conviction for endangering the welfare of a child. The sentence resulted in the principal being incarcerated for a minimum of three years and having to register as a sex offender. In that case, the franchise agreement contained a provision which permitted termination in the event the principal was convicted of a felony or any other criminal misconduct "which is relevant to the operation of the franchise." Despite the termination, the franchisee kept operating and the franchisor, IHOP, sought an injunction to prevent the franchisee from continuing to use its marks. The court declined to granted the injunction, finding, "On the record before the Court, there is nothing to suggest that the crime occurred at Pancake House, that IHOP received any adverse publicity, that Pancake House or other IHOPs have become less profitable as a result of the conviction, or any other direct factual nexus between Cregg's conviction and the business conducted pursuant to the franchise." However, in a subsequent motion for an injunction in this case, the court did find in IHOP's favour after it was found that sufficient statutory notice had been provided for a "just cause" termination under a state franchise statute, and that the absence of the principal due to his prison term connected the conduct sufficiently to be "relevant to the operation of the franchise." [7]

In contrast, the court in *Boston Pizza* had little difficulty in finding that the GST tax evasion offences impaired Boston Pizza's goodwill, holding that:

> There can be few more compelling justifications for terminating a Boston Pizza franchise than the conviction of an operator for GST tax evasion. When a franchisee is convicted of such offence, the suggestion of fraud necessarily taints the franchisor's reputation.

[6] *International House of Pancakes, LLC v. Parsippany Pancake House Inc*. (*Parsippany 1*), No. 12-3307, 2012 WL 2476407 (D. N.J., Jun. 27, 2012).

[7] *International House of Pancakes, LLC v. Parsippany Pancake House Inc* (Parsippany 2), No. 12-3307 2012 WL 4465517 (D. N.J. Sep. 23, 2012). The court commented: "*It is undisputed that once Cregg begins serving his prison term, he will be unable to actively participate in Pancake House's day-to-day operations, although he is obligated to do so under the terms of the Agreement. On these facts, the Court finds that IHOP has demonstrated that it is likely to prevail on its claim that Cregg's conviction "is relevant to the operation of the franchise" and that IHOP therefore had the right to terminate the Agreement...*"

> That such a charge amounts to good cause would seem to be indisputable.
> ...
> If a franchisee is convicted of a criminal offence which carries with it the taint of fraud and the offence is related to the operation of the business, a court will normally conclude that the franchisor's reputation and goodwill is significantly impaired or that it has been injured or prejudiced. This conclusion is reached by an objective consideration of the nature of the offence and the connection of the offence with the business operations of the franchisor.[8]

Accordingly, if the termination provision contains a requirement of good cause or reputational impairment, Canadian courts may take into consideration both the nature of the offence and whether the offence is at all tied into the franchise's operation. This leaves open the possibility that a minor offence that is inherently unconnected with the business may not be sufficient grounds to terminate the franchise.

As a result of *Boston Pizza*, franchisors can have some confidence that Canadian courts will be willing to apply termination for criminal conduct provisions without extreme scrutiny. However, such provisions have not been significantly examined in Canadian courts (and, notably, not in Ontario), so it remains to be seen how this area of contractual interpretation will develop. Given the significant financial consequences of termination, there is little doubt that this issue will emerge again.

The holding in the *Boston Pizza* decision is reflective of some American jurisprudence. For example, in *Dunkin' Donuts Inc. v. Martinez*,[9] the court addressed the termination of a donut shop franchise because the principals had failed to comply with federal income tax and employment laws. The franchise agreement contained an "obey all laws" provision as well as a general provision preventing the franchisee from committing acts that would be injurious or prejudicial to the franchisor's goodwill. The court held that the termination was justified, holding

[8] *Boston Pizza, supra*.
[9] *Dunkin Donuts Inc. v. Martinez*, 2003 WL 685875 (U.S. District Court, S.D. Florida) ("*Martinez*").

that the franchisee had committed a material breach of the franchise agreement. The court bluntly commented that:

> As a general proposition, a franchisee's violation of the law may justify termination of its franchise agreement on the principal that the "good faith belief of the franchisor that the franchisee is untrustworthy or engages in fraudulent practices undermines the entire franchise relationship."...Here, the Plaintiffs have contracted for the right to terminate Defendants when Defendants engage in unlawful activity which undermines the franchise relations.[10]

Martinez demonstrates that U.S. courts have broadly interpreted "obey all laws" provisions and have held that the failure to comply with federal or local law is a material breach warranting termination. Other examples of upheld terminations in this context included selling cigarettes to minors, drug smuggling, and tax fraud.

Helpfully for franchisors, the *Martinez* decision takes an aggressive approach to the interpretation of "obey all laws" provisions, stating that "even in the absence of an arrest, indictment or conviction, the franchisee's ongoing criminal activity, once known by the franchisor, is sufficiently potentially injurious and prejudicial to Plaintiffs' goodwill to justify termination."[11] In other words, the franchisor does not have to wait until the public becomes aware of the activity to terminate the franchise agreement. It is unclear whether Canadian courts would take a similar approach unless the franchisor is able to establish the allegedly illegal conduct to the evidentiary satisfaction of the court.

Other American cases have engaged in similar analysis of the issue. In *Palombi v. Getty Oil Co*., the court, in reviewing a termination resulting from the franchisee's conviction on price gouging offences, examined whether the offence was "related to the operation of the business" and whether it would "tend to defame the reputation" of the franchisor.[12] In *Everything Cycles Inc. v. Yamaha Motor Corporation, U.S.A., Inc*., the court addressed the validity of a motorcycle

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[10] *Martinez*, *supra*.

[11] *Dunkin' Donuts Inc. v. Martinez*, 92 A.F.T.R.2d 5671 (U.S. Dist. Ct. S.D. Fla. 2003

[12] *Palombi*, *supra*.

dealership termination due to the franchisee's conviction for offences concerning stolen motorcycles. The court held that the conviction (as well as a subsequent loss of business license) constituted good cause for termination, upholding a lower court decision that found "crimes of dishonestly involving [the dealer's] business, and his failure to comply with the agreed-upon and reasonable terms of the franchise agreement, justify termination. The court will not force [the franchisor] to continue its business relationship with [the dealer], whose convictions adversely affect [the franchisor's] reputation and violate the Sales and Service Agreements."[13]

It is notable that in at least one American case, *Dunkin Donuts v. Gav-Stra Donuts*,[14] the fact that one partner in a franchisee business committed an offence was sufficient to ground a termination of the franchise agreement despite the fact that the other innocent partners had taken active steps to report the offence to the franchisor. If the franchise is owned and/or operated by more than one individual, the legal misconduct of one may present a difficult scenario for the remaining franchise agreement parties. In such a case, the threat of a potential termination may lead to a buy-out scenario that preserves the interests of the innocent principals while motivating the offending principal to exit the system. However, the reputational damage inflicted by the offending principal may be so injurious to the franchise system that a termination of all franchisees, innocent or not, will be required.

The main takeaway from the American and Canadian jurisprudence on terminations for criminal conduct is that franchisor's must consider at least five different contextual factors in determining whether they have grounds to terminate:

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[13] *Everything Cycles, Inc. v. Yamaha Motor Corporation, U.S.A., Inc.*, 2008 W.L. 3523230 (U.S. Dist. Ct., D. Oregon).

[14] *Dunkin Donuts v. Gav-Stra Donuts, Inc*. 139 F.Supp.2d 147, 154 (D. Mass. 2001). See also Brigid Harrington, "*Termination for a Criminal Conviction: Cruel and Unusual Punishment?*" [Winter 2013] Franchise Lawyer.

1) The specific language of their franchise agreements and the type of provision(s) they have to address this conduct (as strict provisions may obviate the need for further analysis);

2) If there is a need to produce evidence of the misconduct;

3) Whether the offence is related to the operation of the franchise; and

4) The seriousness of the offence;

5) Whether the offence would detrimentally impact the franchise system's goodwill.

B. Succession Planning (Franchisee Death or Retirement)

By their very nature, franchise agreements generally contemplate long-term relationships between franchisors and franchisees. Having each contributed what are often significant investments in the business and shared confidential and proprietary information, both parties have a vital interest in ensuring security of tenure for the franchisee and in maintaining the uninterrupted and efficient operation of the franchisor's system.[15] While much of the focus during the negotiation of franchise agreements may be directed at term renewals and extension rights,[16] succession planning in the event of the franchisee's retirement or death is an essential, yet often overlooked,[17] component of any attempt to ensure stability and continuity within the franchise network. The following paragraphs provide an overview of the legal considerations that may arise and that should be addressed in the context of succession planning.

[15] See *Boston Pizza International Inc. v 395047 BC Ltd*, 2008 BCSC 1016 at para 16.

[16] For a comprehensive look at renewal rights, see Adam Ship, "Common Law Treatment Of Renewal Rights In Commercial Agreements: A Special Look At Franchises, Distributorships And The Duty Of Good Faith" [2013] Can Bus LJ 53; Adam Ship & Mohammed Sohail, "Franchise Renewals and Transfers in Canada's Common Law provinces", (2015) 35:2 Franchise LJ 237 [Ship & Sohail].

[17] For example, a 2011 PwC found that only 55% of Canadian auto dealers had succession plans in place. See PwC, "Automotive Trendsetter Report 2012: Paving the way to a smooth transition", online: <https://www.pwc.com/ca/en/automotive/publications/pwc-trendsetter-report-2012-04-en.pdf>.

Unlike some American states, Canadian common law provinces do not directly regulate transfer rights in franchising statutes.[18] As such, parties to franchise agreements are largely free to choose how to address succession issues bound only by basic principles of freedom to contract, the statutory duty of good faith and the common law of commercial contract assignment.[19] The effectiveness and level of sophistication of a franchise succession plan is context-sensitive, depending largely on the nature of the business, the ease with which franchisees may be replaced upon exit and the value of the parties' investment in the franchise. Where multiple individuals operate one franchise under a single agreement, franchisors may consider devising tailored succession plans for each co-franchisee. For example, in *Milligan v Gemini Mercury Sales Ltd* (1971),[20] the Ontario Supreme Court found it fair and reasonable that a succession plan provide for the winding-up of the franchise upon the death of a franchisee with particular skills essential to the operation of the business and for its continuance upon the death of his partner, who did not possess similar qualifications. In addition to factoring in the particularities of their businesses, franchisors should be mindful that the manner with which succession planning is addressed in their franchise agreements may be construed as a broad indicator of the nature of the franchisor-franchisee relationship. Indeed, courts have found that some succession planning provisions may serve as evidence that the parties envisioned and provided for long-term commitments, which may be taken into account in resolving issues

[18] Ship & Sohail, *supra*, at 240. For a comprehensive analysis of American law, see Phyllis Alden Truby & David A Beyer, "Fundamentals 201: Transfers and Assignments in Franchising" (Paper delivered at the 37th American Bar Association Annual Forum on Franchising, 15–17 October 2014) [Truby & Beyer].

[19] See *C Corp (Ontario) Ltd v Wesbru Holdings Ltd*, 91 AR 210 at 46; *TDL Group Ltd v 1060284 Ontario Ltd*, [2000] OJ No 1239 at 14–16; Ned Levitt & Frank Robinson, "Legal and Business Considerations Affecting Franchise Transfers and Renewals Paper" (November 2012) (Paper delivered at the 12th Annual Franchise Law Conference, 6 November 2012) at 5 [Levit & Robinson].

[20] *Milligan v Gemini Mercury Sales Ltd*, [1977] O.J. No. 161.

unrelated to succession planning such as assessing the reasonability of the period of time allowed to investigate and cure defaults.[21]

The most restrictive of franchise agreements allow little leeway for succession planning and simply provide for termination upon the franchisee's exit from the business. Franchisors wishing to preclude franchisees from transferring their businesses to successors should insist on including explicit and absolute language to this effect, or alternatively, language which triggers the franchisor's right of first refusal to sales to third parties. In some circumstances, default provisions may also achieve results similar to termination, for example when a franchise is left without a full-time trained manager upon the franchisee's retirement or death. As a general rule, Canadian courts defer to, and enforce, clear and unambiguous restrictions to franchise transfers.[22] In any case, franchisors should be wary of relying on formulaic provisions to the effect that a franchise agreement is personal in nature and granted based on the franchisee's particular characteristics, which have been given little weight by courts in determining whether a franchise may be transferred or not, albeit in contexts unrelated to succession matters.[23]

Franchisors open to transfers may adopt either a reactive or a proactive approach to succession planning. A reactive approach consists of allowing for the transfer of the franchise to a successor identified and approved by the franchisor following the franchisee's exit from the business. Most often, this is done through provisions requiring that the franchise be transferred to a successor within a specified time period that can range from months to years, contingent on the franchisor's approval and waiver of its right of first refusal. This approach may subject the

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[21] *Valley Equipment Ltd v John Deere Ltd*, 223 NBR (2d) 264 at pp 21, 51.

[22] See Ship & Sohail, *supra* at 247–48; *Brio Beverages (BC) Inc v Koala Beverages Ltd*, 114 BCAC 247 [*Brio*].

[23] See *Ford Credit Canada Ltd v Welcome Ford Sales Ltd*, 2011 ABCA 158 [*Welcome Ford*], with respect to court-ordered transfers of franchise agreements pursuant to section 84.1(4) of the *Bankruptcy and Insolvency Act*.

franchisee's estate to considerable pressure to propose a suitable transferee rapidly. By contrast, a proactive approach calls for the vetting of a successor by the franchisor prior to the franchisee's exit, often accomplished through "succession addenda" annexed to the franchise agreement that designate a replacement franchisee. Seeing as this requires parties to go through the successor approval process even if the franchisee has no plans to actually transfer the business in the foreseeable future, the proactive approach may be administratively burdensome. However, advance planning does allow the franchisor and the franchisee to jointly address important issues upfront, such as confirming that the potential successor is effectively committed to taking on the business in the future and navigating competing interests between multiple potential successors such as family members and long-standing employees. Critically, this approach also gives the franchisor time to develop a relationship with the selected successor and to provide any required upfront training or assistance in anticipation of the franchisee's exit, thus paving the way for a smooth transition.[24]

Irrespective of whether a successor is identified before or after the franchisee's exit, franchisors will invariably want to retain a right to approve or veto any proposed successor to protect the best interests of the franchise and its network of franchisees.[25] The degree of discretion retained by the franchisor in making this decision should be expressly addressed in the franchise agreement and may range from absolute and unqualified discretion, to undertakings not to unreasonably withhold successor approval.[26] In the absence of contractual

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[24] Edward A Gramigna Jr & Kristen A Curtolo, "Planning for Franchisee Succession, Asset Protection" (2013) 16:4 ABA Forum on Franchising, online: <www.americanbar.org/publications/franchise_lawyer/2013/fall_2013/planning_for_franchisee_succession.html>.

[25] *1518628 Ontario Inc. v. Tutor Time Learning Centres*, [2006] OJ No 3011 at 25 [*Tutor Time*].

[26] Courts have gone so far as to enforce provisions allowing the franchisor to "arbitrarily" withhold consent to transfer the franchise agreement. See *Brio*, supra at 13. See also Truby & Beyer, *supra* at 30. Such terms may conceivable be challenged on the ground that they breach the duty of good faith prescribed by provincial statutes. See Ship & Sohail, *supra* at 242. For the law related to consent to assignment that may not be unreasonably withheld, see *Tradedge Inc. v Trio-Novo Group Inc.*, 2007 ONCA 562.

terms to this effect, the franchisor will simply be held to a standard of good faith and fair dealing, which requires that the franchisor give consideration to the interests of the franchisee in the exercise of its discretion.[27] Franchisors should consider disclosing a non-exhaustive list of factors it may take into consideration in approving successors, including financial stability, qualifications, reputation, familiarity with the franchise and commitment to devote full time and attention to the business. Other conditions precedent to successor approval should include the transferee's consent to the terms of the then-current form of franchise agreement, landlord approval to the transfer of all leases, and lender approval of all loan assignments.[28] Finally, it may be advisable for franchisors to establish a probation period during which the franchisor will evaluate the performance of the successor and reserve the right to terminate the franchise agreement in the event that reasonable requirements are not met.

With respect to disclosure, sub-section 6(18) of the General Regulation under the *Arthur Wishart Act* (the "**Act**")[29] requires franchisors to provide a description of all restrictions or conditions in the franchise agreement related to termination and transfers. While no case law exists on this topic, franchisors would be well-advised to disclose their practices with respect to succession to prospective franchisees.[30] In addition, adequate disclosure remains a critical issue once a franchise agreement is in place and its transfer to an approved successor is contemplated. Sub-section 5(7)(d) of the Act exempts certain parties from disclosure obligations, including when the transfer is effected by persons acting on behalf of the franchisee's estate, seeing as they may not have sufficient knowledge of the business to make

[27] Ship & Sohail, *supra* at 247. See *Shelanu Inc. v Print Three Franchising Corp*, 64 OR (3d) 533 at 69.

[28] Levit & Robinson, *supra* at 11, 15; Truby & Beyer, *supra* at 42. See also *2176693 Ontario Ltd v Cora Franchise Group Inc.*, 2015 ONCA 152.

[29] O Reg. 581/00, s 6(18) [*General Regulation*]

[30] A 2010 bill to amend the *Arthur Wishart Act* which died on the Order Paper specified that franchisors should disclose "what happens to the business in the event of prolonged illness or death of the prospective franchisee and whether succession is addressed clearly", signaling that succession planning is an area of concern in the franchise context. See Bill 102, *An Act to amend the Arthur Wishart Act (Franchise Disclosure), 2000*, 2nd Sess, 39th Leg, Ontario, 2010.

meaningful representations. Further, sub-section 5(8) of the Act provides that the franchisor's disclosure obligations are not triggered by the mere fact that it retains a right to approve or to veto the grant of a franchise. Still, even given the narrow interpretation given by courts to these sections of the Act,[31] franchisors would nevertheless be well advised to mitigate the risk of subsequent claims for rescissions from successors by providing full and complete disclosure, in addition to contractually requiring departing franchisees to communicate and deliver all relevant information and documentation.

C. Franchisee Incapacity

Franchise agreements should attempt to address contingencies that could affect the proper operation of the franchise. One such contingency is the potential incapacity of the franchisee, either mental or physical. This consideration is especially important if a franchise system consists of or contemplates aging franchisees and operators. In such cases, the contracts between the parties should address how the business can be transitioned to someone else.

A typical approach to dealing with this issue is that if the franchisee or the principal becomes incapacitated or is not able to devote full time and attention to the operation of the franchised business, heirs or representatives of the franchisee are permitted to transfer the rights in the franchise to a third party subject to the approval of the franchisor. This does not differ dramatically from the succession planning addressed above. In incapacity scenarios, a franchisor may retain the right to, at its option, purchase the franchise itself at a fair market value instead of the franchise being sold to a third party. Alternatively, the spouse or the adult children of the operator may be given the option of assuming control of the franchise, subject to the approval of the franchisor.

[31] *2189205 Ontario Inc v Springdale Pizza Depot Ltd*, 2011 ONCA 467 at 32.

A difficult issue that may arise in respect of an incapacity scenario is if the franchisee or operator does not personally believe that they are incapable of operating the franchise. To address that scenario, a franchisor may include language to retain the right to make a good faith determination as to whether the franchisee is capable of operating the business. Any exercise of this provision would likely have to be substantiated with sufficient evidence to convincingly establish incapacity, particularly given the stakes and the possibility of a bad faith exercise of this discretion.

There is a dearth of case law concerning franchisee incapacity. The only cases that broach the topic address capacity in respect of the enforceability of franchise-related documents (such as arbitration agreements) against franchisees who allege to be subject to the incapacity of unequal bargaining or the lack of legal representation. In-term incapacity in respect of how to address a transition of franchise agreement obligations is simply not addressed in the jurisprudence. In a bankruptcy and insolvency context, in *Great Atlantic & Pacific Co. of Canada Ltd. v. 1167970 Ontario Inc.*,[32] the court permitted a grocery franchisor (and debtor) to appoint an interim receiver with limited powers while the franchisee was incapacitated with illness.

It must be remembered that a consequence of franchisee incapacity may be the franchisee's inability to execute a settlement agreement and/or release with the franchisor, conduct the sale of the franchise, or adequately litigate any case that it brings or responds to in respect of the franchise. Franchisors and their counsel who have dealt with fundamentally incapable franchises in court can anecdotally speak to the difficulty in managing the litigation process and the inadequacy of the court process to address the issue. Franchisors may need to

[32] *Great Atlantic & Pacific Co. of Canada Ltd. v. 1167970 Ontario Inc.*, 2002 CanLII 12215 (ON SC), <http://canlii.ca/t/1cl13>

adjust their expectations of how a litigation process may proceed in the case of an incapable franchisee as compared with another typical franchisee.

D. Franchisee Divorce/Separation

The contractual rights embodied in franchise agreements are often the most valuable property possessed by franchisees.[33] As such, they have the potential to become the target of acrimonious litigation in the wake of the breakdown of franchisees' marital relationships. In the absence of a marriage contract, franchises – whether owned personally or through holding corporations – can be subject to equalization as part of the franchisee's net family property.[34] In some cases, franchisees may need or wish to sell their business to a third party, subject to the franchisor's right of first refusal, to liquidate the business in order to comply with equalization or spousal support obligations.[35] In circumstances where equalization payments do not adequately address the shifting of wealth between the franchisee and a spouse who is not a party to the franchise agreement but who has contributed significantly to the business, courts may hear claims of unjust enrichment and consider the creation of a constructive trust in favor of the non-party.[36] Such recourses are also available to unmarried spouses. Where a franchise is held by a holding corporation, this may lead to court orders requiring the transfer of shares or the issuance of new shares to non-franchisee spouses. In the face of the uncertainty occasioned by family law proceedings, franchisors should take steps to mitigate the risk of disruption associated with the breakdown of franchisees' spousal relationships and to protect the integrity of their franchise system.

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[33] *Welcome Ford*, *supra* at para 38.

[34] See e.g. *Bateman v Bateman*, 2013 BCSC 2026; *McInnes v McInnes*, [1992] No 5920/008669A Nanaimo Registry.

[35] See e.g. *1250264 Ontario Inc. v Pet Valu Canada Inc.*, 2011 ONSC 3871At 7–8; *IF v RJR*, 2015 BCSC 793.

[36] See *Mcclenahan v Clarke*, 2004 CanLII 25843 (ON SC) at 149–157.

Chief among franchisors' concerns is invariably the prospect of a court ordered transfer of all or part of the franchisees' interest in the business to a spouse who is not a party to the franchise agreement. To this end, provisions precluding the transfer of franchise agreements by court order are common. For clarity, "transfer" should be defined to capture any transfer of shares, or at the very least, any change of control of a corporate franchise.[37] While no case law specifically addresses the issue in the context of family law disputes, it is reasonable to expect that courts will, as a general rule, take note of explicit prohibitions against unilateral transfers included in franchise agreements in light of the judiciary's recognition of the importance of franchisee vetting and approval processes.[38] In many circumstances however, franchisors may wish to adopt less restrictively drafted transfer provisions that allow for court-ordered transfers where the spouse complies with the franchisor's usual requirements. This more flexible approach may be advantageous for the franchisor in the event that the incoming spouse is familiar with the business, qualified and an attractive candidate from a financial standpoint.

Spousal guarantees and spousal consents are mechanisms commonly used in the United States to mitigate the risks related to the marital status of franchisees.[39] Whereas spousal guarantees bind a franchisee's spouse to financial obligations under the franchise agreement, spousal consents set out non-financial commitments, such as agreements to exclude the franchise from marital property in the event of divorce. While these practices have not been the subject of much jurisprudence in Canada, the Ontario Superior Court

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[37] See Ship & Sohail, *supra* at 241; Levit & Robinson, *supra* at 13.

[38] *Tutor Tim*e, *supra* at 25. In *Welcome Ford*, *supra*, the Alberta Court of Appeal Court ordered the transfer of an automobile dealership pursuant to section 84.1(4) of the *Bankruptcy and Insolvency Act* despite the franchisor's opposition to the assignment. In its reasons, the Court found it appropriate to do so within the context of the subsection's purpose to "preserve the value of the estate as a whole". It remains to be seen if a court would come to a similar conclusion in light of the *Family Law Act*'s remedial purpose to "provide for the equitable resolution of economic disputes that arise when intimate relations between individuals who have been financial interdependent break down" (*M v H*, 31 OR (3d) 417).

[39] See Ronald A Giller, Lisa K Garner & Adam L Sheps, "Yours, Mine, Ours, and Theirs: The Role of Spousal Guaranties and Consents in the Franchise Relationship", (2013) 33:1 Franchise Law Journal 72.

acknowledged in *1518628 Ontario Inc. v Tutor Time Learning Centres* (2006) (which concerned an Ontarian location of an American franchise system) that the practice of obtaining spousal guarantees "can be considered as reasonably prudent for a franchisor".[40] Seeing as spousal consents and guarantees can be construed as a joint exercise of the freedom to contract of the non-franchisee spouse and of the franchisor (much in the same manner as marital contracts between married couples), it is reasonable to suggest that Canadian courts would afford a measure of deference to such agreements, particularly where the non-franchisee spouse has obtained independent legal advice.[41]

The bulk of Canadian family law jurisprudence involving franchises is concerned, to varying degrees, with the valuation of franchises in the context of establishing each spouse's net family property.[42] In most circumstances, the issue is settled on the basis of expert valuations adduced into evidence by the parties. While matrimonial proceedings involving franchisees may not generally be of direct interest to franchisors, they may nevertheless wish to have some input in judicial determinations that impact their franchise network's worth. This can be achieved through provisions of the franchise agreement that allow the franchisor to set the sales prices for franchises. Such provisions can have important implications with respect to the determination of franchises' fair market value for the purpose of equalization payments.[43] Additionally, franchisors may wish to seek intervenor status in divorce proceedings where valuation or other litigious points involve the interpretation of their franchise agreements.[44]

[40] See e.g. *Tutor Time*, *supra* at 41.

[41] On the issue of freedom to contract, marriage contracts and judicial deference, see generally *Miglin v Miglin*, 2003 SCC 24, [2003] 1 SCR 303; *Hartshorne v Hartshorne*, 2004 SCC 22, [2004] 1 SCR 550 at 40; *Desramaux v Desramaux*, 15 RFL (5th) 337 at 76.

[42] See e.g. *Lynk v Lynk*, 21 RFL (3d) 337; *Hill v Hill*, 2003 213 NSR (2d) 185; *CVD v ID and Swain*, 2005 MBQB 215 [Swain]; *Foulidis v Foulidis*, 2016 ONSC 4819.

[43] *Cooke v Cooke*, 2011 BCCA 44 at 14.

[44] *Nielsen v Nielsen*, 2014 MBQB 110.

E. Dissolution of Franchisee Corporations and Partnerships

The implosion of franchisee corporations and partnerships has reverberating effects on franchisors. Franchisees may wish to end their operations and dissolve for a variety of reasons, including a breakdown in the relationship between shareholders or partners. Alternatively, some franchisees may attempt to permit some or all shareholders or partners to exit the franchise business by effecting a change of control of the franchisee. Whereas the franchisee ceases to exist in the first scenario, it subsists in the second and remains a party to the franchise agreement. Franchisors looking to protect their interests should address both eventualities in their franchise agreements, in addition to securing personal guarantees from partners and majority shareholders and subjecting these individuals to non-compete covenants.[45]

The dissolution of the franchisee may simply be addressed by standard language providing for the termination of the franchise agreement. Termination may take effect upon prior written notice of the anticipated dissolution by the franchisee. Even if other provisions may obliquely achieve the same result (such as requirements that franchisees maintain possession of the franchise premises), franchisors should consider explicitly stating that the winding up of the franchisee without prior written notice constitutes a default under the franchise agreement and triggers its immediate termination. Upon receiving notice of the projected dissolution of a franchisee, franchisors wishing to prevent interruptions of the business may consent to its

[45] Courts will generally enforce restrictive covenants against non-signatories to the franchise agreement when these individuals, “with knowledge of or wilful blindness to the obligations in the restrictive covenant, engage in conduct in concert with the franchisee that breaches the terms of the covenant”. See Jennifer Dolman, Adam Ship, Rebecca Hall-McGuire and Tyler Wentzell, “Governing Principles & Recent Trends in the Enforcement of Restrictive Covenants in Franchise Agreements” (2014) 43 Adv Q 448 at 458.

transfer to an assignee proposed by the exiting franchisee or exercise a right of first refusal to buy back and operate the franchise themselves.[46]

In circumstances where a franchisee's dissolution causes the termination of the franchise agreement prior to its expiry, franchisors may be entitled to remedy in the form of damages and interlocutory injunctions. Cases considering early termination prompted by franchisees have generally followed the principle that the measure of damage should be the monetary loss of royalties sustained by the franchisor for the period of time that it would need to establish another franchise in the same territory.[47] Case law suggests that a period of 18 to 24 months is usually appropriate for franchisors to mitigate their losses.[48] However, one case determined that one year was sufficient where the franchisor would not face competition from its former franchisee in attempting to establish a new franchise in the same area.[49]

With respect to interlocutory injunctions restraining franchisees from breaching and terminating their franchise agreements prematurely, case law provides little guidance. In *Bark & Fitz Inc. v 2139138 Ontario Inc.* (2010),[50] Madam Justice Karakatsanis concluded that a franchisor had raised a serious issue to be tried for breach of contract by 17 of its 20 franchisees who had stopped paying their royalty dues. The Court noted that the franchisor could not survive financially pending trial, that a franchise system requires advertising and marketing, and that the franchisees intended to remove all signage and continue operation, subject to the outcome of the application. Concluding that this "would result in the demise of this

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[46] With respect to "buy back guarantees" in the context of franchise agreements and disclosure obligations, see e.g. *Ma v. Nutriview Systems Inc.*, 2014 BCSC 725.

[47] *Yazdi Integrated Health Group Ltd v Unihealth Management Ltd*, 2014 BCSC 22 at 15 [*Yazdi*]; *Damack Holdings Ltd v Saanich Peninsula Savings Credit Union*, (1982) 19 BLR 46 at 55 [*Damack*]; *2 for 1 Subs Ltd v Ventresca*, [2006] OJ No 1528 at 62 citing *Unilever PLC v Procter & Gamble Inc*, [1995] FCJ No. 1005 (FCA) [*2 for 1*].

[48] *A&W Food Services of Canada Ltd v Leslie*, (1989) 93 NSR (2d) 111 (18 months); *Pizza Delight Corp v White Rock Pizza Take-out Ltd* (1985), 9 CPR (3d) 282 (2 years); *Damack*, *supra* (2 years); *2 for 1*, *supra* (2 years).

[49] *Yazdi, supra* at 15 (1 year).

[50] *Bark & Fitz Inc v 213138 Ontario Inc*, 2010 ONSC 1793 [*Bark*].

franchise system”,[51] the Court found that the franchisor would suffer irreparable harm without an interlocutory injunction. The Court granted an interlocutory motion ordering the 17 franchisees not to terminate their contracts and to pay all advertising and royalty fees into counsel trust accounts.

With respect to protecting franchisors from any threat of change of control of the franchisee, prevention is the best remedy. In keeping with its purpose to protect franchisees,[52] the *Act* imposes obligations on franchisors to make adequate disclosure with respect to their corporate form, their business background and that of their directors, officers and general partners.[53] In light of the fact that franchisees have no reciprocal statutory disclosure obligations and that franchisors do not benefit from a right of rescission under the *Act*, franchisors should conduct a thorough due diligence exercise prior to entering into a franchise agreement and review all corporate documentation necessary to identify all persons exercising ownership and control of the franchisee.[54] Agreements subsequently entered into with vetted franchisees should set out requirements to maintain particular corporate structures that ultimately protect general partners and the voting rights of majority shareholders who have pledged personal guarantees in favour of the franchisor.[55] Such provisions must be the subject of adequate disclosure provided to prospective franchisees.[56] Where language purporting to subject corporate restructurings to franchisor approval is included in the franchise agreement but does

[51] *Bark*, supra at 33.

[52] *2176693 Ontario Ltd v Cora Franchise Group Inc*, 2015 ONCA 152 at 56; *Landsbridge Auto Corp v Midas Canada Inc*, 2010 ONCA 478 at 30.

[53] *General Regulation*, *supra*, s 2.

[54] When developing a due diligence checklist, the General Regulation under the Act may serve as a useful starting point, as adapted to be applicable to franchisee disclosure.

[55] Franchise agreement provisions with respect to franchisee corporate structure will generally include requirements to: cause the franchisee to limit its activities to the franchised business; cause the franchisee to restrict the transfer of shares or the issuance of new securities without prior consent of the franchisor; print legends on share certificates to the effect that these securities are subject to the terms of the franchise agreement. See *Canadian Franchise Guide* (Toronto: Carswell, 2015) (loose-leaf 2015 supplement), ch 3 at 9.

[56] *General Regulation*, *supra*, s 6(18).

not appear in a franchisee’s constating documents, termination of the franchise agreement for breach of contract may be the only available remedy and franchisors may not be able to prevent restructurings from proceeding.[57]

Conclusion

As addressed above, there are significant considerations for franchisors when dealing with an atypical exit of a franchisee from their system. Franchisors should carefully consider whether their franchise agreements can accommodate non-traditional departures, namely in-term exits for reasons unrelated to commonplace operational terminations. If not, they should amend their franchise document to ensure that they have the contractual flexibility required. Furthermore, in exercising their contractual rights regarding these exits, franchisors should ensure that they do so in a manner that reflects the agreement of the parties but is also reflective of their good faith obligations. Given the important stakes to franchisees (their livelihoods), courts will likely provide close scrutiny on franchisor conduct.

[57] *Gray v Gray*, 2004 MBQB 171 at 21–27.