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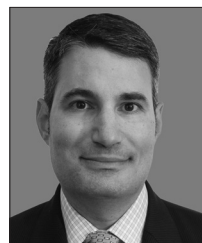
45th Forum on Franchising Annual Meeting: November 2–4, 2022

Ben Reed & Jason Adler

We are excited to invite you to the 45th Forum on Franchising Annual Meeting on November 2–4, 2022 at the Marriott Marquis San Diego Marina! It's been twelve years since the Forum held its annual event in San Diego, and five years since we've hosted the meeting in California, so we are looking forward to seeing you all in the Golden State this fall. The Annual Meeting is the Forum's premiere event, and this year we will again provide content that is both informative and timely to franchise practitioners, from experienced franchise counsel to attorneys new to the practice of law and to franchising. As always, we've strived to offer programming that appeals to both litigators and transactional attorneys. But we've also endeavored to include programs that have practical application for both litigation and transactional/regulatory practices.



Mr. Reed



Mr. Adler

Our meeting this year kicks off with three intensive programs on November 2. First, the essential program for those just starting out in or relatively new to franchising (or those who want a refresher): Fundamentals of Franchising. The full-day Fundamentals program provides a full overview of franchising and the broad range of legal issues that arise in it, along with a copy of the Forum's *Fundamentals of Franchising* publication. Our second intensive program is an in-depth overview of key issues that brands must consider and address when preparing to expand internationally—and we hope that many of our international members and associate members will be able to join us for this program. Attendees will have the opportunity to select two of the Forum's three international Fundamentals publications as part of their registration. Finally, our third intensive program will present best practices for managing franchise systems and relationships by using operational and brand standards compliance programs, an intensive designed to appeal to franchisor, franchisee, and in-house counsel who advise clients on developing, implementing, and complying with such programs. Attendees of this

intensive will receive a copy of the recently published *Franchise Law Compliance Manual, Third Edition*.

Our second day kicks off with the Forum's crown jewel event: Annual Developments. Our co-speakers this year, Dan Oates and Susan Tegt, will present a wide range of interesting and important case law and legal developments involving franchising from the past year—you will not want to miss the show!

The Annual Developments plenary leads into our twenty-five workshops that our selected speakers will present in concurrent sessions over the next two days. A highlight of our workshops is four programs that include government representatives who have graciously agreed to provide their perspectives on issues of import to franchise practitioners: (1) regulators' views on enforcement of state franchise laws, including input from regulators from California and Washington; (2) the 2022 NASAA statement of policy and other regulatory updates addressed by a panel of regulators and a seasoned practitioner; (3) financing and Small Business Administration loan issues, with a lawyer from the SBA on the panel; and (4) issues related to advertising, both to consumers and prospective franchisees, which includes the perspective of a Federal Trade Commission attorney on those issues. In addition to those programs, our other workshop topics include recent legal precedent impacting the evergreen topic of the enforceability and other aspects of agreements to arbitrate; litigating brand standards disputes; the use of experiential-based expert opinions in franchise disputes; taking and defending depositions in franchise cases; using the franchise disclosure document (FDD) as a sword and shield in litigation; issues related to the use of financial performance representations in 2022 and beyond; updating franchise agreements to account for changes in technology and the delivery of goods and services to customers, as well as dealing with anachronistic or legacy agreements; and issues to consider in franchising a foreign concept in the United States. Finally, we are offering exclusively for our corporate counsel attendees a workshop that has not been presented since 2014: a panel discussion of in-house counsel on hot topics and legal issues.

Inspired by the positive reception from the LADR lunch at the 2021 Annual Meeting, the Friday plenary session is our ethics program and will examine the legal and ethical issues that can arise when attorneys suffer from mental health and wellness issues derived from stress and substance abuse. One of our past chairs, Eric Karp, will moderate a panel that includes the head of the State Bar of California Lawyer Assistance Program, a former California State Bar prosecutor, and a former general counsel of one of San Diego's largest firms (and a specialist in defending legal malpractice claims).

In addition to all of this engaging programming, the Annual Meeting also offers ample opportunities for attendees to network and socialize with their colleagues in the franchise bar. The fun begins with our popular welcome reception on Wednesday night at the hotel. On Thursday night, we will take to the water, hosting the Forum's Annual Reception and Dinner aboard the

San Diego Bay Cruises Inspiration Hornblower mega yacht. The ship will be docked for the first two hours of the event and will take a brief cruise of the San Diego Bay to close out the evening. Our Friday night venue, the San Diego Wine and Culinary Arts Center, offers a relaxed atmosphere to try a variety of wines and sample the chef's creations while unwinding with old colleagues and new friends. As always, our Divisions and Caucuses are busy planning their own networking events—breakfasts and lunches for their members to reconnect and engage on topical interests. For those staying over Friday night, on Saturday morning you have the opportunity to take a guided tour of the USS *Midway* aircraft carrier, which is just a few blocks from the hotel.

It's anchors away for the Annual Meeting November 2–4, 2022, in sunny San Diego; we look forward to seeing you there!



From the Editor-in-Chief

John M. Doroghazi

We are now three months into 2022, and the war in Ukraine, for now, has replaced COVID-19 as the center of the world's collective attention. Coincidentally, one of the articles in this edition is "Franchising in Russia—A Primer," by Katya Logunov and Sergey Medvedev. The article, a comprehensive overview of franchising in Russia, was drafted before the Ukrainian conflict began and had final edits submitted only a few days after war broke out. I did not ask the authors to address the war, both for practical reasons (the publication cycle waits for no one) and to avoid creating any potential personal or professional headaches for them.¹



Mr. Doroghazi

It would be incongruous for an edition of the *Journal* containing an article about franchising in Russia to not address the elephant in the room in some way. It is beyond obvious that Russia's (i.e., Vladimir Putin's) aggression has created a significant geopolitical crisis,² inflicted immeasurable suffering on the Ukrainian people,³ and affected directly or indirectly every person on the planet.⁴ As it relates to franchising and the law, the Ukrainian war reinforces two simple, but important, truths.

1. Russia increased censorship since fighting broke out. Anton Troianovski, *Russia Takes Censorship to New Extremes, Stifling War Coverage*, N.Y. TIMES (Mar. 4, 2022), <https://www.nytimes.com/2022/03/04/world/europe/russia-censorship-media-crackdown.html>. As such, I have not asked either author to provide their opinion on the war in the article or even privately. I would not want to place them in a position of either having to misrepresent their true opinions for fear of reprisal or provide their honest opinions and face reprisal.

2. Mary Elise Sarotte, *I'm a Cold War Historian. We're in a Frightening New Era*, N.Y. TIMES (Mar. 1, 2022), <https://www.nytimes.com/2022/03/01/opinion/russia-ukraine-cold-war.html?msclkid=b867486aac3711eca2ca1545d89482df>.

3. Press Statement, Secretary of State Antony J. Blinken, War Crimes by Russia's Forces in Ukraine (Mar. 23, 2022), <https://www.state.gov/war-crimes-by-russias-forces-in-ukraine>.

4. Among other things, the war may spark a global famine due to Ukraine being one of the largest grain exporters in the world. Kaamil Ahmed, *UN Warns Russian Blockade of Ukraine's Grain Exports May Trigger Global Famine*, GUARDIAN (Mar. 18, 2022), <https://>

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First, even the best legal strategies and most expertly drafted contracts are meaningless in a business environment that lacks a stable and peaceful government. Following Mr. Putin's invasion, many Western brands chose to stop doing business in Russia—having made the calculation that asserting economic pressure on Mr. Putin through the Russian economy and gaining goodwill from non-Russian consumers outweighed the financial harm caused by ceasing operations (at least temporarily) in Russia. Indeed, McDonald's—the vanguard of Western business in Russia after the Iron Curtain fell and that used a corporate store model to expand there—shut down operations. This was not an inconsequential decision: McDonald's is foregoing \$50 million in revenue each month its restaurants remain shuttered in Russia.⁵ Moreover, the Putin-led government appears to have simply seized the closed restaurants and rebranded them as Uncle Vanya's using a logo that is almost identical to the familiar golden arches.⁶ McDonald's multi-decade strategy in Russia, which certainly relied on top-flight legal talent and tens of millions of dollars of investment, came to a screeching halt because of Mr. Putin's desire for control of the Ukraine. What is more, after the war ultimately ends, it is unclear whether the Putin-led government will ever let McDonald's reopen.

The second truth is that the consequences of the surrender of some control by the franchisor in the franchise relationship is very real (despite what many members of this Forum advocate and what some regulators believe). The Ukraine crisis highlights the extent to which this reality of the franchise model can have profound effects. Many blue-chip franchise brands have not ceased operations in Russia. But that decision is not because the brands are pro-Putin, pro-war, or inherently greedy. Rather, these brands used a franchise model to expand in Russia. Their independent Russian franchisees have chosen to continue operations, even when the franchisor has asked for operations to cease.⁷ Those franchisors are now faced with a lose-lose choice: either potentially breach hundreds of franchise agreements or

www.theguardian.com/global-development/2022/mar/18/un-warns-russian-blockade-of-ukraines-grain-exports-may-trigger-global-famine.

5. Amelia Lucas, *McDonald's Says Russian Shutdown Will Cost the Fast-Food Chain \$50 Million a Month*, CNBC (Mar. 9, 2022), <https://www.cnbc.com/2022/03/09/mcdonalds-russian-shut-down-will-cost-fast-food-chain-50-million-a-month.html>.

6. Andrew Jeong, *There's a McDonald's Replacement in Russia—with a Strangely Familiar Logo*, WASH. POST (Mar. 18, 2022), <https://www.washingtonpost.com/world/2022/03/18/uncle-vanya-russian-mcdonalds-replacement-logo/>.

7. Editorial Team, *Burger King, Subway, and Papa John's Franchises Stay Open in Russia*, FRANCHISEWIRE (Mar. 19, 2022), <https://www.franchisewire.com/burger-king-subway-and-papa-johns-franchises-stay-open-in-russia%ef%bf%bc>.

honor their contractual obligations and face significant negative publicity.⁸ The franchisees in Russia are, in effect, able to imperil the goodwill of these franchisors' brands throughout the world, and these franchisors have very little recourse.

These two truths are not necessarily new or the product of some profound insight by me, but the size of the Russian economy and the intense media focus on the invasion of Ukraine have brought them to the forefront. It will be interesting to see what lessons, if any, franchisors take from these events, and if franchisors expanding internationally in the future, especially in countries with less stable legal and political systems, will look to other business models than franchising.

Russia aside, this edition of the *Journal* is well-stocked. Leading the way is "The Desperate Consequences of Flunking the 'ABCs'" by former Chair of the Forum Rochelle "Shelley" Spandorf, in which Shelley provides a detailed discussion of the ramifications of the continued attacks on the ABC test to determine a worker's classifications and gives an update on recent case law developments in California.

Next up, Jennifer Dolman and Amanda Arella have put together an excellent and thorough article on the remedy of rescission under Canadian law with the aptly titled "An Overview of the Rescission Remedy in Canada." Because there can never be too much talk of Canada, Lorinda Ritts and David Kornhauser bring us "An explanation of the Canadian Statutory Requirements Governing the Preparation of Canadian Franchise Disclosure Documents and the Ethical and Practical Considerations for U.S. Lawyers Involved in Drafting those Documents." Much to the relief of firm ethics counsel and malpractice insurers everywhere, they have come to the sensible conclusion that U.S. lawyers should leave Canadian law to Canadians.

Aly Conwell and Caroline B. Fichter have authored a tome about the franchising of CBD products (which, as they will tell you, is not merely "weed") titled "An Overview of Legal Issues and Regulations Affecting CBD-Based Franchise Systems."

Finally, Maisa Frank, David Harford, and Sawan Patel have ably put together "LADR Case Notes (September–November 2021) and Franchising & Distribution Currents Spring 2022."

8. Karen Gilchrist, *Over 400 Companies Have Withdrawn from Russia. But Some Western Brands Are Locked In*, CNBC (Mar. 18, 2022), <https://www.cnn.com/2022/03/18/burger-king-subway-ms-western-brands-in-russian-franchise-deals.html?msclkid=43186209ac3a11ecb370413baaaa5c88> (quoting multiple members of the Forum, who ably explain the difficult predicament facing franchisors); Giulia Carbonaro, *Boycott Subway Calls Grow as Company Continues Doing Business in Russia*, NEWSWEEK (Mar. 18, 2022), <https://www.newsweek.com/calls-boycott-subway-grows-company-refuses-sever-ties-russia-1689351>.



The Desperate Consequences of Flunking the “ABCs”

Rochelle Spandorf

What do franchisors, the trucking industry, and bakery producers have in common? At the moment, each is fighting a common enemy—the ABC test of worker status—to protect its independent contractor business model from extinction. Their battle exemplifies a significant problem with today’s worker classification laws: they are ill-suited and unaccommodating to many of the contemporary business models that they regulate. This article examines the key legal and political developments that led to the current dispute and proposes a solution for saving independent contractor business models from ABC obliteration.



Ms. Spandorf

I. A Presumption of Employee Status

California, the nation’s largest economy, is the epicenter of the battle over worker classification.¹ In 2020, the state enacted California Labor Code Section 2775, a three-part ABC test for determining if a worker is an employee or independent contractor in the eyes of the government.² California law

1. California is home to the largest worker population in the country, which exacerbates the problem of ill-suited worker laws. Based on pre-pandemic 2019 economic data, California far outperforms all other states in contributing to the country’s economic welfare. Ryan A. Hughes, *If California Were a Country*, BULL OAK CAPITAL (Dec. 28, 2021), <https://bulloakcapital.com/blog/if-california-were-a-country>.

2. California Labor Code Section 2775 codified California Assembly Bill 5 (AB 5), which was introduced into the California Assembly after the California Supreme Court’s decision in *Dynamex Operations West, Inc. v. Superior Court of Los Angeles County*, 4 Cal. 5th 903 (2018). *Dynamex* adopted the ABC test for determining if workers should be classified as employees or independent contractors for purposes of wage orders (e.g., minimum wages and other minimum worker benefits issued by California’s Industrial Welfare Commission). *Id.* at 956–57. Although *Dynamex* disclaimed that it was making new law, it is hard not to regard *Dynamex* as a seismic shift in California’s labor policy by replacing a long-standing multi-factor flexible

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now presumes all workers who provide labor or services for remuneration are employees unless a “hiring entity” demonstrates that three conditions are present:

Prong A: the person is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact;

Prong B: the person performs work that is outside the usual course of the hiring entity’s business; and

Prong C: the person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.³

Testing the “ABCs” of a commercial relationship is important to a host of legal duties that attach to employers, ranging from responsibility for workers’ compensation benefits to wage and hour laws, unemployment taxes, reimbursement of expenses, and vicarious liability. Firms that properly classify workers as independent contractors need not worry about these legal duties or about anti-discrimination laws, sexual harassment laws, employee bargaining rights, healthcare benefits, or family and medical leave laws. The stakes of misclassifying workers are high: on top of repaying back taxes and benefits with interest, companies face stiff civil penalties for misclassification.⁴

standard for classifying independent contractors with an ABC test that presumes all workers are employees. AB 5 was a huge victory for organized labor, something that California’s politicians wholeheartedly endorsed. See SAN FRANCISCO BUILDING AND CONSTRUCTION TRADES COUNCIL, STATE SENATE PASSES AB 5 (Sept. 30, 2019), <https://www.sfbuildingtradescouncil.org/news/top-stories/1478-state-senate-passes-ab-5> (quoting California’s Governor Gavin Newsom speech on Labor Day 2019 supporting AB 5). When Governor Newsom signed AB 5 into law a few weeks later on September 18, 2019, he lauded it for creating “pathways for more workers to form a union.” See Signing Statement, Office of the Governor (Sept. 18, 2019), <https://www.gov.ca.gov/wp-content/uploads/2019/09/AB-5-Signing-Statement-2019.pdf>. No one disputes that unions were behind AB 5, which by turning more workers into employees makes it easier for unions to organize workplaces. See Josh Eidelson, *The Gig Economy Is Coming for Millions of American Jobs*, BLOOMBERG (Feb. 17, 2021), <https://www.bloomberg.com/news/features/2021-02-17/gig-economy-coming-for-millions-of-u-s-jobs-after-california-s-uber-lyft-vote> (“union leverage is at a nadir”); see also Diane Dixon, *Commentary: New Freelance Law AB5 Illustrates What’s Wrong with the Democratic Super-Majority in Sacramento*, L.A. TIMES (Feb. 18, 2020), <https://www.latimes.com/socal/daily-pilot/opinion/story/2020-02-18/commentary-freelance-law-ab5>. For a more fulsome discussion of AB 5, its requirements, and background, see Anthony Marks & R. Andrew Chereck, *The ABCs of AB-5*, 41 FRANCHISE L.J. 41 (2021).

3. CAL. LAB. CODE § 2775(b)(1)(A)–(C). Like relevant authority on the topic, this article uses “hiring entity” and “hiring firm” interchangeably.

4. California Labor Code Section 2802 requires an employer to reimburse its employees for all necessary expenditures or losses incurred in discharging their employment duties, including paying them for their attorneys’ fees in actions they successfully bring to enforce their rights under Section 2802. CAL. LAB. CODE § 2802(a)–(c). It grants the California Labor Commissioner authority to issue citations to employers that violate reimbursement obligations. *Id.* § 2802(d). Damages for wage order violations include interest on top of back pay or benefits. *Id.* § 2802(b). In *Fleming v. Matco Tools Corp.*, 2021 WL 673445, at *14 (N.D. Cal. Feb. 21, 2021), a court rejected a franchisor’s argument that the franchisee plaintiffs would be unjustly enriched if they were able to retain their profits from franchise operations and also receive reimbursement for their expenses if they were classified as employees, exposing yet another (previously

California’s new ABC test upends a thirty-year-old multi-factor common law test for distinguishing employees from independent contractors articulated in 1989 by the California Supreme Court in *S.G. Borello & Sons, Inc. v. Department of Industrial Relations*.⁵ The *Borello* test is far narrower in scope (meaning that it classifies fewer workers as employees) than California’s new Labor Code Section 2775, which completely rewrites California worker status rules. The *Borello* test now only applies to a handful of statutory exemptions from Labor Code Section 2775.⁶

California’s experience has energized other states to reconsider their own worker classification labor laws, mostly along “blue” versus “red” party lines.⁷ Spurred by employee rights activists that brand misclassification “a longstanding, pervasive problem affecting millions of workers and costing government agencies billions of dollars each year,” numerous ABC-type bills have been introduced or enacted since California passed its law in 2019 expanding the number of jurisdictions that presume a worker’s employee status unless a hiring firm proves otherwise.⁸ Even the federal government is considering legislation that would adopt an ABC test for classifying workers

unimaginable) complication of misclassification: nothing prevents a franchise or distribution relationship from simultaneously being regulated as an employment relationship.

5. See *S.G. Borello & Sons, Inc. v. Dept of Indus. Rels.*, 48 Cal. 3d 341, 351 (1989).

6. See Marks & Chereck, *supra* note 2, at 42–44; see also Littler Publications, *AB 5: The Aftermath of California’s Experiment to Eliminate Independent Contractors Offers a Cautionary Tale for Other States*, JD SUPRA (Mar. 10, 2020), <https://www.jdsupra.com/legalnews/ab-5-the-aftermath-of-california-s-40627> (“One of the key criticisms of [AB 5] was the arbitrary fashion in which some industries—often constituencies with powerful political allies—were granted exemptions from AB 5, while others were left out in the cold.”). Among the many exemptions is one that applies to “business-to-business contracting relationships,” but the conditions to qualify are so numerous and picky that it seems impossible that it actually covers any real-world business-to-business contracts. See CAL. LAB. CODE § 2776. There are other exemptions for assorted professionals, artists, and random “others” as varied as manufactured housing salespersons, commercial fishers working on U.S. vessels, competition judges, and individuals performing services for a motor club. *Id.* §§ 2777–2784.

7. The politicization of misclassification is indisputable. See Kim Kavin, *Welcome to Ms. Kavin’s Neighborhood. Today’s Lesson: The ABCs*, DAILY KOS (Jan. 29, 2020), <https://www.dailykos.com/stories/2020/1/29/1914395/-Welcome-to-Ms-Kavin-s-Neighborhood-Today-s-Lesson-The-ABCs> (written before the 2020 elections, the blog identified worker misclassification as being “key to the Democratic Party’s campaign plans this election year, both at the federal and state levels”); see also Lauren Doroghazi, *Beyond California AB 5—States Address Independent Contractors*, MULTISTATE (Nov. 14, 2019), <https://www.multistate.us/insider/2019/11/14/beyond-california-ab-5-states-address-independent-contractors> (specifically referring to “blue” and “red” states in discussing recent ABC legislative efforts). At the same time—along party lines—that more states are considering enacting ABC legislation, there is an opposite push with other states passing or considering “independent contractor” laws that make it easier for businesses to retain independent contractors. See Max Kutner, *In Classification Debate, Some States Back Contractor Status*, LAW360 (Nov. 10, 2021), <https://www.law360.com/employment-authority/articles/1438848/in-classification-debate-some-states-back-contractor-status>.

8. The quote is from the pro-union Economic Policy Institute’s June 16, 2021, report. Lynn Rhinehart et al., *Misclassification, the ABC test, and Employee Status: The California Experience and Its Relevance to Current Policy Debates*, ECON. POL’Y INST. (June 16, 2021), <https://www.epi.org/publication/misclassification-the-abc-test-and-employee-status-the-california-experience-and-its-relevance-to-current-policy-debates>. An April 20, 2021, Congressional Research Service report identified twenty states and the District of Columbia with some type of ABC test carrying a presumption of employee status. JON O. SHIMABUKURO, CONG. RESEARCH SERV.,

for certain federal labor law purposes, a test that is stricter than the one the Internal Revenue Service now uses to determine independent contractor status.⁹

Like many business-to-business commercial arrangements, franchisors, trucking firms, and bakery producers have always assumed that their business models supported the independent contractor status of their commercial partners: franchisees, drivers, and distributors. The common core of each arrangement is a synergistic, economic codependency. Franchisors expand their brands by awarding licenses that allow franchisees to use the franchisor's trademarks and marketing programs in their own business as long as customers enjoy a similar experience across independently owned locations. Trucking firms depend on independent drivers to use their own rigs and trucks to haul loads for the firms' customers. Bakery producers rely on independent drivers to move inventory from production facilities and warehouses to retailers' shelves. Each "hiring firm" sets the rules of commercial engagement, but each contractor drives its own revenue and influences its own profitability.

II. Historical Perspective

State wage laws, including ABC tests, trace their roots to unemployment compensation laws written during the Great Depression, a time of

R46765, WORKER CLASSIFICATION: EMPLOYEE STATUS UNDER THE NATIONAL LABOR RELATIONS ACT, THE FAIR LABOR STANDARDS ACT, AND THE ABC TEST (2021).

9. In March 2021, the U.S. House of Representatives approved the Protecting the Right to Organize Act of 2021 (PRO Act), which would amend the National Labor Relations Act (NLRA) in two significant ways. See Snell & Wilmer, *The PRO Act's Potential Effect on Employers*, JD SUPRA (Mar. 16, 2021), <https://www.jdsupra.com/legalnews/the-pro-act-s-potential-effect-on-5634391>. First, it would codify the joint employer standard articulated by the NLRB in *Browning-Ferris Industries, Inc.*, 362 N.L.R.B. 1599 (Aug. 27, 2015). The *Browning-Ferris* standard attaches joint employment status to a company that *indirectly controls or reserves the right to control* another company's working conditions, even when there is no evidence of actual control. Second, it would adopt a California-like ABC test to identify who is an employee for purposes of union organizing and collective bargaining. H.R. 842, 117th Cong. (1st Sess. 2021). Just like AB 5, the PRO Act is unapologetically pro-union and designed to increase union membership in the United States. See *Why the US PRO Act Matters for the Right to Unionize: Questions and Answers*, HUMAN RIGHTS WATCH (Apr. 29, 2021), https://www.hrw.org/news/2021/04/29/why-us-pro-act-matters-right-unionize-questions-and-answers#_How_else_would (addressing how the PRO Act would strengthen unions); see Alan I. Model, Kevin E. Burke, Maury Baskin & Michael J. Lotito, *PRO Act Would Upend U.S. Labor Laws for Non-Union and Unionized Employers Alike*, LITTLER (Feb. 10, 2021), <https://www.littler.com/publication-press/publication/pro-act-would-upend-us-labor-laws-non-union-and-unionized-employers>. Critics of the PRO Act call it as outdated as ABC laws. See Kavin, *supra* note 7 ("The root of the problem with legislation like California's AB 5 and the federal PRO Act is the outdated ABC test, written in the 1930s"); see also Anna Deknatel & Lauren Hoff-Downing, *ABC on the Books and in the Courts: An Analysis of Recent Independent Contractor and Misclassification Statutes*, 18 U. PA. J.L. & SOC. CHANGE 53, 65–66 (2015) (observing that sixteen states enacted ABC legislation between 2004 and 2012, but the IRS's twenty-factor test for identifying the existence of an employer-employee relationship has remained untouched since its adoption in 1987). Kavin observes that "the ABC test is far stricter than the modern test that the Internal Revenue Service uses to determine who is a legal independent contractor." Kavin, *supra* note 7.

unprecedented unemployment when the U.S. workforce’s needs and economic landscape were nothing like they are today.¹⁰ The focus on misclassification today is largely driven by unions that frame the conversation in black-and-white terms that cast companies utilizing independent contractors as exploitive and opportunistic.¹¹ Unions have fought for years to shrink the growing ranks of self-employed workers by pushing ABC legislation.¹² Their efforts began gaining traction in 2000, after a report commissioned by the Department of Labor (DOL) revealed that as many as thirty percent of audited businesses misclassified their workforce under then-applicable legal tests.¹³ The misclassification issue became more acute beginning in 2007 when the Great Recession collapsed state tax revenues triggering budget gaps in states across the country.¹⁴ Since then, there has been a marked uptick in union-backed efforts to overhaul labor laws focused particularly at owner-operator programs.¹⁵

III. Complicating Current Events

Several attention-grabbing aftershocks have occurred since California’s ABC test became law in 2020. In November 2020, “gig economy” companies, Uber, Lyft, Instacart, and DoorDash, long in the crosshairs of employee rights advocates, used their deep pockets to pass Proposition 22, a California public referendum preventing app-based drivers from being classified as

10. See *Carpet Remnant Warehouse, Inc. v. N.J. Dep’t of Lab.*, 593 A.2d 1177, 1183–84 (N.J. 1991) (tracing the roots of state ABC legislation to New Deal legislation).

11. The pro-union Economic Policy Institute’s June 16, 2021, report links to its Twitter page where it tweets: “Most people know that unions improve wages and benefits for workers, but do you know just how beneficial they really are? Take our quiz . . .” Rhinehart et al., *supra* note 8; see also Rebecca Dixon, *The Gig Is Up on 21st-Century Exploitation*, TECHCRUNCH (Apr. 29, 2021), <https://techcrunch.com/2021/04/29/the-gig-is-up-on-21st-century-exploitation> (discussing misclassification and identifying app-based companies as “the face of a larger, sinister trend”).

12. See Taylor Johnston, *The U.S. Labor Movement Is Popular, Prominent and Also Shrinking*, N.Y. TIMES (Jan. 25, 2022), <https://www.nytimes.com/interactive/2022/01/25/business/unions-amazon-starbucks.html>. This article notes that, despite their shrinking ranks, the popularity of unions is the highest it has been in decades. Unions are using their popularity to lock in political advantages. For example, the PRO Act would overturn state right-to-work laws that make it unlawful to compel employees to join or pay dues to a union as a condition of their employment. Snell & Wilmer, *supra* note 9; Model et al., *supra* note 9.

13. Deknatel & Hoff-Downing, *supra* note 9, at 55 n.10.

14. *Id.* at 57, n.12.

15. See Richard Reibstein, *The Past Decade of Independent Contractor Misclassification and Compliance Law*, JD SUPRA (Jan. 3, 2020), <https://www.jdsupra.com/legalnews/the-past-decade-of-independent-24702>. The term “owner-operator” includes sole proprietors, as well as contractors, that are business entities or have employees of their own. Misclassification involves a single firm as the putative employer or a worker. A hiring firm can be guilty of misclassifying a contractor even when that contractor has employees of its own (and the hiring firm would also be guilty of misclassifying the contractor’s employees). See, e.g., *Alexander v. FedEx Ground Package Sys., Inc.*, 765 F.3d 981, 993 (9th Cir. 2014) (finding FedEx drivers were employees even though they operated through a business entity and had employees of their own). Joint employer liability, often discussed together with misclassification, is, as the term implies, a “two employer” test that evaluates if both the hiring firm and contractor employ the contractor’s workers. See *Joint Employment: Overview*, Practical Law Practice Note Overview 9-523-4928 (maintained).

employees.¹⁶ Less than a year later, these “gig” giants put a similar public initiative on the November 2022 ballot in Massachusetts, a state with a substantially similar ABC law (predating and inspiring California’s version).¹⁷ The “gig” companies’ victory in California shows that the cause of “worker freedom” resonates with voters.¹⁸ Complicating their California victory, however, on August 20, 2021, Proposition 22 was ruled unconstitutional, a decision currently on appeal.¹⁹

In January 2021, the California Supreme Court exacerbated the newly inked ABC test’s impact on California businesses by ruling in *Vazquez v.*

16. “Gig economy” companies sold Proposition 22 to the public by committing to pay app-based drivers at least 120% of minimum wage and provide health insurance subsidies and accident subsidies. See CAL. BUS. & PROF. CODE § 7453(d)(4)(A). Critics of Proposition 22 are quick to point out that app-based drivers in California still make subminimum wages due to fine print conditions in the public measure. See Brian Chen & Laura Padin, *Prop 22 Was a Failure for California’s App-Based Workers. Now, It’s Also Unconstitutional.*, NAT’L EMP. LAW PROJECT (Sept. 16, 2021), <https://www.nelp.org/blog/prop-22-unconstitutional>.

17. See Rebecca Bellan, *Massachusetts AG Greenlights Uber, Lyft-backed Gig Worker Ballot Initiative*, TECHCRUNCH (Sept. 1, 2021), <https://techcrunch.com/2021/09/01/massachusetts-ag-greenlights-uber-lyft-backed-gig-worker-ballot-initiative>. An article published in the *Harvard Political Review* says the amalgam of conditions that attach to the 2022 Massachusetts initiative would leave Massachusetts drivers with a subminimum wage should the initiative pass. Mary Cipperman, *Work A La Carte*, HARV. POL. REV. (Oct. 18, 2021), <https://harvardpolitics.com/work-a-la-carte>.

18. The Proposition 22 California victory exposes an interesting political conundrum: while legislators elected “by the people” pass state ABC laws that treat all workers as employees, their constituents are voting to protect on-demand independent contractor models from extinction. A worker’s classification as an independent contractor may not preclude them from being able to collectively bargain. See *Federal Court Rules that Seattle’s “Uber Ordinance” Violates Federal Antitrust Law*, NAT’L FED’N OF INDEP. BUS. (May 22, 2018), <https://www.nfib.com/content/legal-blog/economy/federal-court-rules-that-seattles-uber-ordinance-violates-federal-antitrust-law> (discussing the Ninth Circuit’s decision in *Chamber of Commerce of the United States v. City of Seattle*, 890 F.3d 769 (9th Cir. 2018), which held that a Seattle ordinance giving independent contractor drivers the right to collectively bargain was preempted by federal antitrust law). *City of Seattle* did not classify app-based drivers as protected employees under the NLRA but did rule that the Seattle ordinance giving drivers collective bargaining rights was not preempted by the NLRA. 890 F.3d at 794; see also Thomas W. Joo & Leticia Saucedo, *A New Paradigm: Rideshare Drivers, Collective Labor Action, And Antitrust*, 69 BUFF. L. REV. 805, 824–26 (2021). The right of independent contractors to collectively bargain is an unsettled question that is outside the scope of this article.

19. *Castellanos v. State*, 2021 WL 3730951, at *2 (Cal. Super. Ct. Aug. 20, 2021), *appeal filed*, Case No. A163655 (2021). The force behind *Castellanos* is the Service Employees International Union (SEIU), the same union behind numerous misclassification lawsuits over the last decade, including the “McDonald’s Fight for \$15” cases. See Ken Green, *Unionizing the Gig Economy: A Path Forward for Gig Workers* (July 6, 2021, updated Aug. 30, 2021), <https://uniontrack.com/blog/unionizing-the-gig-economy>; see also Kate Conger & Kellen Browning, *A Judge Declared California’s Gig Worker Law Unconstitutional. Now What?*, N.Y. TIMES (Aug. 23, 2021), <https://www.nytimes.com/2021/08/23/technology/california-gig-worker-law-explained.html> (calling it “an awkward turn of events” that the California Attorney General’s office, which had sued Uber and Lyft before Proposition 22’s passage for misclassifying their drivers, is now defending Proposition 22 against the SEIU’s constitutional challenge). At the time of this article’s submission for publication, the appeal filed by the State of California and the “gig” company respondents in late September 2021 is pending. *Castellanos v. State*, Case No. A163355 (Cal., 1st App. Dist., Div. 4). The *Castellanos* ruling does not make app-based drivers employees in California, but does leave their status unsettled. See Sean King, *The End of Proposition 22?: How a California Court Is Labeling the Initiative Unconstitutional*, ST. JOHN’S LAB. & EMP’T LAW F. (Oct. 6, 2021), <https://stjcleblog.org/2021/10/the-end-of-proposition-22>.

Jan-Pro Franchising International, Inc. that the test applies retroactively.²⁰ As a result of *Vazquez*, “relationships that were never considered or expected to be employment relationships [are] deemed employment relationships by law.”²¹ Suddenly franchisors, trucking firms, bakery producers, and numerous others are scrambling to save their independent contractor networks—some decades old—sparking intense lobbying for new exemptions or other strategies to avoid having their business models obliterated by California’s ABC test.

Finally, the pandemic has produced what economists call the “Great Resignation,” a worker shortage choking industries like technology and healthcare and challenging the country’s economic recovery. The Great Resignation has particular implications for California, a hotbed for startups that depend on younger workers who comprise a material percentage of overall resignations.²² It has spurred some employers to volunteer generous pay and employee benefits to lure workers back. It also has given unions new muscle to advance their pro-ABC legislative agendas.²³

IV. The “B” Problem

Prong B is the most vexing element of the ABCs as it conditions independent contractor status on a worker performing work outside the usual course of the hiring entity’s business.²⁴ This requirement is incompatible with arrangements where a hiring firm’s revenue directly depends on someone else’s work, which swallows nearly every independent contractor arrangement. Prong B presents an insurmountable problem not just for vertically integrated arrangements between brands and franchisees and suppliers and distributors, but also for arrangements between any two links in a supply chain. Because the ABC test is conjunctive, companies operating in states that incorporate the “usual course of business” version of Prong B cannot lawfully classify their workers as independent contractors if workers perform services that reasonably could be provided by an employee.²⁵ This vague

20. *Vazquez v. Jan-Pro Franchising Int’l, Inc.*, 10 Cal. 5th 944, 948 (2021).

21. See Marks & Chereck, *supra* note 2, at 42.

22. See *The Great Resignation: What It Means for California Startups and Young Talent*, JOBAMAX (Oct. 11, 2021), <https://jobamax.medium.com/the-great-resignation-what-it-means-for-california-startups-and-young-talent-2049be53ab21>.

23. The Great Resignation is empowering union-backed employees to strike for better working conditions, adding clout to the workers’ rights movement. On top of this, unions are gaining in popularity. A Gallup Poll conducted in August 2021 shows pro-union sentiment is at its highest level since 1965, up twenty points since 2016. Megan Brenan, *Approval of Labor Unions at Highest Point Since 1965*, GALLUP (Sept. 2, 2021), <https://news.gallup.com/poll/354455/approval-labor-unions-highest-point-1965.aspx>.

24. While Prong B varies across states, tougher ABC laws like California’s and Massachusetts’s condition independent contractor status on a worker performing work outside the usual course of the hiring entity’s business. CAL. LAB. CODE § 2750.5; MASS. GEN. LAWS ch. 149, § 148B.

25. *Dynamex Operations W., Inc. v. Superior Court*, 4 Cal. 5th 903, 959 (2018) (explaining Prong B to mean that workers must be classified as employees when their “services . . . would

legal standard leaves companies highly vulnerable to misclassification challenges to their independent contractor arrangements.²⁶

V. Judicial Battleground

Each of the groups profiled in this article has challenged California's ABC test in the courts. First, trucking companies have twice challenged the law on constitutional grounds, although only one case remains alive. In a last-gasp plea to the U.S. Supreme Court, the California Trucking Association has asked the Court to find that the Federal Aviation Administration Authorization Act (F4A) preempts California's ABC test as it applies to motor carriers.²⁷ Although the association's petition remains pending, the Court refused to hear a similar constitutional preemption argument on October 4, 2021.²⁸

Second, on September 21, 2021, the U.S. District Court for the Southern District of California held in *Goro v. Flowers Foods, Inc.* that bakery giant Flowers Foods, producer of Wonder Bread, Tastykake, and Dave's Killer Bread, had misclassified its distributors even though distributors use their own vehicles and employees to bring the company's bakery products to national, regional, and local accounts in their territory; decide when to work, how to staff, what routes to travel, and how much time to spend at each retail location; establish their own relationships with local store management; and exercise autonomy over other business needs like insurance.²⁹ Flowers Foods' consignment-based direct-store-delivery system is widely used by other bakery producers throughout the United States.³⁰

ordinarily be viewed by others as working in the hiring entity's business and not as working, instead, in the worker's own independent business").

26. Prong B asks if the work being performed is *integral* to the hiring firm's usual course of business, which is an evidentiary issue unrelated to whether the worker sets prices, quality, and service levels and therefore controls its own profits and losses. CAL. LAB. CODE § 2750.5. The importance of setting prices, quality, and service levels is discussed later in this article. See *infra* Part VII.

27. See Cal. Trucking Ass'n v. Bonta, 996 F.3d 644 (9th Cir. 2021), *petition for cert. filed* (U.S. Aug. 11, 2021) (No. 21-194).

28. Cal Cartage Transp. v. State, 217 Cal. Rptr. 3d 570 (2020), *cert. denied*, 2021 WL 4507665 (U.S. 2021) (No. 20-1453); see also Cheryl Miller, *SCOTUS Rejects Trucking Company's Challenge to California's Worker Classification Law*, RECORDER (Oct. 4, 2021), <https://www.law.com/therecorder/2021/10/04/scotus-rejects-trucking-companys-challenge-to-californias-worker-classification-law/?slreturn=20211004164154>. The *Cal Cartage* case could still go back to California courts or regional federal courts.

29. *Goro v. Flowers Foods, Inc.*, 2021 WL 4295294, at *2, *3 (S.D. Cal. Sept. 21, 2021).

30. *Id.* at *2 ("Other bakeries also use this distribution model, which was developed in the 1950s."). At some point in the last ten years, Flowers Foods must have recast its distribution program as franchises—possibly to add additional armor against misclassification claims. The strategy had initial success as the *Goro* decision mentions that, in December 2017, the California Labor Commission rejected a Flowers Foods distributor's misclassification claim finding the distributor to be a "franchisee and therefore outside of the Labor Commission jurisdiction." *Id.*, at *4. Not all bakery chains that utilize a Flowers Foods-type consignment-based distribution model are franchises. See, e.g., *Atchley v. Pepperidge Farm, Inc.*, 2012 WL 6057130, at *1 (E.D. Wash. Dec. 6, 2012) (rejecting a distributor's Washington Franchise Investment Protection Act claims because the distributorship did not meet the statute's "franchise" definition).

In the decision, the district court shredded Flowers Foods’ arguments, one based on the alleged preemption of any one of three different federal laws, and the other based on alleged disputed facts that Flowers Foods argued entitled it to a jury trial on whether its distributors were independent contractors. The court summarily rejected all three preemption arguments because (1) the Ninth Circuit, it said, had already rejected an earlier argument that the F4A preempted California’s ABC test as applied to motor carriers; and (2) Flowers Foods had failed to identify an actual conflict between the federal franchise and trademark laws and California’s ABC test or a “clear and manifest” intent by Congress to preempt state labor laws justifying preemption.³¹ It called Flowers Foods “disingenuous” for claiming to be in the “bakery business” while its distributors were in the transportation or delivery business.³² According to the court, there was too much evidence that Flowers Foods’ business encompassed sales, delivery, and merchandising, the very functions distributors performed whose work was necessary, not incidental, to Flowers Foods’ business.

Third, on November 17, 2020, the International Franchise Association (IFA) borrowed a page out of 7-Eleven’s playbook, which two months earlier had convinced a Massachusetts federal judge that the federal franchise rule preempted Massachusetts’s ABC test and required dismissal of a misclassification lawsuit filed by 7-Eleven franchisees.³³ The IFA’s action, which was

31. *Goro*, 2021 WL 4295294, at *9, *11 (citing *Cal. Trucking Ass’n v. Bonta*, 996 F.3d 644, 659 (9th Cir. 2021)).

32. *Id.* at *12. On December 3, 2021, the *Goro* court rejected Flowers Foods’ motion for summary judgment on plaintiffs’ state law wage claims. *Goro v. Flower Foods, Inc.*, 2021 WL 5761694 (S.D. Cal. Dec. 3, 2021). It found “genuinely disputed material facts” as to whether the distributors operated in interstate commerce, which would have exempted Flowers Foods from California’s wage laws. *Id.* at *8.

33. See Complaint, Int’l Franchise Ass’n v. California, Case No. 3:20-CV-02243-BAS-DEB (S.D. Cal. 2020). The Massachusetts case is *Patel v. 7-Eleven, Inc.*, 485 F. Supp. 3d 299, 307 (D. Mass. 2020) (ruling that genuine issues of fact precluded summary judgment that franchisees were employees under the Massachusetts independent contractor law (“Massachusetts ICL”)), *appeal filed*, 8 F.4th 26 (1st Cir. 2021), *certifying questions to* No. SJC-13166, 2022 WL 869486 (Mass. Mar. 24, 2022). On March 24, 2022, the Massachusetts Supreme Judicial Court answered the questions certified to it by the First Circuit by ruling that there was no conflict between the Massachusetts ICL and the FTC Rule and, thus, no federal preemption. *Patel v. 7-Eleven, Inc.*, 2022 WL 869486, at *1 (Mass. Mar. 24, 2022). Specifically, the Massachusetts Supreme Judicial Court found that the “free[dom] from control” required by Prong A to establish an independent contractor relationship under the Massachusetts ICL did not conflict with the FTC Rule’s “significant . . . control” over the franchisee’s “method of operation,” which is one of two alternatives to establish a franchise under federal law (the other alternative being significant assistance). *Id.* at *3, *6. The court explained that, although the FTC Rule and Prong A both use “control” in their respective legal tests, “significant . . . control” over a franchisee’s business operations is broader than control over workplace decisions under Prong A, quoting *Goro*, which observed that “the phrase ‘method of operation’ in the FTC Franchise Rule is broader than the phrase ‘performance of [services]’ appearing in the ABC Test.” *Id.* at *7 (quoting *Goro*, 2021 WL 4295294, at *10). The court dismissed arguments that its ruling would destroy the franchise business model, citing recent FRANData and IFA reports extolling franchising’s steady growth despite rulings under common law and ABC tests finding franchisees to be employees. *Id.* at *8. According to the court, applying the Massachusetts ICL test to franchise relationships would not “result in every franchisee being classified as an employee of the franchisor.” *Id.* at *9. The court also noted that the “controls required under the Lanham

filed in the same court that later issued the *Goro* decision, sought to declare California's ABC test inapplicable to the franchise model on constitutional grounds based on preemption arguments similar to 7-Eleven's: (1) neither the federal franchise rule nor trademark law allow a franchisee "to be free from the control and direction of the franchisor," in direct conflict with Prong A, and (2) franchising's trademark licensing feature prevents a franchisee from operating "outside the usual course" of a franchisor's business, in direct conflict with Prong B. The thrust of the IFAs' argument was that strict application of the ABC test would convert every California franchisee to an employee of the franchisor and dismantle the franchise business model:

It cannot be the case . . . that, in qualifying as a franchisee . . . an individual necessarily becomes an employee . . . [S]uch a ruling . . . would eviscerate the business franchise model, rendering those who are regulated by the FTC Franchise Rule criminally liable for failing to classify their franchisees as employees.³⁴

After the *Goro* ruling rejected the same preemption arguments at the foundation of the IFAs' case, the State of California moved to dismiss the IFAs' complaint. In early 2022, the court ruled for defendants and dismissed the IFAs' constitutional challenge without prejudice (and also without leave to amend), finding no justiciable dispute at the moment.³⁵

These outcomes have pulled the rug out from under the feet of Flowers Foods and other bakery producers with distributors in California, trucking firms and franchisors doing business in California, and companies utilizing similar owner-operator business models still undetected by misclassification radar. Even though *Dynamex* said that it did not change existing law, until *Dynamex* no one saw the ABC test coming in a way that might topple decades-old business models (some say franchising was invented during the Middle Ages).³⁶ These companies are now in the unenviable position of

Act, 15 U.S.C. § 1064 (5) (A)" did not conflict with the "free[dom] from control" required by Prong A for independent contractor status. *Id.* at *7, n.16, *8. In dicta, the court reasoned that a putative franchisee carries the burden of proof on a threshold issue in every misclassification franchise case, which is to show that it performs services for the alleged employer/franchisor, a threshold that the court said is "not satisfied merely because a relationship between the parties benefits their mutual economic interests." *Id.* at *9.

34. *Patel*, 485 F. Supp. 3d at 310.

35. Int'l Franchise Ass'n v. California, 2022 WL 118415, at *7 (S.D. Cal. Jan. 12, 2022). The court did not offer the IFA leave to amend because the IFA had not asked for leave and had already amended its complaint once before. *Id.* It found the IFAs' arguments about fitness for review both theoretical ("the Court is left to speculate if or how Section 2275(b)(1) might be applied to franchisees") and unconvincing ("Plaintiffs have not shown a plausible basis to fear an immediate enforcement of Section 2275(b)(1) [sic] against all franchise relationships, devoid of context"). *Id.* at *6.

36. *Dynamex Operations W., Inc. v. Superior Court of L.A. Cnty.*, 4 Cal. 5th 903, 964 (2018). See *supra* note 2 and accompanying text. By ruling the ABC test was not new law, the California Supreme Court paved the way for *Vazquez* to hold a few years later that the ABC test applies retroactively to arrangements in place before the *Dynamex* decision. *Vazquez v. Jan-Pro Franchising Int'l, Inc.*, 10 Cal. 5th 944, 955 (2021). Labor advocates say the corporate lobby should have seen *Dynamex* coming. Caitlin Vega, *What's the Real Story on Dynamex?*, CAL. LAB. FED'N (Aug. 13, 2018), <https://calaborfed.org/whats-the-real-story-on-dynamex/>. For the roots of franchising, see Robert W. Emerson & Michala Meiselles, *U.S. Franchise Regulation As a Paradigm*

defending business models that rely on economic allocations that are incompatible with employment relationships or facing significant costs and penalties as employers if their luck in court does not improve.³⁷

VI. Political Ping-Pong and Mismatched Legal Tests

No one benefits from the political ping-pong that labor laws have experienced in the last decade, with Obama-era policies summarily replaced by Trump-era policies, and Trump-era policies undone by Biden-era policies.³⁸ Swatting labor laws back and forth between extremes hinders the ability of companies and workers to plot their future and destroys the predictability of laws necessary for the free flow of interstate commerce.³⁹

States with ABC laws that presume all workers are employees cling to old-fashioned ideas about work, ignore new technologies that have changed the way work is and can be performed, and disregard the modern needs of today's workforce that strongly desires flexibility.⁴⁰ The twenty-first century

for the European Union, 20 WASH. U. GLOB. STUD. L. REV. 743, 746 (2021) (“Franchising, as a concept, dates back to the thirteenth century or earlier, over four hundred years before it was first adopted as a business model.”).

37. The potential implications of a misclassification ruling involving the groups profiled in this article—the trucking industry, bakery producers, and franchisors—are staggering. If required to reclassify their California network members as employees, each might owe each network member and their employees for missing wages including documented overtime and expense reimbursements with interest, plus fines, penalties, and attorneys’ fees, without receiving credit for profits that a network member earned from operating their own business. See Kai Thordarson, *AB-5 and Drive: Worker Classification in the Gig Economy*, 17 HASTINGS BUS. L.J. 137, 149–50 (2021) (discussing the harsh penalties in ABC laws as a mechanism for compliance).

38. See Robert Nagle, *Watch the Pendulum Swing—NLRB’s Acting GC Rolls Back Predecessor’s Guidance Memoranda*, JD SUPRA (Feb. 9, 2021), <https://www.jdsupra.com/legalnews/watch-the-pendulum-swing-nlrbs-acting-6244431>. As this article goes to print, the Democrat-controlled NLRB is playing politics by inviting the public to file briefs in a non-franchise NLRB case involving the independent contractor status of workers who provide makeup and hairstyle services to the Atlanta Opera, specifically on the issue of whether the NLRB should follow the independent contractor standard that the NLRB articulated in 2019 when the NLRB was Republican-controlled, return to the Obama-era independent contractor standard, or fashion a new standard. *NLRB Invites Briefs Regarding Independent Contractor Standard*, NAT’L LAB. RELS. Bd. (Dec. 27, 2021), <https://www.nlr.gov/news-outreach/news-story/nlr-invites-briefs-regarding-independent-contractor-standard>. Like all NLRB decisions, the Atlanta Opera case will be reviewed by the U.S. Court of Appeals for the D.C. Circuit, which, in the past, has strongly rebuked the NLRB for favoring politics over legal precedent and ignoring the court’s prior rulings in its decisions. See Richard Reibstein, *Courts Unlikely to Accept a New NLRB Independent Contractor Test*, LOCKE LORD (Dec. 29, 2021), <https://www.lockelord.com/newsandevents/publications/2021/12/courts-unlikely-to-accept-a-new-nlr-independent-c>.

39. The California Trucking Association makes these points in its petition to the U.S. Supreme Court seeking to overturn the Ninth Circuit’s holding that the F4A does not preempt California’s ABC test as applied to motor carriers. See *Petition for Writ of Certiorari* at 15–16, *Cal. Trucking Ass’n v. Bonta*, 996 F.3d 644 (9th Cir. 2021) (No. 21-194).

40. See Andrew G. Malik, *Worker Classification and the Gig Economy*, 69 RUTGERS U. L. REV. 1729, 1747–48 n.106 (2017) (discussing 2015 statistics regarding the varied backgrounds of the 40,000 active Uber drivers at the time who chose to drive for Uber because of the platform’s “flexibility and convenience”—“it fit their life well, not because it was their only option.”); see also Rani Molla, *Service Workers Are Getting Paid More Than Ever. It’s Not Enough*, VOX (Nov. 1, 2021), <https://www.vox.com/recode/22748448/service-food-hotel-workers-pay-raise-resignation-jobs-wages-bene>.

economy is service and consumption driven and qualitatively different than the manufacturing-centric economy dominating most of the twentieth century.⁴¹ Yet work arrangements are subject to growing orders of ABC worker classification laws rooted in New Deal-era social policies.

Although Uber and other “gig” companies are the poster children of this new economy, the complications presented by ABC laws are not confined to platform technology firms. None of the groups profiled in this article that are fighting for their business model’s survival—franchisors, the trucking industry and bakery producers—is a technology or “gig” firm run by platform companies like Uber, Lyft, or DoorDash. Worker classification laws are industry-agnostic. What the groups profiled in this article have in common with their “gig” cohorts is that they produce jobs that create economic codependency between brand owners and contractors while at the same time allowing contractors significant autonomy over the manner and means of work when compared to traditional employees.⁴²

Whether one calls today’s new economy a sharing economy, on-demand economy, gig economy, peer economy, collaborative economy, or something else, many of the jobs being generated are attractive to workers who “value autonomous, short-term, flexible work over lifetime job security.”⁴³

fits (exploring some of the existential reasons for the Great Resignation and concluding that employees left traditional hourly jobs during the pandemic not out of a desire to stop working altogether, but to secure a better work-life balance for themselves, which adds pressure on companies to change traditional work models).

41. See Mike Moffatt, *History of American Economic Growth in the 20th Century*, THOUGHTCO (Aug. 1, 2018), <https://www.thoughtco.com/us-economic-growth-in-the-20th-century-1148146>; Megan Carboni, *A New Class of Worker for the Sharing Economy*, 22 RICH. J.L. & TECH. 11 (2016); Emily C. Atmore, *Killing the Goose That Laid the Golden Egg: Outdated Employment Laws Are Destroying the Gig Economy*, 102 MINN. L. REV. 887, 907–08 (2017) (“[T]wentieth-century legislators . . . could not have conceived of a mutually beneficial business model that successfully operates on minimal operating costs, a remote technological marketplace, and international demand.”).

42. Another commonality of franchising and gig arrangements is that both result in “fissured workplaces” according to proponents of “fissured workplace” labor theories, where multiple non-affiliated organizations influence worker relationships. See DAVID WEIL, *THE FISSURED WORKPLACE* 8–9 (2014) (describing workplace “fissuring” as the phenomenon where large “lead businesses” no longer directly employ workers to accomplish their business goals, but instead rely on “a complicated network of smaller businesses” operating in a highly competitive environment that shrinks their profit margins, which, in turn, result in “increasingly precarious working conditions” for the workers of these lower-level small employers). Dr. Weil’s book profiles different fissured workplaces including various subcontracting relationships, franchise relationships, technology arrangements, and outsourcing arrangements. *Id.* at 13, 99–121 (subcontracting relationships), 122–58 (franchise relationships); 159–81 (supply chains, outsourcing, technology).

43. See Kaiponanea T. Matsumura, *Breaking Down Status*, 98 WASH. U. L. REV. 671, 701, nn.179, 185 (2021) (referring to surveys revealing how gig workers prefer independent contractor status over being an employee even without the benefits that employee status confers). Likewise, V.B. Dubai, *Wage Slave or Entrepreneur?: Contesting the Dualism of Legal Worker Identities*, 105 CALIF. L. REV. 65, 118 (2017), studied the San Francisco taxi industry and found immigrant and racial-minority taxi workers strongly preferred independent contractor status not because they misunderstood what it meant to be an employee, but because it fulfilled their personal aspirational identity to be an entrepreneur and freed them from top-down work rules even if it meant less stable income.

The twentieth century legal tests for classifying workers are not helpful in addressing these new workplace realities.⁴⁴

It should be possible for governments to design a third worker category, a flexible contractor model with some traditional labor protections like paid sick leave and occupational accident insurance to prevent companies from abusing independent contractor status and pushing worker welfare responsibility entirely on to governments’ backs. This third category must recognize a distinct class of worker who brings “services integral to the employer’s business, works subject to both their own criteria and the employer’s criteria, . . . performs activities autonomously . . . and . . . [is] paid based on the quality and quantity of work performed,” not according to pay laws that measure work “with a clock.”⁴⁵ The notion of a third worker category is not unprecedented: the United Kingdom uses three categories for classifying individuals who render services to a company.⁴⁶ Canada recognizes a third

44. See Atmore, *supra* note 41, at 889 (concluding that applying traditional binary employee classification tests to today’s workers pushes a “square peg” through one of “two round holes” and advocates for comprehensively reforming worker classification rules so that they foster and support, not complicate, today’s economic forces). The references to “square peg” and “two round holes” come from *Cotter v. Lyft, Inc.*, 60 F. Supp. 3d 1067, 1081 (N.D. Cal. 2015), a decision that rejected cross-motions for summary judgment in Lyft drivers’ misclassification class action. The *Cotter* court was highly critical of the legal tests that it had to work with, saying the test “developed over the 20th Century for classifying workers isn’t very helpful in addressing this 21st Century problem.” *Cotter*, 60 F. Supp. 3d at 1081; see also Malik, *supra* note 40, at 1731 (“If a third category is not created, both courts and gig-economy companies will be forced to settle for one of the first two options—at the expense of innovation and advancement.”).

45. Tad Devlin & Stacie Chiu, *Is Your Uber Driver or Lyft Driver an Employee or Independent Contractor and Why Does It Matter?*, THOMSON REUTERS (June 2017), <http://www.kdvlaw.com/wp-content/uploads/2017/07/Westlaw-Shared-Economy-Is-Uber-Driver-an-Employee-or-Independent-Devlin-June-2017.pdf>; see also Robert Sprague, *Updating Legal Norms For a Precarious Workplace*, 35 A.B.A. J. LAB. & EMP. L. 85, 85 (2020) (noting that “the legal tests used to classify whether a worker is an employee, who is afforded various workplace protections, or an independent contractor, who is not entitled to workplace protections, have not kept pace with evolving, on-demand work”). The Sprague article does not endorse a third worker category. *Id.* at 101–11. It reviews state legislative efforts to counteract ABC laws by enacting independent contractor laws that give contractors various portable employment-like benefits decoupled from any particular job or company.

46. Vinson & Elkins LLP, *A Third Approach to Classification—What Is a British “Worker?”*, LEXOLOGY (June 19, 2018), <https://www.lexology.com/library/detail.aspx?g=54faa142-d9e4-41c2-bf8d-673cb3397370>. The United Kingdom recognizes employees, independent contractors and workers defined this way:

- **Employees** are party to a contract of employment and have the “full suite” of employment rights, including to equal pay, sick pay, holiday pay, non-discrimination, and protection from unfair dismissal;
- **Independent contractors** are party to contracts for (not necessarily personal) services, but are not employees, and do not have any of the rights that flow from a contract of employment; and
- **Workers** are in an intermediate category, in that they are party to contracts for (personal) services rather than contracts of employment, and do not have all the benefits of an employee, but do have rights to equal pay and non-discrimination.

See Miriam A. Cherry & Ana Santos Rutschman, *Gig Workers As Essential Workers: How to Correct the Gig Economy Beyond the Covid-19 Pandemic*, 35 A.B.A. J. LAB. & EMP. L. 11, 14 (2020). The UK approach distinguishes a “worker” and an “independent contractor” by asking (1) is the contract for personal services; and (2) is the company the client or customer of the individual rendering

“dependent contractor” category, Italy and Spain each recognize their own third worker category, as do South Korea, Germany, and other European Union countries.⁴⁷

For vertically integrated business models, which include most franchises, where companies require their own workforce to discharge their contractual duties to franchisors or some other hiring firm, it should be sufficient for workers to have one W-2 employer, the party that actually hires them, supervises their performance, and decides all incidents of their employment. Efforts to hold franchisors and others similarly connected to a worker’s W-2 employer liable as joint employers of that worker should be recognized for what they are: pro-union, not pro-employee.⁴⁸

VII. Saving Independent Contractor Business Models from ABC Obliteration

Reflexively, a third worker category in the United States seems like it should be an easy solution to implement, but experiences elsewhere suggest otherwise. Critics of third worker categories in other countries say the third category adds complexity to worker classification disputes, delivers unintended consequences, and results in many more, not fewer, workers classified as employees under labor laws.⁴⁹ Based on these lessons, a third worker

services? Vinson & Elkins LLP, *supra* note 46. If the answer to (1) is yes and the answer to (2) is no, the individual is likely a worker, not an independent contractor. *Id.*; see Jennifer M. Leaphart, *Sharing Solutions?: An Analysis of Taxing the Sharing Economy in the United States and Europe*, 91 TUL. L. REV. 189, 208–10 (2016) (explaining the UK system).

47. Section II of the Cherry and Rutschman article, *supra* note 46, reviews various proposals for adding a third worker class in the United States. Most proposals spotlight “on-demand” workers and the gig economy. For example, Seth D. Harris & Alan B. Krueger, *A Proposal for Modernizing Labor Laws for Twenty-First-Century Work: The “Independent Worker”* (Hamilton Project, D.C.), Dec. 2015, at 22–24, suggest creating an “independent workers” category covering workers in a “triangular relationship” between customers needing a service (e.g., a car ride or food delivery) and an intermediary, typically a technology company (e.g., Uber or Postmates). None of the third worker category proposals that this author has reviewed is broad enough to capture non-gig business arrangements like those profiled in this article. See discussion *infra* note 62.

48. It is obviously easier for unions to organize workers if they can bargain with the joint employer at the top of the chain—the franchisor, licensor, or supplier—than if they must bargain with each individual employer—the franchisee, licensee, or distributor—each with their own separate workforce. As a matter of public policy, however, if franchisees occupy the employer role, why do their workers need, or for that matter deserve, two W-2 employers, the franchisor and franchisee, jointly and severally? The author of this article can think of no reason except to appease unions.

49. Miriam A. Cherry & Antonio Aloisi, “Independent Contractors” in the Gig Economy: A Comparative Approach, 66 AM. U. L. REV. 635, 646–50 (2017). For a discussion of the United Kingdom supreme court’s dismissal of Uber’s appeal of a February 2021 landmark ruling that rejected Uber’s claim that drivers should be classified as contractors, finding them instead to be workers with access to a minimum wage, pension benefits, and paid holidays, see Bama Athreya, *Gig Workers Are in the Driver’s Seat in Europe. Is There Hope for the US?*, INEQUALITY.ORG (Dec. 13, 2021), and Natasha Lomas, *UK High Court Deals Huge Blow to Uber-Style Ride-Hailing Contracts*, TECHCRUNCH (Dec. 6, 2021), <https://techcrunch.com/2021/12/06/uk-high-court-uber-contracts-loss>.

category in the United States may not be the ideal solution for the groups profiled in this article and others like them to ensure contractor status for their business models. Indeed, despite all the problems with the traditional binary model, it may prove just as challenging and equally unsatisfying to create a common set of organizational features for a third worker category that are shared by the assorted commercial arrangements scattered around the murky edges of the traditional binary divide (especially when new work models are constantly appearing).⁵⁰

A better option for saving contractor status for the businesses profiled in this article and others like them may be to amend ABC laws to add a rebuttable presumption that a business-to-business contracting arrangement is an independent contractor relationship, not an employment relationship, when the contractor can influence its revenue by setting prices to consumers, exercises control and discretion over the means and manner of executing customer service standards, and can control its profits and losses. These are the core functions whereby a business demonstrates its independence.⁵¹

The idea for this legislative solution comes from an unlikely source: Professor David Weil, the Obama-era chief administrator of the Wage and Hour Division of the DOL and author of *The Fissured Workplace* and the DOL's informal guidance on joint employment under the Fair Labor Standards Act (Administrator's Interpretation No. 2016-1).⁵² Dr. Weil is a foe of “fissured workplaces,” which, as noted, include franchises, subcontracting, outsourcing arrangements, and digital platforms that connect consumers with workers.⁵³ He likely was not thinking about saving franchising or other fissured arrangements as independent contractor models when he critiqued the ABC test in a 2021 law review article. But, in that article, Dr. Weil and his coauthor, Tanya Goldman, assail the ABC test for being “over-inclusive” and not a tractable legal standard for businesses today.⁵⁴ They propose to

50. Gali Racabi, *Despite the Binary: Looking for Power Outside the Employee Status*, 95 TUL. L. REV. 1167, 1183 (2021) (“This problem of matching legal status to a specific collection of organizational features is magnified tenfold when firms introduce new organizational structures.”).

51. Tanya Goldman & David Weil, *Who's Responsible Here? Establishing Legal Responsibility in the Fissured Workplace*, 42 BERKELEY J. EMP. & LAB. L. 55, 112 (2021).

52. Weil, *supra* note 42.

53. *Id.* at 66 (“Fissured workplace business models incentivize violations of our fundamental labor and employment standards.”). In June 2021, President Biden nominated Dr. Weil for his old job at the DOL. Press Release, The White House, President Biden Announces Key Nominations (June 3, 2021), <https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/president-biden-announces-key-nominations>. After his nomination failed to get out of committee, on January 4, 2022, Biden renominated Dr. Weil in this new session of Congress. Press Release, The White House, Nominations Sent to the Senate (Jan. 4, 2022), <https://www.whitehouse.gov/briefing-room/statements-releases/2022/01/04/nominations-sent-to-the-senate-54>. But on March 30, 2022, the Senate voted to deny Weil his old job. See Paige Smith, *Senate Turns Back David Weil as Labor's Top Wage-Hour Enforcer*, BLOOMBERG LAW (March 30, 2022), <https://news.bloomberglaw.com/daily-labor-report/senate-turns-back-david-weil-as-labors-top-wage-hour-enforcer>.

54. Goldman & Weil, *supra* note 51, at 88. Goldman and Weil point out that after enacting Labor Code Section 2775, the California legislature needed to enact a mishmash of exemptions to rebalance its overbroad employee test. The random exemptions reflect “political will and

rebalance the ABC test to incorporate aspects of the economic realities analysis that highlight the specific defining attributes of an independent business entity.⁵⁵ The Goldman and Weil article observes: “[T]he core functions of a business revolve around its ability to set price, quality, and service levels.” By contrast, “[a]n economic actor that lacks this capacity operates in an environment where economic returns are determined almost exclusively by the party compensating them.”⁵⁶ A better test of employment status, Goldman and Weil propose, “would center on evaluating the worker’s opportunities for profit or loss beyond just accepting or rejecting more work.”⁵⁷ They elaborate as follows:

Critical activities would include setting price and quality standards for goods or services provided; setting key product or service standards and characteristics; overseeing the marketing and development of products; making expansion and contraction decisions; and making decisions affecting the costs of service provision or production. The ability to directly affect profit or loss in significant ways indicates whether a party has meaningful bargaining power going beyond the decision to say “yes” or “no” to a job or gig. Incorporating those criteria into a modified ABC test would link the test back to the purposes of regulating work in the first place.⁵⁸

Goldman and Weil offered this critique of the ABC test in opposing claims by technology firms that their business arrangements with drivers deserve independent contractor protection.⁵⁹ With dispatch, the authors say that platform companies are employers because they use technology and algorithms to control prices.⁶⁰ Consequently, they conclude, drivers have no control over their profits and the only way that drivers can derive greater return for their effort is by working more.⁶¹

Here is where the Goldman and Weil article exposes the possibility of defending business-to-business arrangements like those profiled in this article as independent contractor arrangements. If franchisees, distributors, and licensees control the economic drivers of their brand relationship and the means and methods for executing brand standards, then they can control

power,” not adherence to legal doctrine. *Id.* at 111 (“Our main concern with the tractability of the ABC test is that if it is truly overinclusive, legislatures will continue to include carve-outs, which often reflect political will and power rather than a need to re-balance power in a working relationship.”).

55. *Id.* at 111–12. To avoid confusion, this article’s proposal for amending California Labor Code Section 2775 draws inspiration from ideas presented by the Goldman and Weil article, but does not adopt their third option per se, which they describe as a three-part “concentric circle framework” (only the middle circle is discussed in this article). *Id.* at 88. This article agrees with the criticism by Goldman and Weil that California Labor Code Section 2775 is over-inclusive and out of touch with modern business formats. *Id.*

56. *Id.* at 112.

57. *Id.* To avoid confusion, by “third option,” Goldman and Weil are not proposing a third worker category; they are creating a new test for employee status that blends the ABC and economic realities test. *Id.* at 111–12.

58. *Id.*

59. *Id.* (“evaluating platform models’ business structures”).

60. *Id.* at 113.

61. *Id.*

their own profits and, according to Goldman and Weil, deserve to be classified as independent contractors, not employees. Goldman and Weil use the example of janitorial franchises where the franchisor controls an individual franchisee’s pricing, customer contracts, service relationships, and even the ability to take on additional work.⁶² Such an arrangement, Goldman and Weil say, lacks the defining characteristics of business independence and, therefore, should be classified as an employment relationship. But this means the converse is also true: franchises should be classified as independent contractor relationships when franchisees determine consumer prices and the means and methods for executing brand standards and control their own profits. Under the standard proposed by Goldman and Weil, franchisors would not be doomed categorically to employer status; there would be a way out of ABC purgatory if they can make this showing.⁶³

Specifically, as to franchises, in most franchise programs, franchisees control their own profits through a combination of setting consumer prices and controlling overhead. In the vast majority of franchise programs, a franchisee’s economic returns are not determined *almost exclusively* by the franchisor.⁶⁴ Admittedly, franchisors can and do influence consumer prices at franchisee outlets by engaging in brand marketing promoting prices at “participating locations,” but franchisees may elect not to participate in these programs without jeopardizing their franchise rights. Even though some franchisors may set maximum prices when legally permissible and permitted by the parties’ franchise agreement, this is not price control because franchisees remain free to charge less. Further, real-world competition is always operating to temper franchisee pricing decisions so franchisor maximum-pricing strategies should matter less. Franchisors encourage and many require their franchisees to engage in local marketing (subject to franchisor approval over trademark use) and other activities designed to drive revenue including by maintaining high levels of customer service. Although mandatory buying programs and subleasing requirements in some franchise systems may impact a franchisee’s overhead, franchisees control their employee costs

62. *Id.* at 108.

63. At the moment, franchises seem stuck in ABC purgatory in California. The IFA has tried unsuccessfully to convince the union-beholden California legislature to adopt a categorical exemption from Labor Code Section 2775 for relationships that fit the franchise definition. As noted, the *Goro* decision summarily dismissed the supplier’s federal franchise preemption argument, and the IFA’s constitutional challenge to Labor Code Section 2775 was recently tossed. *Goro v. Flowers Foods, Inc.*, 2021 WL 4295294, at *5 (S.D. Cal. Sept. 21, 2021). In early 2022, the California legislature took up a previously narrowly defeated union-backed proposal to create an appointed—not elected—body called the Fast Food Sector Council that would have authority to determine workplace policies across all fast-food restaurants in California and create statutory joint liability between franchisors and their California-based franchisees. Mary Vinnedge, *IFA Remains Concerned About California’s FAST Act*, FRANCHISEWIRE (Jan. 20, 2022), <https://www.franchisewire.com/ifa-remains-concerned-about-californias-fast-act>. California continues to slam the door in the face of franchisors desperately seeking to protect their independent contractor business model. *Id.*

64. Goldman & Weil, *supra* note 51, at 112 (using the phrase “almost exclusively” to identify the defining quality of an employee).

and most if not all of the revenue drivers of their business. In sum, under the Goldman and Weil test of who qualifies for independent contractor or employee status, franchisees merit treatment as independent contractors.⁶⁵

To ensure its predictability, an amendment to California Labor Code Section 2775 would need to identify at least two (though maybe only two)

65. At the time of this article's submission for publication, the Goldman and Weil article has been cited only once. See Andrew Elmore, *Regulating Mobility Limitations in the Franchise Relationship as Dependency in the Joint Employment Doctrine*, 55 U.C. DAVIS L. REV. 1227 (2021). Elmore discusses joint employer liability, not misclassification, the subject of the Goldman and Weil article, which immediately strains Elmore's reliance on the Goldman and Weil thesis. See Goldman & Weil, *supra* note 51, at 116 n.25 ("The fissured workplace also presents an issue of joint employment, but this article focuses on . . . employees . . . misclassified as independent contractors. We recognize that these issues are intertwined but do not address matters of joint employment in this Article." [error in original text]). Elmore claims that relaxed enforcement of antitrust laws since the 1970s vis-à-vis vertical restraints (which Elmore uses as a proxy for franchise relationships) explains "the current judicial trend of presuming that franchisors do not jointly employ franchisee employees," a trend that he condemns. Elmore, *supra*, at 1241. Elmore argues for a blanket presumption that all franchisors are joint employers of their franchisees' employees based on a franchisee's operational dependence on the franchisor. *Id.* at 1268 ("The dependency of franchisees on franchisors for continued operation can also justify a presumption of joint employment . . ."). Elmore contends that the same ABC test that presumes that franchisees are misclassified employees supports a presumption of the franchisor's joint employer status: franchising, he argues, categorically robs franchisees of their independence and renders them "dependent subordinate firms," which prevents franchisees from qualifying as an "independent trade or business," a fact necessary to satisfy Prong C of the ABC test and qualify for independent contractor status. *Id.* at 1268–70. By creating operational dependency and subjugating franchisees to subordinate status, franchisors "shape subordinate firm workplaces," which, Elmore says, justifies a presumption that all franchisors are joint employers of their franchisees' employees. *Id.* at 1268–70.

Elmore's joint employer argument is fundamentally flawed. The biggest problem with it is that Elmore completely ignores the importance of the trademark license to the franchise relationship. The trademark license has long been regarded as the cornerstone, the bedrock, of every franchise relationship. See *Susser v. Carvel Corp.*, 206 F. Supp. 636, 640 (D.C.N.Y. 1962). Elmore sharply criticizes *Patterson v. Domino's Pizza, LLC*, 333 P.3d 723, 743 (Cal. 2014), in which the California Supreme Court refused to find that the trademark license at issue imposed sufficient control over the franchisee to hold the franchisor liable, as an employer would be liable, for wrongdoing committed by a franchisee's employee. *Patterson* viewed franchisees as "entrepreneurs" and regarded a franchisor's "systemwide standards and controls" as "a means of protecting the trademarked brand at great distances." *Id.* at 734. *Patterson* heralded the trademark license, saying it "benefits both parties," explaining that franchisors use the trademark license "to build and keep customer trust by ensuring consistency and uniformity in the quality of goods and services . . ." *Id.* at 725, 733. Not only does Elmore cold-shoulder the importance of the trademark license, he ignores the role of federal trademark law in the franchise relationship, something that *Patterson* says "obligates a licensor of trademarks, such as a franchisor, to protect the integrity of its registered and unregistered marks by monitoring their use, as well as the quality of the goods and services bearing such marks." *Id.* at 734 (quoting Dean T. Fournaris, *The Inadvertent Employer: Legal and Business Risks of Employment Determinations to Franchise Systems*, 27 FRANCHISE L.J. 224, 224 (2008)). Elmore narrows *Patterson* to the slightest of margins, confining *Patterson*'s "reasoning to employment discrimination laws that adopt vicarious liability standards." Elmore, *supra*, at 1256. Indeed, Elmore sweepingly condemns all laws that rely on the trademark license to shield franchisors from liability as joint employers. *Id.* at 1245–46. Elmore also pays no attention to what Goldman and Weil identify as the *sine qua non* of independent contractor status: the ability to set prices, quality, and service levels and ultimately profits. Goldman & Weil, *supra* note 51, at 111. Indeed, Elmore declines to frame the joint employer inquiry in economic terms as Goldman and Weil do with misclassification. *Id.* As a result, the Goldman and Weil thesis offers Elmore's flawed joint employer presumption absolutely no support.

co-existing factors for a hiring firm to earn the presumption of independent contractor status: the contractor must be able to (1) set prices (either the prices paid by consumers or by the hiring firm to the contractor); and (2) execute customer service standards on its own.⁶⁶ The amendment also should clarify that the presumption is not negated if the hiring firm (i) recommends consumer prices; (ii) engages in brand marketing featuring suggested consumer prices; (iii) sets maximum consumer prices; or (iv) articulates customer service standards without prescribing the means or methods for accomplishing them. When the contractor retains control over these two factors, the proposed amendment would presume that the contractor has economic independence and shift the burden to the plaintiff to rebut the foundational facts.⁶⁷

This proposed amendment would not categorically exempt all franchises, nor would competitors necessarily fare the same way. The goal is to respect the essential characteristics for when a contractor is really in business for itself and overcome the roadblocks presented by California’s ABC law.

66. The devil of any legislative proposal is in articulating its details so that a statute’s application is predictable. The amendment proposed in this article may need additional refinement, but at least it shines a light on a path forward for the profiled business models that, up to now, have found a dead end in California. Which half of the traditional binary divide should receive the statutory presumption—employee vs. independent contractor—is a matter of public policy preference. See 21B CHARLES A. WRIGHT & ARTHUR R. MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 5122 (2d ed. 2021). The party with the burden of proof carries the load. *Id.* § 5222.2.

67. Many states define “independent contractor,” but the author of this article has not found any with a law of general application that focuses on the indices of business independence. Some state laws assign independent contractor status to workers in a specific industry (construction subcontractors (e.g., California), drivers (e.g., Louisiana), and licensed workers (e.g., Oregon)). CAL. LAB. CODE § 2750.5; LA. REV. STAT. § 23:1021; OR. REV. STAT. § 670.660(2). Many states have “marketplace contractor” statutes applicable to on-demand workers. See Robert Sprague, *Using the ABC Test to Classify Workers: End of the Platform-Based Business Model or Status Quo Ante?*, 11 WM. & MARY BUS. L. REV. 733, 746–48 (2020); Robert Sprague, *Are Airbnb Hosts Employees Misclassified as Independent Contractors?*, 59 U. LOUISVILLE L. REV. 63, 69 (2020) (identifying states with “marketplace contractor” laws). At least one state, Indiana, uses the elaborate IRS twenty-factor test of independent contractor status. IND. CODE § 22-3-6-1(b)(7). Florida defines “independent contractor” for purposes of workers’ compensation, but not generally. FLA. STAT. § 440.02(15)(d)(1)(a). Some states use a circular definition of independent contractor (e.g., Alabama, where an independent contractor is someone self-employed that does not meet the definition of employee). ALA. CODE § 25-7-41(a)(2). Prior commentators have offered their own solution for fixing the over-inclusive, hodgepodge legislative approach for defining independent contractor, but their solution fixes the problem for the gig industry, not more generally. Travis Clark, *The Gig Is Up: An Analysis of the Gig-Economy and an Outdated Worker Classification System in Need of Reform*, 19 SEATTLE J. SOC. JUST. 769, 805 (2021); Harris & Krueger, *supra* note 47, at 27.

There is another view. The California legislature should take heed of the criticism leveled at California’s ABC test by two of labor’s biggest supporters and add a presumption of independent contractor status, not merely an exemption, for business-to-business arrangements regardless of the industry they operate in when the contractor possesses the indices of business independence that Goldman and Weil highlight: the ability to control prices and execute customer service standards and thereby to control profitability. After all, what is the use of the current business-to-business exemption from California’s ABC test if, in reality, it protects no one? See *supra* note 6. If the California legislature refuses to add a presumption of independent contractor status, the proposed amendment in this article would work as another exemption to California Labor Code Section 2775.

This proposal, moreover, may prod some business-to-business programs, including franchises, to recalibrate their business models to earn independent contractor status. In the franchise context, such prodding may curb some current franchisor practices that critics argue cannot fairly be defended in the name of protecting the franchise brand.⁶⁸ Franchisors have long justified their extensive controls over franchisee operations by claiming that they must insist on absolute uniformity of operations across businesses with different owners to protect brand goodwill.⁶⁹ This article's proposal for saving the independent contractor model may force some trademark owners to reexamine their contracts, scale back those controls not essential to brand integrity, and give franchisees, distributors, and licensees control over the economic drivers of the brand relationship as a tradeoff for retaining contractor status.⁷⁰

A legislative solution that corrects for the ABC test's over-inclusiveness without attempting categorically to exempt franchisors, the trucking industry, bakery producers, and others like them (something the California legislature refuses to do) may be the most realistic path forward for these groups to save their business models.

VIII. Conclusion

Governments should not keep their thumb on the scale by continuing to pass laws that enshrine traditional models of employment and ignore the

68. See Erin Conway & Caroline Fichter, *Surviving the Tempest: Franchisees in the Brave New World of Joint Employers and \$15 Now*, 35 FRANCHISE L. J. 509, 519–20 (2016). In the context of advising franchisors how to reduce their joint employer liability risks, authors Conway and Fichter point out that the federal Lanham Act does not require a franchisor to control a mark absolutely by leaving a licensee no discretion over their day-to-day operations; it only requires a trademark owner to have “adequate control” over the quality of goods or services offered under the mark.” *Id.* at 519. These authors conclude that franchisors must strike “the right balance” if they want “to expand rapidly and build a strong brand presence across the nation (or even the world)” yet avoid liability for their franchisees’ operations as a joint employer, offering that “[t]his balance will necessarily look different in different types of franchise systems.” *Id.* at 519–20.

69. See, e.g., David J. Kaufmann, Felicia N. Soler, Breton H. Permesly & Dale A. Cohen, *A Franchisor Is Not the Employer of Its Franchisees or Their Employees*, 34 FRANCHISE L.J. 439, 455 (2015) (“[T]he Lanham Act not only fosters the notion of brand uniformity but requires trademark and/or service mark licensors—and every franchisor is a trademark and/or service mark licensor—to impose standards and controls upon their licensees (and every franchisee is a trademark and/or service mark licensee) to ensure that the mark in question serves its intended purpose: uniformity of goods or services of a certain type and quality, uniformity of appearance, and uniformity of operations. Critically . . . if a franchisor (as licensor) does not impose upon franchisees such standards, that franchisor’s trademark (applicable to goods) or service mark (applicable to services) may be deemed abandoned as a matter of law, as it could be viewed as standing for nothing.”).

70. Conway & Fichter, *supra* note 68, at 520 (“Striking this perfect balance may seem an unfair task to assign to franchisors. However, given the advantages provided to franchisors by the very nature of franchising . . . perhaps it is a natural cost of doing business in this manner.”).

needs of a modern economy.⁷¹ Based on California’s experience with Proposition 22, a restless populace is looking for governments to offer a more balanced way to categorize contemporary business arrangements that allow contractors control over their own profitability. An appropriately framed classification test that recognizes the economic realities of what it means to be an independent business would supply well-respected business models a safe haven for continuing to offer opportunities to those who want to be their own boss. In the meantime, however, franchisors, the trucking industry, bakery producers, and others like them utilizing independent contractors have little choice but to do whatever they can to avoid flunking the ABCs.

71. On March 1, 2022, the UC Berkeley Labor Center released a report regarding the role of independent contracting in California’s economy. See Annette Bernhardt et al., *Independent Contracting in California: An Analysis of Trends and Characteristics Using Tax Data*, UC BERKELEY LAB. CTR. (Mar. 1, 2022), <https://laborcenter.berkeley.edu/independent-contracting-in-california>. Studying tax data from 2014 to 2016 (more recent tax data was not available), researchers found that, in 2016, only nine percent of California workers earned a living solely through independent contracting, another nine percent combined a traditional W-2 job with independent contracting, and eighty-two percent earned a living through one or more W-2 jobs. *Id.* Among the more interesting findings: (1) “gig” workers represented less than two percent of all independent contracting in 2016 despite all of the attention they receive from politicians; (2) workers who relied exclusively on independent contracting for their income tended to be older, married, and lived in lower-income households and had low earnings on average compared to W-2 workers; and (3) only nineteen percent of hiring firms issued their contractors 1099 forms, which limited researchers’ analysis. *Id.* Researchers avoided revealing their own bias on whether AB 5 benefits or hurts California’s economy. Instead, they pressed for expanded rigorous research and urged policymakers to use scientific data, not partisan politics, to fashion laws like AB 5, noting “a chronic lack of clarity about independent contracting, affecting policymakers as well as tax authorities.” *Id.*

One certainty about the politically charged topic of the future of independent contracting is that new developments will continue. After this author must put her pen down, new cases will be filed, new legislation will be introduced, and new opinions will be expressed that might shape this author’s views. There will be another chapter in the saga of the risks to businesses of flunking the ABCs.



An Overview of the Rescission Remedy in Canada

Jennifer Dolman & Amanda Arella

Despite the many commonalities between the United States and Canada, Canadian franchise legislation, and judicial decisions interpreting that legislation, create significant differences in franchising obligations between the countries. In particular, Canadian franchise disclosure obligations differ from the required contents of franchise disclosure documents in the United States. The statutory rescission remedy is the main mechanism for ensuring that franchisors fulfill their disclosure obligations, and noncompliance can have considerable consequences.¹



Ms. Dolman



Ms. Arella

This article will explore the statutory rescission remedy in Canada, summarizing recent leading cases and providing an analysis of the judicial developments that have heightened the consequences of noncompliance for franchisors. Part I provides a brief introduction to franchise disclosure obligations in Canada. Part II considers the statutory rescission remedy and analyzes the judicial expansion of this remedy by Ontario's appellate court. Part III discusses how the statutory language and its interpretation by the courts have resulted in a strict liability regime, where franchisors must return the franchisee to its position before entering into the franchise agreement, regardless of any mitigating or aggravating circumstances on the part of the franchisee or the franchisor. Part IV considers procedural issues and practical considerations of rescission litigation in Canada. Part V introduces the

1. Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c 3; Franchises Act, R.S.A. 2000, c F-23; Franchises Act, R.S.P.E.I. 1988, c F-14.1; Franchises Act, R.S.N.B. 2014, c 111; Franchises Act, C.C.S.M. c F156; Franchises Act, S.B.C. 2015, c 35.

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unique statutory concept of the franchisor's associate, which may extend liability to individuals, including officers, directors, shareholders, and landlords in certain situations. Part VI provides an overview of the equitable rescission remedy, which is less frequently used in light of the statutory remedy, but remains available at law in certain circumstances.

One final introductory note: only six of the thirteen Canadian provinces and territories have enacted franchise legislation. The provinces of Alberta, British Columbia, Manitoba, New Brunswick, Ontario, and Prince Edward Island have each enacted their own franchising legislation.² In those provinces, the franchising relationship is governed by the respective provincial act (collectively, the Acts).³ In the unregulated provinces and territories of Quebec, Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, Saskatchewan, and the Yukon, the franchise relationship is governed by either the common law of contract, or the Civil Code in the case of Quebec.⁴

In 2005, the Uniform Law Conference of Canada (ULCC) developed a model Franchises Act and Regulation based on Ontario's Arthur Wishart Act (Franchise Disclosure), 2000 (the Wishart Act).⁵ Alberta, British Columbia, Manitoba, New Brunswick, and Prince Edward Island subsequently developed franchise legislation based on the ULCC model.⁶ Consequently, the six provincial Acts are similar but not identical. Because of these similarities, this article will focus on the franchise disclosure obligations in Ontario's Wishart Act and related jurisprudence, while still highlighting important distinctions between jurisdictions. Nonetheless, even slight nuances in the law between provinces can have significant practical implications, emphasizing the importance of consulting Canadian counsel who are familiar with navigating the different provincial franchising regimes.

I. Introduction to Franchise Disclosure Obligations in Canada

The focus of the Acts and the most significant and onerous obligation that they create is the requirement for a franchisor to prepare and provide a pre-sale franchise disclosure document to prospective franchisees.⁷ Under the Wishart Act, a disclosure document must contain prescribed information, such as financial statements, as well as all "material facts."⁸ The scope of the

2. *Id.*

3. *Id.*

4. OSLER, HOSKIN & HARCOURT LLP, CANADIAN FRANCHISE GUIDE § 2:1 (2017) [hereinafter CANADIAN FRANCHISE GUIDE]. For further discussion of franchising in Quebec, see Andraya Frith, Éric Préfontaine & Gillian Scott, *La Belle Province: A Practical Business Guide to Key Legal Issues When Franchising in Quebec*, 36 FRANCHISE L.J. 303 (2016).

5. CANADIAN FRANCHISE GUIDE, *supra* note 4, § 1:12.

6. *Id.*

7. CANADIAN FRANCHISE GUIDE, *supra* note 4, § 2:10; see also George J. Eydt & Edward Levitt, *The Devil Is in the Details: How Canadian and U.S. Franchise Legislation Differs*, 32 FRANCHISE L.J. 237, 238 (2013).

8. CANADIAN FRANCHISE GUIDE, *supra* note 4, § 4:2.

requirement to include all material facts has, surprisingly, not yet received significant judicial consideration.⁹ The lack of judicial clarity, coupled with extreme penalties for failing to meet disclosure requirements, has led franchisors to adopt a conservative and overinclusive approach to their disclosure in Canada.¹⁰

In addition, unlike the United States, there is no government or administrative agency in Canada that reviews, approves, or provides guidance on a franchisor's disclosure document.¹¹ Furthermore, franchise disclosure documents are not registered in Canada. Thus, franchisors receive no preapproval on the adequacy of their disclosure, and they bear the obligation to satisfy the detailed disclosure requirements set out by the legislation, regulations, and associated jurisprudence. Importantly, franchisors are required to provide a new disclosure document to every prospective franchisee, and judicial interpretation of disclosure requirements demonstrates that disclosure documents must be customized to include facts specific to the particular franchise that is the focus of the disclosure.¹² Consequently, disclosure in Canada is much more fluid and ongoing than in the United States. In the authors' experience, franchisors preparing Ontario disclosure documents rely heavily on franchise counsel, rather than regulatory approval, to ensure that their form of disclosure is sufficient.

II. The Statutory Rescission Remedy and Its Interpretation by the Courts

Canadian courts have held that franchise legislation, including the Wishart Act, is a form of remedial legislation, akin to consumer protection legislation designed to address the power imbalance between franchisees and franchisors.¹³ The primary way this power imbalance is addressed is by imposing detailed and prescriptive requirements on franchisors to disclose certain material information to franchisees before they enter into a franchise agreement.¹⁴ This way, the franchisee is duly informed before making what is

9. David Kornhauser, *Materiality in Franchise Disclosure: An Analysis of How "Material Facts" Have Been Interpreted Under Other Legislation*, 53 ALBERTA L. REV. 115, 116 (2015).

10. CANADIAN FRANCHISE GUIDE, *supra* note 4, § 4:2.

11. *Id.* § 4:1.

12. See Andraya Frith, Judy Rost & Larry Weinberg, *Canadian Fundamentals of Franchising*, A.B.A. 40TH ANN. FORUM ON FRANCHISING W-23, at 20 (2017).

13. See, e.g., 2122994 Ontario Inc. v. Lettieri, 2016 ONSC 6209, ¶ 59 (Can. Ont.), *aff'd*, 2017 ONCA 830 (Can. Ont.); 2240802 Ontario Inc. v. Springdale Pizza Depot Ltd., 2015 ONCA 236, ¶ 5 (Can. Ont.). For a view that this purpose has been judicially constructed, see Peter Dillion, *Canada: It's Like Watching a Car Crash in Slow Motion*, 37 FRANCHISE L.J. 265, 284-87 (2017).

14. See 2619506 Ontario Inc. v. 2082100 Ontario Inc., 2021 ONCA 702, ¶ 7 (Can. Ont.); see also Mendoza v. Active Tire & Auto Inc., 2017 ONCA 471, ¶¶ 13, 26 (Can. Ont.); Salah v. Timothy's Coffees of the World Inc., 2010 ONCA 673, ¶ 26 (Can. Ont.); 6792341 Canada Inc. v. Dollar It Ltd., 2009 ONCA 385, ¶ 13 (Can. Ont.). See generally Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c 3, § 5, which provides the franchisor's obligation to disclose, discussed in Part I of this paper.

typically a significant and long-term investment. Unlike in the United States where there is regulatory oversight of the franchisor's disclosure document, the Acts do not provide a regulatory regime. Rather, franchisees are provided private rights of action to pursue statutory remedies.¹⁵ Rescission is one such right of action.¹⁶

Under the Acts, a franchisee is provided two timelines for rescission, depending on the deficiency of the disclosure by the franchisor. First, a franchisee may rescind the franchise agreement no later than sixty days after receiving the disclosure document if the franchisor fails to provide the disclosure document or a statement of material change within the time requirements of the legislation, or the contents of the disclosure document do not meet the requirements of the legislation.¹⁷ Second, a franchisee may rescind the franchise agreement within two years after entering into the agreement if the franchisor never provided a disclosure document.¹⁸

A. *Judicial Expansion of the Two-Year Rescission Remedy*

In Ontario, the courts have expanded the two-year rescission remedy beyond the black-letter text of the legislation to situations where a disclosure document is so materially deficient as to amount to no disclosure at all. A series of decisions from the Ontario Court of Appeal, the province's highest appellate-level court, held that the test for assessing material deficiency of disclosure documents is an objective standard that must be determined on the facts of each case.

In *6792341 Canada Inc. v. Dollar It Ltd.*, the Ontario Court of Appeal considered the interplay between the sixty-day and two-year rescission remedies.¹⁹ In this case, the franchisor delivered a disclosure document that lacked material information, including financial statements or a balance sheet, a certificate from the franchisor certifying the disclosure document was complete and accurate, and any details or a copy of the lease or offer to lease. The judge at first instance found that because a disclosure document was delivered, regardless of deficiencies with disclosure, the franchisees were limited to rescinding the franchise agreement within the sixty-day window. The Court of Appeal overturned this decision. In so doing, the Court of Appeal took a purposive approach to interpreting the Wishart Act and explained that a narrow or formalistic interpretation of either the disclosure

15. CANADIAN FRANCHISE GUIDE, *supra* note 4, § 2.17.

16. In Ontario, there is also a right of action for misrepresentation and failure to disclose. Although a claim may be outside a statutory rescission period, if a franchisee has a right of action, they may still bring a claim for damages. For a more detailed discussion on this right of action, see CANADIAN FRANCHISE GUIDE, *supra* note 4, § 2.18.

17. Arthur Wishart Act (Franchise Disclosure), § 6(1); Franchises Act, R.S.A. 2000, c F-23, § 13(a); Franchises Act, R.S.P.E.I. 1988, c F-14.1, § 6(1); Franchises Act, R.S.N.B. 2014, c 111, § 6(1); Franchises Act, C.C.S.M. c F156, § 6(1); Franchises Act, S.B.C. 2015, c 35, § 6(1).

18. Arthur Wishart Act (Franchise Disclosure), § 6(2); Franchises Act, R.S.A. 2000, c F-23, § 13(b); Franchises Act, R.S.P.E.I. 1988, c F-14.1, § 6(2); Franchises Act, R.S.N.B. 2014, c 111, § 6(2); Franchises Act, C.C.S.M. c F156, § 6(2); Franchises Act, S.B.C. 2015, c 35, § 6(2).

19. *6792341 Canada Inc. v. Dollar It Ltd.*, 2009 ONCA 385 (Can. Ont.).

requirements or the penalties for nondisclosure would be contrary to the purpose of the Wishart Act, which is to “protect the interest of franchisees.”²⁰ The Court of Appeal stated plainly that “calling something a disclosure document doesn’t make it one.”²¹ The franchisees were not provided with a document that enabled them to make an informed decision whether to enter into the franchise agreement.²² In the circumstances where the disclosure document contained many material deficiencies, the Court of Appeal found that the “only reasonable conclusion” was that the franchisor never provided a disclosure document, engaging the two-year rescission period.²³

The Court of Appeal affirmed its *Dollar It* reasoning in *Mendoza v. Active Tire & Auto Centre Inc.*²⁴ The franchisor failed to provide a certificate that the disclosure document was complete and accurate, the certificate did not have the requisite two signatures of directors or officers of the franchisor, and the financial statements were not in compliance with the Wishart Act. Both the first level and appellate courts agreed that these deficiencies were the most significant in the disclosure document, but diverged on whether they represented material deficiencies. Whereas the judge at first instance found these deficiencies to be insignificant, the Court of Appeal held that they were fatal deficiencies such that the disclosure document did not fall within the requirements of the Wishart Act and the two-year rescission remedy was engaged.²⁵ The test to determine whether the two-year rescission remedy is triggered rests on whether the disclosure document is materially deficient and is not conditioned on the actions or reactions of a franchisee to the disclosure document. The Court of Appeal emphasized that whether or not a franchisee has scrutinized a disclosure document before entering into the franchise agreement, they “are entitled to rely on its contents and the ability to later verify what they believed and understood when they decided to proceed with the franchise.”²⁶ The Court of Appeal’s judgment in *Mendoza* made clear that the test for evaluating the adequacy of disclosure (and therefore determining the availability of the rescission remedy) is strictly objective.

The following year, the Court of Appeal issued *Raibex Canada Ltd. v. ASWR Franchising Corp.*²⁷ In that case the court emphasized that rescission is an “extraordinary remedy” under the Wishart Act.²⁸ In light of this

20. *Id.* ¶ 12.

21. *Id.* ¶ 75.

22. *Id.* ¶ 20.

23. *Id.* ¶ 76.

24. *Mendoza v. Active Tire & Auto Centre Inc.*, 2017 ONCA 471 (Can. Ont.). For an overview of Canadian appellate court decisions on franchising, see Jennifer Dolman & Jean-Marc Leclerc, *The Last Word on Franchise Law: Lessons for Businesses Arising from Canadian Appellate Court Decisions*, CFA LAW DAY (2017), <https://cfa.ca/wp-content/uploads/2017/09/Jennifer-Jean-CFA-Law-Day-2017.pdf>.

25. *Mendoza*, 2017 ONCA 471, ¶¶ 20–21 (Can. Ont.).

26. *Id.* ¶ 26.

27. *Raibex Canada Ltd. v. ASWR Franchising Corp.* 2018 ONCA 62 (Can. Ont.).

28. *Id.* ¶ 42.

determination, the sixty-day and two-year rescission remedies must not be conflated. The Court of Appeal clarified that the Wishart Act makes an “important legislative distinction” between situations where a franchisor provides imperfect disclosure and situations where a franchisor provides no disclosure.²⁹ Only the latter gives rise to the two-year window for rescission.³⁰ The franchisee therefore must demonstrate not merely that a disclosure document is deficient, but so deficient that the franchisor effectively never provided a disclosure document.³¹ Whether deficiencies give rise to the two-year rescission remedy is a context-specific inquiry determined on the specific facts of every case.³²

The Court of Appeal’s decision in *Raibex* signaled an important step toward a more balanced approach to the rescission remedy. On the one hand, franchisors must meet an objective standard of adequate disclosure, effectively barring any potential defenses based on a lack of prejudice to a particular franchisee. Indeed, in her text *Franchise Law in Canada*, Stephanie Sugar commented that “[t]he right of rescission is absolute; it is not based on the particularities of any given franchise, is not conditional on the conduct of any particular franchisee, and it is no defence to rescission that a franchisee may not have read the disclosure.”³³ On the other hand, franchisors may take comfort in the knowledge that a deficiency in their disclosure document does not automatically render the disclosure null; the deficiency must be sufficiently material for the two-year remedy to be engaged. This approach to the two-year rescission remedy is consistent with the Court of Appeal’s frequently cited statement that “a fair interpretation of the [Wishart] Act is one that balances the rights of both franchisees and franchisors.”³⁴

Raibex provided welcome clarity to franchise law practitioners. In the wake of the early rescission cases decided under the Wishart Act, franchisor counsel expressed concerns about a lack of clarity regarding the test to determine whether the two-year rescission remedy is engaged.³⁵ Commentators also cautioned that the case law had created a regime where the consequences of even small omissions in disclosure had a disproportionate impact on franchisors and a potentially chilling effect on franchise business.³⁶

Furthermore, *Raibex* highlighted the importance of scrutinizing the disclosure provided in the specific context of the facts of the case to appropriately

29. *Id.* ¶ 57.

30. *Id.* ¶ 57.

31. *Id.* ¶ 40.

32. *Id.* ¶ 49.

33. STEPHANIE SUGAR, *FRANCHISE LAW IN CANADA* 177 (2019).

34. 4287975 *Canada Inc. v. Imvescor Rests. Inc.*, 2009 ONCA 308, ¶ 40 (Can. Ont.).

35. See, e.g., Frank Zaid, Jennifer Dolman & Andraya Frith, *Ontario’s Franchise Legislation: Lessons Learned in the First Decade and What’s Ahead for the Future*, 29 *FRANCHISE L.J.* 63, 64 (2009).

36. See, e.g., Peter Dillion, *Canada: It’s Like Watching a Car Crash in Slow Motion*, 37 *FRANCHISE L.J.* 265, 291 (2017); Adam Ship, *Strict Liability and Statutory Rescission of Franchise Agreements in the Ontario Court of Appeal*, 52 *CAN. BUS. L.J.* 287, 299 (2012).

distinguish between imperfect and effectively nonexistent disclosure.³⁷ In one of the first lower court decisions to consider *Raibex, 1680960 Ontario Inc. v. Print Three Franchising Corp.*, the Ontario Superior Court declined to grant a motion for summary judgment in a rescission case.³⁸ The court held that the Court of Appeal's decision in *Raibex* made clear that the facts of the case are very important to the determination of the main issue in the case: whether the franchisee was deprived of the opportunity to make an informed investment decision.³⁹ Much of the evidence regarding what was provided to the franchisee was in dispute, including the extent to which the franchisee was given financial documents, a copy of the head lease, an amendment to the head lease, and the agreement of purchase and sale.⁴⁰ The court determined that it would not be possible to arrive at a fair and just decision given that so much of the relevant evidence was in dispute and that a full trial was required.⁴¹

Following its decision in *Raibex*, the Court of Appeal held that determining whether a franchisee is able to make an informed investment decision is a question of mixed fact and law, which attracts the “palpable and overriding error” standard of review.⁴² As such, any finding of fact made by the judge at first instance related to the adequacy of disclosure will attract appellate deference. In *2619506 Ontario Inc. v. 2082100 Ontario Inc.*, the Court of Appeal upheld the motion judge's finding that the absence of recent financial information rendered the disclosure document so deficient as to amount to no disclosure at all.⁴³ In light of this ruling, the factual record of the case is an increasingly important consideration for determining whether a franchisee can invoke the two-year rescission remedy.

B. Delivering a Notice of Rescission

From a practical standpoint, it is rare for franchisees to seek either legal assistance or rescission within sixty days of receiving the disclosure document, and thus the only option for most franchisees is to determine whether their claim may fit within the two-year rescission remedy.⁴⁴ Where a claim is past the two-year window, it will not be considered by the courts as it is “plain and obvious” that the claim cannot succeed.⁴⁵ Interestingly, the action which “starts the clock” on the time period for rescission varies between the sixty-day and two-year rescission remedies. The period for the sixty-day

37. *Raibex Canada Ltd. v. ASWR Franchising Corp.*, 2018 ONCA 62, ¶¶ 46–48 (Can. Ont.).

38. *Raibex, 1680960 Ontario Inc. v. Print Three Franchising Corp.*, 2018 ONSC 1192, ¶ 28 (Can. Ont.).

39. *Id.* ¶ 23.

40. *Id.* ¶¶ 13–14, 22.

41. *Id.* ¶¶ 27–29.

42. *2619506 Ontario Inc. v. 2082100 Ontario Inc.*, 2021 ONCA 702, ¶ 6 (Can. Ont.).

43. *Id.* ¶ 9.

44. Jean-Marc Leclerc, *Litigating Franchise Disputes—The Rescission Remedy*, 4TH ANN. BUS. L. SUMMIT (2014).

45. *2176693 Ontario Ltd. v. Cora Franchise Group Inc.*, 2012 ONCA 477, ¶ 1 (Can. Ont.); see also SUGAR, *supra* note 33, at 181.

rescission remedy begins from the date that disclosure is provided to the franchisee, whereas the period for the two-year rescission remedy begins from the date the agreement was signed.⁴⁶ This is consistent with the distinct purposes of the two rescission remedies, and an important reason not to conflate them. The sixty-day rescission remedy cures instances where the franchisor failed to meet the timing or contents of the disclosure requirement in the Wishart Act by providing a period of approximately two months during which a franchisee can review the disclosure document and determine whether to rescind a binding franchise agreement.⁴⁷ In contrast, the two-year rescission remedy is intended to cure the failure of the franchisor to provide a disclosure document.⁴⁸

In *4287975 Canada Inc. v. Imvescor Restaurants Inc.*, the Ontario Court of Appeal considered the question of whether a franchisee who signed a franchise agreement more than sixty days after receiving a compliant disclosure document has the right to rescind under the two-year rescission remedy.⁴⁹ The Court of Appeal concluded that where a franchisee has been provided a fully compliant disclosure document more than sixty days in advance of signing the franchise agreement, the purpose of the sixty-day rescission remedy has been fulfilled.⁵⁰ The franchisee was provided with the time to consider all the necessary information before making a significant and long-term investment.⁵¹ As such, unless the disclosure document was materially deficient, the franchisees would not be entitled to the two-year rescission remedy, notwithstanding there was no franchise agreement to rescind during the sixty-day period.

For both the sixty-day and two-year rescission remedies, the franchisee must give clear notice of their intention to rescind the franchise agreement through a notice of rescission. The Acts provide that a notice of rescission must be in writing and delivered to the franchisor.⁵² The notice must make it clear to the franchisor that the franchisee is exercising its statutory right of rescission (as opposed to equitable rescission) and must inform the franchisor that the time period in which the franchisor must fulfill its significant obligations to compensate the franchisee has begun.⁵³ Beyond these minimal requirements, a franchisee does not have to fulfill any other prerequisites to rescind the franchise agreement. Indeed, the Court of Appeal has recently

46. See SUGAR, *supra* note 33, at 181.

47. *4287975 Canada Inc. v. Imvescor Rests. Inc.*, 2009 ONCA 308, ¶ 32 (Can. Ont.).

48. *Id.* ¶¶ 37–41.

49. *Id.*

50. *Id.* ¶ 39.

51. *Id.*

52. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c 3, § 6(3); Franchises Act, R.S.P.E.I. 1988, c F-14.1, § 6(3); Franchises Act, R.S.N.B. 2014, c 111, § 6(3); Franchises Act, C.C.S.M. c F156, § 6(3); Franchises Act, S.B.C. 2015, c 35, § 6(3). Note that the Alberta Franchises Act specified only that the notice must be given to the franchisor or its associate. Franchises Act, R.S.A. 2000, c F-23, § 13.

53. *779975 Ontario Ltd. v. Mmmuffins Canada Corp.*, [2009] O.J. No. 2357, ¶ 45 (Can. Ont. S.C.).

gone so far as to permit a pleading to be considered a notice of rescission. In *2352392 Ontario Inc. v. Msi*, the Court of Appeal emphasized the remedial purpose of the Wishart Act, holding that “to preclude a franchisee from using a pleading to provide notice of rescission to a franchisor . . . would be to favour form over substance and create a barrier to enforcement of the rights of franchisees.”⁵⁴ Nonetheless, the Court of Appeal commented that delivering a written notice of rescission before a pleading is the “normal and preferable procedure.”⁵⁵ The Court of Appeal’s decision in *Msi* indicates that unless a franchisor has been prejudiced by a deficiency in a notice of rescission, procedural or technical irregularities will be unlikely to bar franchisees from pursuing rescission claims.⁵⁶

III. The Imposition of a “Strict Liability” Regime

A. Damages Flowing from the Rescission Remedy

The rescission provisions are at the core of the remedial purpose of the statutory franchise regime in Canada. If properly invoked, the remedy imposes “sweeping obligations” that carry “extraordinary consequences,” particularly for franchisors.⁵⁷ Rescission is a draconian remedy, principally requiring the franchisor to “pay back what the franchisee paid.”⁵⁸ In Ontario, the courts have found that the Wishart Act imposes “dramatic financial consequences on franchisors” for not complying with their disclosure obligations.⁵⁹

Once notice of rescission is provided to the franchisor, certain obligations upon the franchisor are automatically triggered. For example, subsection 6(6) of the Wishart Act provides that within sixty days of the date in which the notice of rescission is effective, the franchisor *shall*:

- (a) refund to the franchisee any money received from or on behalf of the franchisee, other than money for inventory, supplies or equipment;
- (b) purchase from the franchisee any inventory that the franchisee had purchased pursuant to the franchise agreement and remaining at the effective date of rescission, at a price equal to the purchase price paid by the franchisee;

54. *2352392 Ontario Inc. v. Msi*, 2020 ONCA 237, ¶ 12 (Can. Ont.). Osler, Hoskin & Harcourt LLP represented the respondents, The Works Gourmet Burger Bistro Inc., The Works Realty Corp., Fresh Brands Inc., Andrew O’Brien aka Thomas Andrew O’Brien, Sean Bell, and David Wilson.

55. *Id.* ¶ 15.

56. Rory McGovern & Daniel Freiheit, *When Is a Notice of Rescission a Notice of Rescission?*, ONTARIO BAR ASS’N, FRANCHISE L. SEC. (July 30, 2020), <https://www.oba.org/Sections/Franchise-Law/Articles/Articles-2020/July-2020/When-is-a-Notice-of-Rescission-a-Notice-of-Resciss?lang=en-ca>.

57. *4287975 Canada Inc. v. Imvescor Rests. Inc.*, 2009 ONCA 308, ¶ 25 (Can. Ont.).

58. *2122994 Ontario Inc. v. Lettieri*, 2017 ONCA 830, ¶ 5 (Can. Ont.).

59. *779975 Ontario Limited v. Mmmuffins Canada Corp.*, 2009 CanLII 28893, ¶ 30 (Can. Ont. S.C.).

(c) purchase from the franchisee any supplies and equipment that the franchisee had purchased pursuant to the franchise agreement, at a price equal to the purchase price paid by the franchisee; and

(d) compensate the franchisee for any losses that the franchisee incurred in acquiring, setting up and operating the franchise, less the amounts set out in clauses (a) to (c).⁶⁰

Subsections 6(6)(a) to (d) prescribe the specific steps a franchisor must take, which are intended to put the franchisee back into the position that it would have been in had it not entered into the franchise agreement. There have been few reported decisions that address the categorization and quantification of refunds, repurchases, and compensation paid to franchisees under subsection 6(6).⁶¹ Nonetheless, a plain reading of subsections 6(6)(a) to (d) reveals that franchisors have significant financial exposure on rescission.⁶² However, particularly when seeking compensation for losses under section 6(6)(d), franchisees must provide evidence that proves their losses, and cannot claim “ballpark” or “speculative” losses.⁶³ Notably, the British Columbia Franchises Act is unique among Canadian franchise legislation in that it has a provision expressly preventing the double counting by a franchisee who rescinds a franchise agreement while also bringing an action for damages.⁶⁴

Where the rescission remedy is properly invoked, there is no discretion provided to the franchisor under the statutory regime. Just as the franchisee does not need to demonstrate that it relied on a disclosure document, it is not required to prove any fault on the part of the franchisor or the franchisor’s associate.⁶⁵ Nor can the franchisor avoid fulfilling its obligations under the remedy by raising issues with the conduct of the franchisee.⁶⁶ The franchisor has no equitable defenses. Furthermore, the remedy remains available to sophisticated franchisees who have legal counsel.⁶⁷ The rescission remedy has therefore been described as creating a regime akin to strict liability.⁶⁸ The Ontario Superior Court has stated that adopting a fault-based approach

60. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c 3, § 6(6). Franchisors in Alberta must fulfill these obligations within thirty days and, as discussed in greater detail below, must only compensate franchisees for net losses. See Franchises Act, R.S.A. 2000, c F-23, § 14(2).

61. For a categorization of expenses falling under each subsection, as well as an overview of common quantification errors, see Ephraim Stulberg & Jonathan Mesiano-Crookston, *Rescission Under the Ontario Arthur Wishart Act: Quantifying the Remedy*, 33 FRANCHISE L.J. 33, 235 (2013); see also CANADIAN FRANCHISE GUIDE, *supra* note 4, § 28:17 (quantifying rescission claims under Section 6(6) of the Arthur Wishart Act (Franchise Disclosure), 2000).

62. CANADIAN FRANCHISE GUIDE, *supra* note 4, § 2.20.

63. 2189205 Ontario Inc. v. Springdale Pizza Depot Ltd., 2012 ONSC 3344 (Can. Ont.), *aff’d*, 2013 ONCA 626 (Can. Ont.).

64. Franchises Act, S.B.C. 2015, c 35, § 11(3).

65. See SUGAR, *supra* note 33, at 176.

66. Personal Service Coffee Corp. v. Beer, 2005 CanLII 25180, ¶ 34 (Can. Ont. C.A.). In this case, the franchisee began operating a competing business on the same day he delivered notices of rescission to the franchisor. The court held that if the franchisor has a complaint about the conduct of the franchisee, it must bring a claim under sections 3 (fair dealing) or 9 (no derogation of other rights) of the Wishart Act. See *id.* ¶ 35.

67. Mendoza v. Active Tire & Auto Inc., 2017 ONCA 471, ¶ 18 (Can. Ont.).

68. Ship, *supra* note 36, at 296.

to liability would frustrate the purpose of the Wishart Act, which is to protect franchisees from inadequate or inaccurate disclosure and provide them with a right of action in the event they are victims of such.⁶⁹

In Ontario, the courts have held that the rescission remedy is available even to a profitable franchisee. In *2189205 Ontario Inc. v. Springdale Pizza Depot Ltd.*, the franchisees operated a Pizza Depot franchise and earned a net profit of \$8,314.48 prior to rescinding the franchise agreement.⁷⁰ The defendants, including the franchisor, argued that this amount should be set off against the amounts owing to the franchisees under subsection 6(6). The court rejected this argument, emphasizing that “[t]he amounts under ss. 6(6)(a)–(c) are payable to the rescinding franchisee regardless of revenue earned and they are specifically exempted from subsection 6(6)(d) to prevent double counting.”⁷¹ A rescinding franchisee is therefore entitled to recover all amounts under subsections 6(6)(a) to 6(6)(c), even where it has made a profit. The only difference in the application of section 6(6) to profitable franchisees is that they are not compensated under subsections 6(6)(d) for their losses.

In addition, the Court of Appeal in *2122994 Ontario Inc. v. Lettieri* determined that a franchisee is entitled to a refund of all amounts paid to the franchisor, regardless of the sources of the funds.⁷² In *Lettieri*, the franchisor was appealing the decision of the trial judge that the franchisor must refund the franchisee the cost of \$163,000 made in leasehold improvements under section 6(6)(a) of the Wishart Act.⁷³ On appeal, the franchisor claimed that the franchisee received a bank loan to fund the costs of the leasehold improvement made to the property, the bank had a judgment in excess of \$300,000 against the franchisee, and an arrangement had been made between the bank and the franchisee regarding this judgment.⁷⁴ The franchisor argued that the trial judge erred by not permitting the franchisor to cross-examine the franchisee about its arrangement with the bank, and not permitting the franchisor to inform the court of the existence of the arrangement.⁷⁵ The Court of Appeal rejected the franchisor’s submissions, holding that the arrangement between the franchisee and the bank are “irrelevant to this issue between the franchisor and franchisee.”⁷⁶ The Court of Appeal emphasized that the franchisee has a statutory entitlement based on the Wishart Act, and the legislative language is clear: whatever was paid by the franchisee must be refunded by the franchisor.⁷⁷ The Court of Appeal’s decision in *Lettieri* is further

69. *Sovereignty Inv. Holdings, Inc. v. 9127-6907 Quebec Inc.*, [2008] O.J. No. 4450 (QL), ¶ 56 (Can. Ont. S.C.).

70. *2189205 Ontario Inc. v. Springdale Pizza Depot Ltd.*, 2013 ONSC 1232, ¶ 25 (Can. Ont.).

71. *Id.* ¶ 29.

72. *2122994 Ontario Inc. v. Lettieri*, 2017 ONCA 830 (Can. Ont.).

73. *Id.* ¶ 1.

74. *Id.* ¶ 2.

75. *Id.* ¶ 1.

76. *Id.* ¶ 3.

77. *Id.* ¶¶ 4–5.

demonstration that the *Wishart Act* operates as a strict liability regime—the effect of subsection 6(6) is to ensure that the franchisor does not retain any money provided by the franchisee, even where it may result in a windfall to the franchisee.

The regime created by subsection 6(6) of the *Wishart Act* varies significantly from the requirements of the *Alberta Franchises Act*, where franchisors must only compensate rescinding franchisees for net losses. Subsection 14(2) provides that:

(2) The franchisor or its associate, as the case may be, must, within 30 days after receiving a notice of cancellation under section 13, compensate the franchisee for any net losses that the franchisee has incurred in acquiring, setting up and operating the franchised business.⁷⁸

In *1777453 Alberta Ltd. v. Got Mold Disaster Recovery Services Inc.*, the Alberta Court of Appeal held that net losses are to be calculated as the difference between the revenue generated by the franchisee during the pendency of the franchise agreement and the expenses incurred to acquire, set up and operate the franchised business during that same period of time.⁷⁹ Interestingly, the Alberta Court of Appeal described this calculation as returning a franchisee to the financial position that it was in before entering into the franchise agreement.⁸⁰ The varied approaches under the franchise legislation in these two provinces demonstrate that both the Ontario and Alberta legislature and courts have a different theoretical understanding of how the principle of returning a franchisee to its pre-franchise state is applied.

B. Fatal Flaws to Disclosure Documents

A further indication that the statutory rescission remedy has developed into a strict liability regime is the existence of categories of deficiencies in disclosure that will automatically trigger the two-year rescission remedy. Indeed, courts in Ontario have recently begun to describe these as “fatal flaws,” justifying rescission under the two-year rescission remedy.⁸¹ Where these fatal flaws exist, a franchisee is deemed to have never received a disclosure document, and it is unlikely a court would find that a franchisee made an informed investment decision. Moreover, franchisees are not required to demonstrate, or even allege, that their ability to make an informed investment decision was compromised.⁸² The categories of fatal flaws are irregularities with the fran-

78. *Franchises Act*, R.S.A. 2000, c F-23, § 14(2).

79. *1777453 Alberta Ltd. v. Got Mold Disaster Recovery Servs. Inc.*, 2021 ABCA 9, ¶ 28 (Can. Alta.).

80. *Id.*

81. See *2611707 Ontario Inc. v. Freshly Squeezed Franchise Juice Corp.*, 2021 ONSC 2323, ¶ 43 (Can. Ont.); *2364562 Ontario Ltd. v. Yogurtworld Enters. Inc.*, 2021 ONSC 5112, ¶ 37 (Can. Ont. S.C.). Osler, Hoskin & Harcourt LLP represented the defendant Yogurtworld Enterprises Inc. in that case.

82. *2483038 Ontario Inc. v. 2082100 Ontario Inc.*, [2020] O.J. No. 580 (QL), ¶¶ 23, 37–38 (Can. Ont. S.C.).

chisor's certificate, noncompliant financial statements, piecemeal disclosure, and insufficient or improper location-specific disclosure.⁸³

(i) Irregularities with the Franchisor's Certificate

The requirement of a franchisor's certificate fulfills an important policy objective consistent with the objective of the Wishart Act as remedial legislation. The purpose of this requirement is to make clear to the individual or individuals signing the disclosure certificate that it is not merely a formality—the signatories have a personal responsibility to ensure that the disclosure document is complete and accurate, and they may be sued personally.⁸⁴ Early cases decided by both the Alberta and Ontario Courts of Appeal held that a certificate missing the requisite amount of signatures could, on its own, be sufficient to render the disclosure document effectively nonexistent.⁸⁵

An unsigned certificate continues to be a fatal flaw following the *Raibex* decision.⁸⁶ In *2483038 Ontario Inc. v. 2082100 Ontario Inc.*, the franchisor, who operated the Fit for Life franchise system, delivered a disclosure document to the franchisee with an unsigned certificate of disclosure.⁸⁷ The defendants in this case argued that *Raibex* requires the franchisee to demonstrate the impact of the disclosure deficiency.⁸⁸ The court rejected this argument, finding that this line of reasoning would shift the onus of the Wishart Act in a way that undermines its purpose.⁸⁹ The court went on to hold that *Raibex* does not explicitly or implicitly overrule earlier cases that have held that a deficient disclosure certificate is a fatal defect that can engage the two-year rescission remedy.⁹⁰

In a case released last year, the Ontario Superior Court signaled that retroactive amendments may cure deficiencies with the franchisor's certificate. In *2611707 Ontario Inc. v. Freshly Squeezed Franchise Juice Corp.*, the franchisee alleged multiple grounds giving rise to the two-year rescission remedy, including that the franchisor's certificate did not contain the requisite number of signatures.⁹¹ Under the Wishart Act, where a franchisor is

83. CANADIAN FRANCHISE GUIDE, *supra* note 4, §2.20; SUGAR, *supra* note 33, at 129–30.

84. *New Vision Renaissance MX Ltd. v. Symposium Café Inc.*, 2020 ONSC 1119, ¶ 106 (Can. Ont.); *see also* *Mendoza v. Active Tire & Auto Inc.*, 2017 ONCA 471, ¶¶ 20–21, 23–24 (Can. Ont.); *6792341 Canada Inc. v. Dollar It Ltd.*, 2009 ONCA 385, ¶ 32 (Can. Ont.); *Hi Hotel Ltd. P'ship v. Holiday Hosp. Franchising Inc.*, 2007 ABQB 686, ¶¶ 59, 69–71, 77–78 (Can. Alta.), *aff'd*, 2008 ABCA 276 (Can. Alta.). Osler, Hoskin & Harcourt represented the defendant/plaintiff by counterclaim, *Holiday Hospitality Franchising Inc.*, in the *Hi Hotel* matter.

85. *6792341 Canada Inc.*, 2009 ONCA 385, ¶ 32; *Hi Hotel*, 2008 ABCA 686, ¶ 135.

86. *Raibex Canada Ltd. v. ASWR Franchising Corp.*, 2018 ONCA 62 (Can. Ont.).

87. *2483038 Ontario Inc. v. 2082100 Ontario Inc.*, 2020 ONSC 475, ¶¶ 16, 42 (Can. Ont. S.C.). For a detailed summary and analysis of this case, see Jennifer Pocock, Sakshi Pachisia & David Kornhauser, *Fit for Rescission?*, ONTARIO BAR ASS'N, FRANCHISE L. SEC. (May 13, 2020), <https://www.oba.org/Sections/Franchise-Law/Articles/Articles-2020/May-2020/Fit-for-Rescission>.

88. *Id.* ¶¶ 35–36.

89. *Id.* ¶¶ 36, 38.

90. *Id.* ¶ 40.

91. *611707 Ontario Inc. v. Freshly Squeezed Franchise Juice Corp.*, 2021 ONSC 2323 (Can. Ont.). For a detailed summary and analysis of this case, see Jennifer Dolman, Amanda

incorporated and had more than one office or director, two signatures were required.⁹² The court found that the second director had resigned in September 2014, but his name had been left on the franchisor's corporate profile register through inadvertence. The court accepted that a Notice of Change dated September 11, 2020, rectified the error retroactive to September 3, 2014, as well as a contemporaneous letter of resignation from the second director. The certificate was therefore properly signed by the sole director and officer of the franchisor.⁹³

(ii) Noncompliant Financial Statements

It is perhaps unsurprising, given that the purpose of the disclosure requirement in the Acts is to allow the franchisee to make an informed investment decision, that incomplete or inaccurate financial statements are considered a fatal flaw. The Acts, as well as the regulations enacted under the Acts, prescribe financial disclosure, including, with some limited exceptions, the financial statements for the most recently completed fiscal year of the franchisor's regulations.⁹⁴ As evidenced by the two cases discussed below, the requirement for complete and timely financial disclosure has been interpreted strictly by the courts, who view financial statements as a "vital piece of information for potential franchisees."⁹⁵

In *Mendoza*, the Ontario Court of Appeal held that financial statements delivered two weeks after the statutory time frame for delivery was a deficiency giving rise to the two-year rescission remedy.⁹⁶ The Court of Appeal took a strict view of the statutory requirement, stating that if a franchisor is unable to deliver financial statements within the applicable timeframe, it is not in a position to operate a franchise system or interact with prospective franchisee in compliance with the Wishart Act.⁹⁷

In *Freshly Squeezed*, the Ontario Superior Court found that the financial statements included in the disclosure document were materially deficient because they did not include the auditor's notes referred to in certain line items.⁹⁸ The court emphasized that financial statements are "fundamentally

Arella & Andraya Frith, *Ontario Court 'Puts the Squeeze' on Franchisors and Their Disclosure Documents*, OSLER (May 20, 2021), <https://www.osler.com/en/resources/regulations/2021/ontario-court-puts-the-squeeze-on-franchisors-and-their-disclosure-documents>.

92. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c 3, § 5(4)(a).

93. *2611707 Ontario Inc.*, 2021 ONSC 2323, ¶¶ 48–54.

94. See e.g., General, O. Reg. 581/00, §§ 3, 4 (Can.). If 180 days have not passed since the end of the most recently completed fiscal year and financial statements have not been prepared and reported for that year, the disclosure document may include financial statements for the franchisor's previous fiscal year. If the franchisor has operated for less than one fiscal year or if 180 days have not yet passed since the end of the first fiscal year of operations and financial statements for that year have not been prepared, the disclosure document must include the opening balance sheet for the franchisor.

95. *2619506 Ontario Inc. v. 2082100 Ontario Inc.*, 2020 ONSC 6817, ¶ 23 (Can. Ont.).

96. *Mendoza v. Active Tire & Auto Inc.*, 2017 ONCA 471, ¶¶ 30–39 (Can. Ont.).

97. *Id.* ¶ 24.

98. *2611707 Ontario Inc.*, 2021 ONSC 2323, ¶¶ 55, 65. The franchisor has appealed this decision.

important” to franchisees, who need a complete financial picture of the franchisor’s business in order to make an informed investment decision.⁹⁹ The fact that the financial notes were referred to in the financial statements, but not themselves included, was sufficient to render the franchisor’s financial statements disclosure incomplete and noncompliant.¹⁰⁰ The court held that the failure to disclose a complete version of the financial statements in the disclosure document is a fatal flaw.¹⁰¹

(iii) Piecemeal Disclosure

In one of the first statutory rescission cases, the Ontario Court of Appeal held that piecemeal disclosure (i.e., not providing disclosure in a single document at one time) is a fatal flaw giving rise to the two-year rescission remedy. In *1490664 Ontario Ltd. v. Dig this Garden Retailers Ltd.*, disclosure was provided to the franchisee through a series of documents over a period of six months.¹⁰² The Court of Appeal found that the failure of the franchisor to comply with the “mandatory” and “unambiguous” statutory requirement to provide a single disclosure document resulted in the franchisee being provided no disclosure.¹⁰³ The Court of Appeal emphasized that the manner in which disclosure is provided is not merely a procedural requirement or formality, stating:

The legislature clearly envisioned that the purpose of the legislation—i.e., ensuring that a decision to enter into a franchise agreement is an informed one—would best be fulfilled by giving prospective franchisees the opportunity to review a single document or documents, so that all the information is before them at the same time. It is simple commonsense that people have more difficulty processing and assessing information given at different times, some of it orally, than they do information provided in a single, written document.¹⁰⁴

(iv) Insufficient or Improper Location-Specific Disclosure

Location-specific disclosure is unique among the fatal deficiencies in that it is not a category prescribed by statute. However, the failure to disclose a copy of the head lease or sublease, or the terms of a lease extension, has been found to constitute a fatal flaw giving rise to the two-year rescission remedy.¹⁰⁵ The Ontario Court of Appeal’s decision in *Raibex* is the leading case on location-specific disclosure issues; however, the Ontario Superior Court recently released two judgments, one of which has created uncertainty

99. *Id.* ¶ 58.

100. *Id.* ¶ 63.

101. *Id.* ¶¶ 17, 63, 65.

102. *1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd.*, [2005] O.J. No. 3040 (QL), ¶ 17 (Can. Ont. S.C.).

103. *Id.* ¶ 19.

104. *Id.* ¶ 18.

105. See *122994 Ontario Inc. v. Lettieri*, 2017 ONCA 830, ¶ 8 (Can. Ont.); *2337310 Ontario Inc. v. 2264145 Ontario Inc.*, 2014 ONSC 4370, ¶¶ 47, 52 (Can. Ont.); *1159607 Ontario Inc. v. Country Style Food Servs. Inc.*, 2012 ONSC 881, ¶¶ 106–111 (Can. Ont.), *aff’d*, 2013 ONCA 589 (Can. Ont.); *6792341 Canada Inc. v. Dollar It Ltd.*, 2009 ONCA 385, ¶¶ 6, 14, 76 (Can. Ont.).

surrounding the extent of location-specific disclosure to be included in disclosure documents.

In *Raibex*, one of the claims that the franchisee advanced in support of rescission was that the franchisor had failed to disclose the head lease.¹⁰⁶ The franchise location, however, had not been selected at the time of disclosure.¹⁰⁷ The Ontario Court of Appeal rejected the franchisee's argument, noting that all parties were aware that the franchise location had not yet been selected, and had agreed to work collaboratively to select a site.¹⁰⁸ This agreement was formally incorporated into the franchise agreement through a clause requiring the parties to exercise "reasonable best efforts in selecting a location."¹⁰⁹ In addition, the franchise agreement contained an opt-out clause that allowed the franchisee to be refunded if it was dissatisfied with the franchise location.¹¹⁰ The Court of Appeal held that these measures were safeguards that provided a complete answer to the franchisee's claim that it was unable to make an informed investment decision.¹¹¹

In *Freshly Squeezed*, the Ontario Superior Court found that the location-specific disclosure was materially deficient.¹¹² First, the franchisor failed to disclose that a head lease did not yet exist.¹¹³ Second, the franchisor should have disclosed the existence of a partly executed agreement to lease between the landlord and franchisor.¹¹⁴ The court found these material deficiencies could have been cured had the franchisee been provided with the "contractual comfort" of an opt-out clause as had been provided in *Raibex*.¹¹⁵ In the absence of this or any other contractual safeguard offered to the franchisee, the court found the location-specific disclosure to be materially deficient.¹¹⁶ The court also found that the franchisor should have disclosed that the franchise was the first non-mall retail location in the franchise system.¹¹⁷

The court's judgment in *Freshly Squeezed* has two implications which are concerning for franchisors.¹¹⁸ First, based on the court's suggestion that the material deficiencies could have been cured by an opt-out clause, it is unclear the extent to which the impact of location-specific disclosure can and

106. *Raibex Canada Ltd. v. ASWR Franchising Corp.*, 2018 ONCA 62, ¶ 54 (Can. Ont.).

107. *Id.* ¶¶ 24, 53.

108. *Id.* ¶ 53.

109. *Id.*

110. *Id.*

111. *Id.* ¶ 54.

112. 2611707 Ontario Inc. v. Freshly Squeezed Franchise Juice Corp., 2021 ONSC 2323, ¶ 65 (Can. Ont.).

113. *Id.* ¶ 78.

114. *Id.* ¶ 81.

115. *Id.* ¶ 82.

116. *Id.* ¶¶ 81–82.

117. *Id.* ¶¶ 89–90.

118. For detailed consideration of this issue, see Christine Jackson & Dominic Mochrie, *Now and Then: An Overview of the Development of Location-Specific Disclosure Requirements, Where We Are and Where We Are Going Following Freshly Squeezed and Yogurtworld*, ONTARIO BAR ASS'N, FRANCHISE L. SEC. (Aug. 19, 2021), https://www.oba.org/Sections/Franchise-Law/Articles/Articles-2021/August-2021/Now-and-Then-An-Overview-of-the-Development-of-Lo#_ftnref2.

should be mitigated through contractual protections allowing franchisees to be released from franchisees agreements in the event that they take issue with the lease or franchise location. The court's comment moves the analysis away from analyzing the adequacy of the disclosure toward an assessment of the commercial bargain between the parties. An assessment of this nature is not contemplated by Canadian franchise legislation. Second, the court's decision may signal an expansion of a franchisor's disclosure obligations to require a form of site-specific negative disclosure (i.e., a lack of head lease or that the franchise had never been operated outside of a mall). Anticipating the extent of negative disclosure that would be required in a disclosure document would place an onerous burden on franchisors. The court's decision has been appealed by the franchisor, which may provide clarity on these disclosure issues.

Shortly after *Freshly Squeezed* was released, the Ontario Superior Court rendered its judgment in *2364562 Ontario Ltd. v. Yogurtworld Enterprises Inc.*¹¹⁹ The franchisee claimed rescission on a number of grounds, including that the franchisor had allegedly failed to disclose that there were no suitable franchise locations in the exclusive territories granted to the franchisee and that the costs of the lease were unknown.¹²⁰ The court rejected the franchisee's claim, finding that the franchisee had failed to prove there were no suitable locations.¹²¹ Furthermore, unlike in *Raibex* or *Freshly Squeezed*, it was the franchisee in this case who had the responsibility to secure a location and negotiate a lease.¹²² The court held that, where a franchisee has the control and responsibility over the location of the franchise and terms of the lease, the financial uncertainty related to the lease is not a fatal deficiency to disclosure.¹²³

Yogurtworld provides welcome clarity that opt-out clauses do not need to be included in every franchise agreement where the franchise location is unknown. However, it remains to be seen whether the Ontario Court of Appeal or future decisions by lower courts will clarify the extent to which negative location-specific disclosure is required and whether courts can or should scrutinize the commercial terms of the franchise agreement when assessing the adequacy of disclosure. Franchisors should follow these judicial developments closely to ensure that their disclosure documents will withstand judicial scrutiny in the event of a rescission claim grounded in an alleged deficiency in the location-specific disclosure.

119. *2364562 Ontario Ltd. v. Yogurtworld Enters. Inc.*, 2021 ONSC 5112 (Can. Ont.). Osler, Hoskin & Harcourt LLP represented the defendant Yogurtworld Enterprises Inc. in this case.

120. *Id.* ¶ 22.

121. *Id.* ¶ 101.

122. *Id.* ¶ 42.

123. *Id.* ¶¶ 41–42, 75.

IV. Litigating the Rescission Remedy: Procedural Issues

This section will provide an overview of two elements in Canadian civil litigation that are relevant to the rescission remedy: the use of summary judgment and the extension of limitations periods in certain jurisdictions as a result of the COVID-19 pandemic.

A. *The Use of Summary Judgment in Rescission Claims*

In the civil context in Canada, summary judgment is a procedural tool that can be used to obtain judgment on certain issues without the requirement for a formal trial.¹²⁴ Courts have historically granted partial summary judgment to the franchisee on the validity of its exercise of the rescission right in a variety of cases.¹²⁵ The test that courts utilize to determine whether summary judgment may be granted on an issue is whether there is a genuine issue requiring a trial.¹²⁶ There is no genuine issue requiring a trial when the motions judge is able to reach a fair and just decision on the merits.¹²⁷ The Supreme Court of Canada has expanded the role of summary judgment in the courts by providing motions judges with additional fact-finding powers with the aim of ensuring proportionate, expeditious, and less expensive avenues to achieve a legal outcome.¹²⁸

Despite the recently expanded role of summary judgment in Canada, there has been a general trend of moving away from the granting of summary judgment in rescission claims. In *1680960 Ontario Inc. v. Print Three Franchising Corp.*, the court refused to grant summary judgment despite several alleged deficiencies in the franchise disclosure document.¹²⁹ In rejecting the claim, the court cited *6792341 Canada Inc. v. Dollar It Ltd.*, which stated that the issue of whether deficiencies in disclosure amount to no disclosure must be decided on the facts of each case.¹³⁰ The court cited conflicting evidence and the fine line between insufficient disclosure and no disclosure at all in stating that a “mini trial” would be required to arrive at a fair and just decision.¹³¹

In *2212886 Ontario Inc. v. Obsidian Group Inc.*, the Ontario Court of Appeal overturned the decision of a motions judge granting rescission on summary judgment, finding a genuine issue requiring trial.¹³² In this case, the motions judge had made determinations of credibility and findings of

124. See generally GEORGE S. HOLMESTED, ET AL., *HOLMESTED AND WATSON: ONTARIO CIVIL PROCEDURE* § 49:8 (1984).

125. *Id.*

126. *Hryniak v. Mauldin*, [2014] 1 S.C.R. 87 (Can.).

127. *Id.*

128. *See id.*

129. *1680960 Ontario Inc. v. Print Three Franchising Corp.*, 2018 ONSC 1192, ¶ 28 (Can. Ont.).

130. *Id.* ¶ 48; see *6792341 Canada Inc. v. Dollar It Ltd.*, 2009 ONCA 385, ¶ 78 (Can. Ont.).

131. *1680960 Ontario Inc.*, 2018 ONSC 1192, ¶ 27.

132. *2212886 Ontario Inc. v. Obsidian Group Inc.*, [2018] O.J. No. 3980 (QL), ¶ 64 (Can. Ont. S.C.).

key facts.¹³³ The Court of Appeal critiqued the decision, stating that the key findings of fact were based upon contradictory evidence, in which oral evidence and cross examination were not utilized.¹³⁴ The court acknowledged the expanded powers afforded to motions judges, yet stated that there was an obvious need for oral evidence that went unmet.¹³⁵ There is an obvious tension and unclear line between the expanded fact-finding powers afforded to motions judges and the requirement for a full trial of the issue. The court stated that motions judges must take great care to ensure that decontextualized affidavit and transcript evidence do not become the means for evaluating difficult issues formerly resolved through trial.¹³⁶ While the courts have by no means done away with summary judgment in the context of rescission claims, in cases where the evidence is complex, even if a “mini trial” is permissible, the evidence required to correctly furnish such a proceeding is becoming more onerous and, once again, more costly.

B. *Limitations Periods*

Another relevant consideration for rescission cases, which has not yet been addressed by the courts, is whether the two-year period to deliver a notice of rescission would be impacted by the suspension of limitations periods as a result of the COVID-19 pandemic. On March 20, 2020, the Ontario government enacted a regulation suspending all limitation periods under any statute, regulation, rule, bylaw, or order of the Government of Ontario, retroactive to March 16, 2020.¹³⁷ The regulation was in force until September 14, 2020.¹³⁸ Specifically, the regulation suspended limitation periods, and “any period of time within which any step must be taken in any proceeding in Ontario, including any intended proceeding,” subject to the discretion of the court, tribunal or other decision-maker responsible for the proceeding.¹³⁹ There are arguments both for and against the treatment of the two-year period as a limitation period or a “step in a proceeding.”

On the one hand, the Court of Appeal has held, outside of the COVID-19 context, that a notice of rescission in and of itself does not create a cause of action under the *Wishart Act*. The cause of action only crystallizes when the sixty-day deadline for the franchisor to pay compensation under section 6(6) of the *Wishart Act* expires or when the franchisor communicates its

133. *Id.* ¶ 16.

134. 2212886 Ontario Inc. v. Obsidian Group Inc., 2018 ONCA 670, ¶¶ 37, 39 (Can. Ont. C.A.).

135. *Id.* ¶ 35.

136. *Id.* ¶ 47.

137. General, O. Reg. 73/29 § 2 (Can.). Three other provinces with franchise legislation have also enacted similar orders: Alberta Ministerial Order M.O. 27/2020 (Can.); British Columbia Ministerial Order M098 (Can.); New Brunswick Renewed and Revised Mandatory Order COVID-19 (Can.).

138. General, O. Reg. 457/29 § 1 (Can.).

139. General, O. Reg. 73/290 § 2 (Can.).

refusal to do so.¹⁴⁰ More recently, the Court of Appeal held that a notice of rescission is not a precondition to litigation and that, in fact, its purpose is to provide an extrajudicial mechanism for ending franchise agreements.¹⁴¹

On the other hand, the time limits for delivery of a notice of rescission could arguably be considered a “limitation period.” A limitation period sets out the time which a party has to preserve its legal remedies and, in some cases, its legal rights. As the failure to deliver a notice of rescission would end a franchisee’s right to pursue a rescission claim, this could arguably be considered a limitation period. Furthermore, the regulation is broadly worded and refers to “any step” in “any proceeding . . . including an intended proceeding.”¹⁴² Given the broad language in the order, as well as the remedial nature of the Wishart Act, it is possible that courts will find a notice of rescission to be a step in a proceeding.

V. The Franchisor’s Associate

While the main parties to any franchise agreement are the respective franchisor and franchisee, the Acts also creates significant liabilities and obligations with respect to the “franchisor’s associate.”¹⁴³ The involvement of a franchisor’s associate triggers a requirement for the disclosure document to include information about the franchisor’s associate. Even more significantly, certain liabilities found within the Wishart Act accrue equally to both the franchisor and the franchisor’s associate. Upon rescission, section 6(6) of the Wishart Act states that the franchisor’s obligations are shared with franchisor’s associates.¹⁴⁴ Courts have interpreted this liability to be joint and several.¹⁴⁵ This liability includes refunding all amounts received by the franchisee and compensating the franchisee for any losses incurred in acquiring, setting up, and operating the franchise.¹⁴⁶ In addition, section 7 of the Wishart Act states that franchisees have a right of action against a franchisor as well as a franchisor’s associate for misrepresentations made in a disclosure document or statement of material change, or a failure to disclose.¹⁴⁷

As a result, franchisees have increasingly looked to the franchisor’s affiliated entities, or even key shareholders or employees of the franchisor, as a

140. 2130489 Ontario Inc. v. Philthy McNasty’s (Enters.) Inc., 2012 ONCA 381, ¶ 39 (Can. Ont.); see also Adrienne Boudreau, *Rescission in the Time of COVID-19*, SOTOS (Apr. 15, 2020), <https://sotosllp.com/rescission-in-the-time-of-covid-19>.

141. 2352392 Ontario Inc. v. Msi, 2020 ONCA 237, ¶ 12 (Can. Ont.); see also Boudreau, *supra* note 140.

142. Ben Hanuka, *Suspension of Limitation Periods and Statutory Franchise Notice of Rescission*, LAW DAILY (Apr. 6, 2020), <https://www.thelawyersdaily.ca/articles/18444>.

143. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c 3 §6(6); Franchises Act, R.S.A. 2000, c F-23 § 14(2); Franchises Act, R.S.P.E.I. 1988, c F-14.1 § 6(6); Franchises Act, R.S.N.B. 2014, c 111 §6(6); Franchises Act, C.C.S.M. c F156 §6(5); Franchises Act, S.B.C. 2015, c 35 §6(5).

144. Arthur Wishart Act (Franchise Disclosure), § 6(6).

145. See, e.g., 2122994 Ontario Inc v. Lettieri, 2016 ONSC 6299, ¶ 86 (Can. Ont.).

146. Arthur Wishart Act (Franchise Disclosure) § 6(6).

147. *Id.* § 7.

potential franchisor's associate in order to obtain a right of action for damages or to require that person to fulfill refunds and other obligations in the event a franchisee exercises a rescission remedy for deficient disclosure.¹⁴⁸ Consequently, it is crucial for franchisors, franchisees, and potential franchisor's associates to understand the definition of "franchisor's associate" and how the definition is utilized by Canadian courts to allocate liability.

The concept of a "franchisor's associate" is unique and is different from other relationships such as agency or affiliation. The Wishart Act's definition of a franchisor's associate is best understood in two parts. First, a franchisor's associate is a person who directly or indirectly controls or is controlled by the franchisor or is controlled by another person who also controls, directly or indirectly, the franchisor. Second, the person must meet one of two additional requirements. The person must either exercise significant operational control over the franchisee and be owed a continuing financial obligation by the franchisee *or* be directly involved in the grant to the franchisee. The person may be directly involved in the grant of the franchise either by being involved in the review or approval of the grant of the franchise or by making representations to the franchisee on behalf of the franchisor for the purpose of granting the franchise, marketing the franchise, or otherwise offering to grant the franchise.¹⁴⁹

The analysis of whether a person is a franchisor's associate is heavily fact-based and is determined case by case.¹⁵⁰ The Wishart Act does not provide any additional guidance on the analysis outside of the definition itself. This lack of legislative clarity, coupled with the potentially significant financial liability of being found to be a franchisor's associate, has resulted in judicial scrutiny of the statutory definition. Current jurisprudence assists in understanding the still-evolving definition of franchisor's associate and its application to unique business situations.

Canadian courts have summarized and simplified the legislative test to determine if a person is a franchisor's associate, stating that the analysis is comprised of two general components. First, the person must exercise some control over the franchisor or its affiliates; and second, the person must have taken some action in relation to the particular franchisee.¹⁵¹ The definition is conjunctive, meaning that both control and action must be established.¹⁵²

Presidents, CEOs, directors, major shareholders and sub-landlords have all been found by the courts to be franchisor's associates in specific

148. CANADIAN FRANCHISE GUIDE, *supra* note 4, § 2:7.

149. Arthur Wishart Act (Franchise Disclosure) § 1(1).

150. CANADIAN FRANCHISE GUIDE, *supra* note 4, § 2:7.

151. *See* New Vision Renaissance MX Ltd. v. Symposium Café Inc., 2020 ONSC 1119, ¶ 141 (Can. Ont.).

152. Raibex Canada Inc. v ASWR Franchising Corp., 2016 ONSC 5575, ¶ 117 (Can. Ont.); Addison Chevrolet Buick GMC Ltd. v. General Motors of Canada Ltd., 2015 ONSC 3404, ¶ 61 (Can. Ont.), *rev'd*, 2016 ONCA 324 (Can. Ont. C.A.). Osler, Hoskin & Harcourt LLP was counsel for the Defendants/Moving Parties General Motors Co. and General Motors LLC.

situations.¹⁵³ The courts have upheld the case-by-case nature of the analysis, noting that there is no requirement that a franchisor's associate simply be a director or officer of the franchisor.¹⁵⁴ The commitment by the courts to a rigorous case-by-case analysis is no more clear than in *Aplouin Imports Ltd. v. Global Diaper Services Inc.*, where an individual who owned fifty percent of the shares of a company was found to not be a franchisor's associate.¹⁵⁵ In this decision, which was addressing a partial motion for summary judgment, there was a lack of evidence suggesting that the shareholder exercised any significant control over the franchisor company despite their significant ownership interest.¹⁵⁶ In sum, determining whether a person is a franchisor's associate for purposes of the Wishart Act requires a case-by-case analysis of whether an individual exercises control over the franchisor and whether the individual has taken action with respect to the specific franchisee at issue. Nonetheless, sole directors, officers, or shareholders of a franchisor will almost always meet the test, as their control and action is necessarily required for the success of the business endeavor.

Franchisor's associates have been held jointly and severally liable to pay damages to franchisees in a number of recent cases. In *2122994 Ontario Inc. v. Lettieri*, the right of rescission was granted to a franchisee, in part because the franchisor's associate failed to sign the certificate setting out the truth and accuracy of the disclosure document.¹⁵⁷ The franchisor's associate was held liable for both the refund of the amounts that had been paid by the franchisee and resulting damages.¹⁵⁸ This decision was upheld on appeal.¹⁵⁹ Similarly, in *2240802 Ontario Inc. v. Springdale Pizza*, the court found that two officers and directors who controlled the entity that signed the head lease and had reviewed and approved the grant of the franchise were jointly and severally liable for damages as franchisor's associates.¹⁶⁰ Finally, in *2483038 Ontario Inc. v. 2082100 Ontario Inc.*, the sole director, officer, and shareholder of the franchisor was found to be jointly and severally liable to repay the purchase price and royalties paid by the franchisee.¹⁶¹ The individual was also held jointly and severally liable for repurchasing the franchisee's inventory, supplies, and equipment, as well as for pre- and post-judgment interest.¹⁶²

153. See, e.g., *2619506 Ontario Inc. v. 2082100 Ontario Inc.*, 2020 ONSC 6817, ¶ 6 (Can. Ont.); *New Vision Renaissance MX Ltd.*, 2020 ONSC 1119, ¶ 142 (Can. Ont.); *2483038 Ontario Inc. v. 2082100 Ontario Inc.*, 2020 ONSC 475, ¶ 55 (Can. Ont.); *212886 Ontario Inc. v. Obsidian Group Inc.*, 2017 ONSC 1643, ¶ 71 (Can. Ont.); *2122994 Ontario Inc. v. Lettieri*, 2016 ONSC 6209, ¶¶ 72–73 (Can. Ont.).

154. *Raibex*, 2016 ONSC 5572, ¶ 122–23.

155. *Aplouin Imports Ltd. v. Global Diaper Servs. Inc.*, 2013 ONSC 2592, ¶ 57 (Can. Ont.).

156. *Id.* ¶ 56.

157. *Lettieri*, 2016 ONSC 6209, ¶ 14.

158. *Id.*

159. *Id.*

160. *2240802 Ontario Inc. v. Springdale Pizza*, 2013 ONSC 7288, ¶ 59 (Can. Ont.).

161. *2483038 Ontario Inc. v. 2082100 Ontario Inc.*, [2020] O.J. No. 580 (QL), ¶ 82 (Can. Ont. S.C.).

162. *Id.* ¶ 82.

The test is the same when considering whether a parent or subsidiary organization is a franchisor's associate. In *Addison Chevrolet Buick GMC Ltd. v. General Motors of Canada Ltd.*, the judge, on a motion to strike that did not result in a final determination on the merits, noted that parent or subsidiary organizations will readily meet the "control" portion of the test.¹⁶³ The only question left to determine with regard to subsidiary or parent organizations is whether the party has taken action in relation to the particular franchise in question. In this case, the question was whether the U.S. defendants had been "directly involved in the grant of the franchise."¹⁶⁴ The court found that the statement of claim failed to allege any factual basis for such a determination.¹⁶⁵ On appeal, however, the Court of Appeal, found that the determination of whether the U.S. parent was a franchisor's associate required a full factual record.¹⁶⁶ In *Burnett Management Inc. v. Cuts Fitness for Men*, in which no one appeared at the trial for the defendants, the Ontario Superior Court of Justice held that all the Cut Fitness companies were franchisor's associates under the Wishart Act on the basis that they carried on the business of a franchisor as a common enterprise.¹⁶⁷ As a result, the defendants were each found jointly and severally liable to the plaintiff for damages for the failure to comply with disclosure obligations.¹⁶⁸

In conclusion, directors, officers, and major shareholders, along with landlords, parent, and subsidiary organizations of a franchisor, must take care to ensure that they do not unintentionally become liable as a franchisor's associates. As Canadian courts continue to assess the franchisor's associate relationship case by case, and as the existence of a franchisor's associate impacts franchise disclosure requirements, franchisors and related parties should carefully consider the status of their relationships at an early stage. Sole directors, officers, or shareholders should recognize and take into account the joint and several liability that would likely be imposed in cases of misrepresentation and rescission. Parent and subsidiary organizations and other control persons should ensure that they have measures in place to avoid taking any action in relation to particular franchises.

VI. Equitable Rescission

In the franchising context, rescission is a remedy available on each side of the border. Despite this, while an equitable rescission remedy is commonly used by franchisees in the United States, most instances of rescission in

163. *Addison Chevrolet Buick GMC Ltd. v. General Motors of Canada Ltd.*, 2015 ONSC 3404, ¶ 64 (Can. Ont.), *rev'd*, 2016 ONCA 324 (Can. Ont. C.A.). Osler, Hoskin & Harcourt LLP was counsel for the Respondents, General Motors Co. and General Motors LLC. *See also* *Raibex Canada Inc. v. ASWR Franchising Corp.*, 2016 ONSC 5575, ¶ 117 (Can. Ont.).

164. *Addison Chevrolet*, 2015 ONSC 3404, ¶ 64.

165. *Id.*

166. *Id.* ¶ 37.

167. *Burnett Mgmt. Inc. v. Cuts Fitness for Men*, 2012 ONSC 3358, ¶ 63 (Can. Ont.).

168. *Id.* ¶ 67.

Canada are cases of statutory rescission under provincial franchise Acts. In Ontario, as discussed throughout this paper, section 6 of the Wishart Act sets out a comprehensive scheme that grants franchisees a right of rescission for late or insufficient franchise disclosure.¹⁶⁹ As noted in the introduction to this paper, only six Canadian provinces—Alberta, British Columbia, Manitoba, New Brunswick, Ontario, and Prince Edward Island—have enacted franchise legislation. Franchising in Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, Saskatchewan, and the Yukon is governed by the common law of contract. In Quebec, the franchising relationship is governed by the general rules of contracts provided in the Civil Code of Quebec. In provinces without franchise legislation, and without the accompanying statutory rescission rights, franchisees can turn to equitable rescission as a remedy.¹⁷⁰ Moreover, there is nothing to preclude franchisees in provinces with franchise legislation from raising equitable rescission alongside statutory rescission as an alternate means for fixing liability. Equitable rescission may also be available where a franchisee is out of time for exercising statutory rescission.

The Ontario Court of Appeal has noted that the statutory rescission enshrined in section 6 of the Wishart Act shares the same underlying goal as the rescission remedy at equity: “to put the franchisee back in its pre-franchise position.”¹⁷¹ Similarly, the Ontario Superior Court of Justice stated that the purpose of section 6 of the Wishart Act is to return the franchisee to the same position it was in prior to entering into the franchise agreement.¹⁷² In equity, this concept is referred to as rescission *ab initio*, or rescission “from the beginning.” The goal is to return each party to their precontractual state, as if the contract never existed. To effect such rescission, both by statute and equity, the franchisor must reimburse all money received from the franchisee and repurchase inventory, equipment, and supplies from the franchisee at the original cost to the franchisee.¹⁷³ In addition, the franchisor must compensate the franchisee for any uncompensated losses incurred in acquiring, setting up, and operating the franchise.¹⁷⁴

Despite these commonalities, the two remedies are distinct.¹⁷⁵ Unlike statutory rescission, equitable rescission is a discretionary remedy.¹⁷⁶ A party

169. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c 3, § 6(1)–(2).

170. For a detailed discussion of the use of equitable remedies in franchising, see Jennifer Dolman & Susan Friedman, *The Role of Equity in Franchise Law*, ONTARIO BAR ASS'N 16TH ANN. FRANCHISE L. CONF. (2016).

171. 1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd., [2005] O.J. No. 3040 (QL), 31 (Can. Ont. S.C.).

172. Payne Envtl. Inc. v. Lord & Partners Ltd., [2006] O.J. No. 273 (QL), ¶ 13 (Can. Ont. S.C.).

173. Ephraim Stulberg & Jonathan Mesiano-Crookston, *Rescission under the Ontario Arthur Wishart Act: Quantifying the Remedy*, 33 FRANCHISE L.J. 235, 4 (2013).

174. *Id.* at 5.

175. Dolman & Friedman, *supra* note 170, at 24.

176. HALSBURY'S LAWS OF CANADA—MISREPRESENTATION AND FRAUD (2019 Reissue), HMF-62.

must request relief from the court on grounds that it would be inequitable for the party to be bound by the contract entered into. The court will then apply the rules of equity upon hearing the evidence to determine what is practically just in each circumstance.¹⁷⁷ Equitable rescission is generally available in three instances: first, where the party mistakenly entered into the contract as a result of fraud or negligence on behalf of the other contracting party;¹⁷⁸ second, where the misrepresentation was the result of an innocent mistake;¹⁷⁹ and third, where the contract was entered into as a result of an unconscionable act or undue influence.¹⁸⁰ If a party can successfully demonstrate that they relied on a misrepresentation to enter into a contract, or that the contract was entered into in unconscionable circumstances, the equitable remedy of rescission is available.

There are many bars to equitable rescission that courts continue to use to reject equitable claims, including misconduct or “lack of clean hands” on behalf of the claiming party, affirmation of the contract, and undue delay in pursuing a remedy.¹⁸¹ These bars demarcate some of the primary practical differences between statutory and equitable rescission. First, the timing requirements for bringing a claim differ. Recall that section 6(1) of the *Wishart Act* allows for rescission for up to sixty days from the date of the disclosure document if disclosure is not provided at least fourteen days before the signing of the franchise agreement or the payment of any consideration relating to the franchise. If disclosure is missing or includes any fatal flaws, the statutory rescission timeline increases to two years. There is no such guidance on timing when it comes to equitable rescission. Parties arguing equitable rescission should bring a claim as soon as possible after discovering a misrepresentation or unconscionable circumstance as courts retain the discretion to bar a claim for undue delay. On the other hand, nothing stops a party from bringing a claim for equitable rescission after the expiration of the period provided for in the statute, although such a claim would likely be similarly barred by delay.

Second, the “clean hands” requirement is not a feature of statutory rescission. In *Personal Service Coffee Corp. v. Beer*, the franchisee was entitled to rescission, yet chose to rescind the franchise agreement two days before the expiry of the two-year deadline.¹⁸² In addition, the franchisee immediately set up a competing business serving the same customers as the franchise.¹⁸³ In finding for the franchisee, the court found that the franchisee had an absolute right to rescission, which was in no way conditional on the conduct

177. *Swan City Taekwon-Do Club v. Podolchuk*, 2017 ABPC 244, ¶ 143 (Can. Alta.).

178. *Choi v. Paik*, 2008 BCSC 1122, ¶ 86 (Can. B.C.); *Swan City*, 2017 ABPC ¶ 143.

179. *Swan City*, 2017 ABPC 244, ¶ 143.

180. *Id.*

181. *New Beginnings Early Learning (White Rock) Ltd. v. CEFA Sys. Inc.*, 2018 BCSC 2417, ¶ 68 (Can. B.C.).

182. *Personal Serv. Coffee Corp. v. Beer*, 2005 CanLII 25180, ¶ 1 (Can. Ont. C.A.).

183. *Id.*

of the franchisee.¹⁸⁴ If such an action were brought in equity, the court may look less favorably on the conduct of the franchisee, and such conduct could potentially bar a successful claim.

Affirmation also operates differently between the equitable and statutory contexts. In *14906664 Ontario Ltd. v. Dig This Garden Retailers Inc.*, the franchisees continued to operate the business for a period of three months following their service of the notice of rescission.¹⁸⁵ The Ontario Court of Appeal held that the fact that the franchisees continued to operate the business was not necessarily an affirmation of the franchise agreement.¹⁸⁶ The court specifically noted that statutory rescission is different from equitable rescission and that the rules of the latter do not apply to the former.¹⁸⁷ The court observed that nothing in the Wishart Act prevents a franchisee from carrying on a business for a time after rescission is sought in order to achieve orderly winding down.¹⁸⁸ Interestingly, the court stated that, because of the rescission, there was no longer a contract that could be affirmed.¹⁸⁹ The same reasoning would not be available for a case of equitable remedy, as the contract remains in existence until a court determines that it may be rescinded. Thus, the risk of affirmation is greater in cases of equitable remedy.

However, the franchisor may have a right of action under common law or equitable remedies where a franchisee continues to operate the business, and is not barred from pursuing such a right of action under the Wishart Act. Section 9 of the Wishart Act provides that “the rights conferred by this Act are in addition to and do not derogate from any other right or remedy a franchisee or franchisor may have at law.”¹⁹⁰ In *Beer*, the Ontario Court of Appeal clarified that, even where a franchisee is entitled to rescind the franchise agreement, Section 9 permits the franchisor to pursue a common law or equitable right of action against the franchisee.¹⁹¹ There, the franchisee set up a competing business the same day that it rescinded the franchise agreement, and the Court of Appeal held that the franchisor had the right to assert a claim against the franchisee by way of an action.¹⁹²

Despite the various differences between the statutory and equitable rescission remedies, one key similarity remains: rescission is a remedy independent of damages. In *2189205 Ontario Inc. v. Springdale Pizza Depot Ltd.*, the court determined that franchisees who are turning a profit are still able to rescind their franchise agreement as long as the franchisor failed to disclose

184. *Id.* ¶ 2.

185. *14906664 Ontario Ltd. v. Dig This Garden Retailers Inc.*, [2004] O.J. No. 3008 (QL), ¶ 11 (Can. Ont. S.C.).

186. *14906664 Ontario Ltd. v. Dig this Garden Retailers Ltd.*, 2005 CanLII 25181 (ON CA), ¶ 28.

187. *Id.*

188. *Id.* ¶ 31.

189. *Id.* ¶ 28.

190. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c 3, § 9.

191. *Personal Serv. Coffee Corp. v. Beer*, 2005 CanLII 25180, ¶ 34 (Can. Ont. C.A.).

192. *Id.* ¶¶ 41–42.

properly, even if by doing so a franchisee ends up with a windfall.¹⁹³ Equitable rescission, too, is based on the refusal of a party to be bound by a contract that was unfairly entered into.¹⁹⁴ Consequently, profitable franchisees are not barred from seeking rescission.

In sum, while the more common statutory rescission remedy prevails in Canada, equitable rescission remains available as a potential claim for franchisees across the country. Equitable rescission can be used by a franchisee who is out of time for a statutory rescission claim or in a province that does not have a right to statutory rescission. In many circumstances, the bars to equitable rescission make equitable rescission a harder case to argue. Despite this reality, if a party discovers an inequity in the contractual franchising relationship and acts promptly and with clean hands, courts still hold the powerful discretion to rescind the contract and return the party to their original financial position.

VII. Conclusion

This article considered the rescission remedy in Canada, and in particular the manner in which the statutory rescission remedy in the Acts has been judicially interpreted and expanded by courts to create a strict-liability regime. Whether a franchisor has met its disclosure obligations, and therefore put the franchisee in a position to make an informed investment decision, will depend on the facts and circumstances of each case. At the same time, certain fatal flaws will render a disclosure document so deficient as to be nonexistent. Canadian courts have been unwavering in giving a liberal interpretation to the Acts to give effect to the underlying purpose of protecting franchisees. Given the draconian consequences of not complying with Canadian franchise disclosure legislation, American franchisors who are currently operating in Canada, or who are considering expanding their operations into Canada, should work with experienced Canadian franchise counsel to carefully prepare disclosure documents and to keep apprised of important judicial developments.

193. 2189205 Ontario Inc. v. Springdale Pizza Depot Ltd., 2013 ONSC 1232, ¶ 30, *aff'd*, 2013 ONCA 626 (Can. Ont.); CANADIAN FRANCHISE GUIDE, *supra* note 4, § 28:16.

194. Guar. Co. of N. Am. v. Gordon Cap. Corp., [1999] 3 S.C.R. 423 (Can.).



An Explanation of the Canadian Statutory Requirements Governing the Preparation of Canadian Franchise Disclosure Documents and the Ethical and Practical Considerations for U.S. Lawyers Involved in Drafting Those Documents

Lorinda Ritts & David N. Kornhauser

I. Introduction

Franchise legislation in Canada is a relatively recent phenomenon. Except for the province of Alberta, from 1971 until 2000 no other province had instituted franchise legislation. When enacted, the original Franchises Act (Alberta),¹ was very similar to the Federal Trade Commission's Franchise Rule² (FTC Rule) and was regulated by the Alberta Securities Commission (ASC). In much the same way as a prospectus for the issuance of securities is designed to provide "full, true and plain disclosure" of all material facts so that the purchaser of securities can make an informed investment decision, the original Franchises Act (Alberta) was designed to afford the same protection to the prospective franchisee. The original Franchises Act (Alberta) intended to prevent a franchisor from trading in a franchise unless the franchisor had filed an Application for Registration of a Franchise with the ASC and a receipt was issued.³ In 1995, the government of Alberta passed



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1. Franchises Act, S.A. 1971, c 38, as replaced by R.S.A. 1980, c F-17, as amended by S.A. 1983, c 30 (Can. Alta.).

2. 16 C.F.R. §§ 436-437 (2007).

3. Franchises Act, S.A. 1971, c 38, s. 5(1).

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new franchise legislation,⁴ which served as the precursor to the franchise legislation that exists today in other provinces across Canada.

It was not until the late 1990s that the government of Ontario—Canada's most populated province—released a consultation paper advocating for a statutory regime creating obligations for franchisors.⁵ The consultation paper sought to provide a framework that would require franchisors to provide prospective franchisees with certain details of the franchise offering so they could make an informed investment decision before signing a contract.⁶ Thereafter, Ontario passed Bill 33, the Arthur Wishart Act (Franchise Disclosure) 2000⁷ (Ontario Act), which was followed by franchise legislation in the provinces of Prince Edward Island,⁸ Manitoba,⁹ New Brunswick,¹⁰ and British Columbia¹¹ (the foregoing, together with the Alberta Act, are collectively referred to as Canadian Franchise Legislation). As of the time of writing, six of ten Canadian provinces have franchise legislation, while four (Newfoundland and Labrador, Nova Scotia, Quebec, and Saskatchewan) have none.

For U.S. franchisors seeking to expand internationally, Canada is often a logical first choice as a destination for a variety of business reasons, including proximity, language, legal system, standard of living, consumer tastes, and consumer demand. Given that the concepts and the requirements of Canadian Franchise Legislation were modeled to some degree on the Uniform Franchise Offering Circular (now known as the Franchise Disclosure Document) and the guidelines developed by the North American Securities Administrators Association,¹² it may be quite natural that, in their desire to provide client service, some U.S. lawyers take it upon themselves to prepare Canadian franchise agreements and ancillary documentation (Canadian Franchise Agreements) and Canadian franchise disclosure documents (CFDDs, and with Canadian Franchise Agreements, collectively Canadian Franchise Documentation).

Most U.S. franchise lawyers are aware that, despite their expertise in preparing U.S. franchise agreements and ancillary documentation (U.S. Franchise Agreements) and U.S. franchise disclosure documents (U.S. FDDs, and with U.S. Franchise Agreements, collectively U.S. Franchise Documentation), they are not professionally qualified to practice law in Canada, prepare

4. Franchises Act, S.A. 1995, c FG-17.1, replaced by the Franchises Act, R.S.A. 2000, c F-23 (the Alberta Act).

5. ONTARIO MINISTRY OF CONSUMER AND COMMERCIAL RELATIONS, ONTARIO FRANCHISE DISCLOSURE LEGISLATION: A CONSULTATION PAPER (June 1998).

6. *Id.*, s. 3.

7. Arthur Wishart Act (Franchise Disclosure), 2000, R.S.O. 2000, c 3 (Can. Ont.).

8. Franchises Act, R.S.P.E.I. 1988, c F-14.1 (Can. P.E.I.).

9. The Franchises Act, C.C.S.M. 2012, c F156 (Can. Man.).

10. Franchises Act, R.S.N.B. 2014, c 111 (Can. N.B.).

11. Franchises Act, R.S.B.C. 2015, c 35 (Can. B.C.).

12. N. AM. SECS. ADMINS. ASS'N, INC., 2008 FRANCHISE REGISTRATION AND DISCLOSURE GUIDELINES (Feb. 26, 2008), <https://www.nasaa.org/1851/2008-franchise-registration-and-disclosure-guidelines> [hereinafter NASAA].

Canadian Franchise Documentation, or proffer advice regarding Canadian franchise laws and Canadian Franchise Legislation. Nonetheless, Canadian franchise lawyers have over the past twenty or so years become aware that some U.S. franchise lawyers endeavor to prepare Canadian Franchise Documentation despite this lack of professional qualification.

In certain instances, the preparation of Canadian Franchise Documentation by U.S. franchise practitioners has resulted in various errors and/or omissions.¹³ These errors arose because of the increasing complexity involved in the preparation of Canadian Franchise Documentation, as well as the differences between Canadian Franchise Documentation and U.S. Franchise Documentation. These differences are attributable not only to the differing provincial franchise statutes, but also to the decisions of Canadian courts, which have regularly opined on the provisions of Canadian Franchise Legislation and have interpreted substantive provisions in Canadian Franchise Documentation in ways that may not be immediately known or obvious to U.S. practitioners. Despite efforts at education,¹⁴ and although the practice has diminished, some U.S. practitioners still continue to prepare Canadian Franchise Documentation. The continuation of such behavior is consequential because of the following:

A) Under Canadian Franchise Legislation, a franchisee is entitled to rescind a Canadian Franchise Agreement at any time up to two years after the execution of the franchise agreement in the event of the failure to deliver a complete CFDD when required, or upon delivery of an improper and/or incomplete disclosure document.¹⁵ This failure potentially not only results in significant liability to the franchisor itself but also personal liability for those individuals who have signed the mandatory certificate attached to every CFDD, as well as those involved in the sale or grant of the franchise.¹⁶ Depending on the franchise system, the amounts claimed as damages can be upwards of seven figures;

13. See 1518628 Ontario Inc. v. Tutor Time Learning Centres LLC, 2006 CanLII 25276 (Can. Ont. Sup. Ct. J.), in which the franchisor provided a U.S. uniform franchise offering circular (UFOC). The court held that, although the UFOC provided some of the information required by the Ontario Act, it did not include all material facts and hence there was not compliant with the Ontario Act. Further, Mr. Kornhauser has, and several other Canadian franchise lawyers have, been involved in, or aware of, several rescission claims that have been resolved before an action was commenced, or a decision reported.

14. These issues have been brought to the attention of U.S. franchise practitioners because of various seminars, papers, and presentations at the ABA Forum on Franchising and messages on ABA Communities (formerly ABA Connect and Listserv) by the Franchise Law section of the Ontario Bar Association and its various members. See, e.g., Jennifer Dolman & Andraya Frith, *Ontario's Franchise Legislation—What Have We Learned?* 26 *FRANCHISE L.J.* 136 (2007); Jennifer Dolman, Andraya Frith & Frank Zaid, *Ontario's Franchise Legislation: Lessons Learned in the First Decade and What's Ahead for the Future*, 26 *FRANCHISE L.J.* 63, (2009); Geoffrey Shaw & Lawrence Weinberg, *An Overview of the Canadian Market for American Franchise Systems*, 31 *FRANCHISE L.J.* 220, (2012); George Eydtt & Edward Ned Levitt, *How Canadian and U.S. Franchise Legislation Differs*, 32 *FRANCHISE L.J.* 237 (2013). Posting of Allan D.J. Dick, adjdick@sotosllp.com on Listserv, on behalf of the Executive of the Ontario Bar Association Franchise Law Section to Joseph Fittante, jfittante@larkinhoffman.com as Chair of the ABA Forum on Franchising (on file with author).

15. See discussion *infra* Section II(A)(1).

16. See discussion *infra* Section II(A)(3) for a list of persons who are potentially liable.

B) The risks to U.S. franchisors from receiving advice on Canadian Franchise Legislation and Canadian laws, including Canadian franchise laws, by lawyers not trained or qualified to practice law in any of the provinces in Canada;

C) U.S. lawyers may not have insurance coverage to address damage claims by their franchisor clients; and

D) The preparation of Canadian Franchise Documentation may constitute the unauthorized practice of law and violate the professional obligations of competency.

Additionally, although not a consequence suffered by either U.S. franchisors or U.S. franchise practitioners, adverse court decisions arising from improper disclosure negatively impacts the Canadian franchise industry in two respects. First, these decisions generate case law adverse to franchisors, which creates a more difficult legal environment. Second, these decisions serve to undermine the overall level of trust and confidence Canadian franchisors hope to establish and maintain for the Canadian franchise industry. The purpose of this paper is to highlight and explore the issues identified above.

II. Canadian Franchise Law

A. *Canadian Franchise Legislation: An Overview*¹⁷

As previously stated, six¹⁸ of the ten Canadian provinces¹⁹ have enacted specific legislation for franchises operating within their respective jurisdictions. While there are differences amongst them, these statutes share certain basic similarities in how they affect the franchise relationship. For simplicity, this article will review Canadian Franchise Legislation through the lens of the Ontario Act. Although the focus will be on the Ontario Act, almost all the principles discussed in this article are relevant to the remaining statutes that comprise Canadian Franchise Legislation.

Canadian Franchise Legislation has three basic elements:²⁰

17. Adapted from a paper co-authored and co-presented at the Ontario Bar Association by Peter Viitre & David Kornhauser, *Franchising 101—Understanding the Fundamental Aspects of the Franchise Relationship*, 8TH ANN. FRANCHISE L. CONF. (2008).

18. Although the province of Quebec does not have franchise-specific legislation, the Civil Code of Quebec, S.Q. 1991, c 64 (Can.), imposes on a franchisor a general good faith obligation. Civil Code of Quebec, S.Q. 1991, c 64, arts. 6, 7, 1375 (Can.). This good faith obligation includes pre-contractual disclosure of all material information relevant to the contract and its purposes unless an exemption is available.

19. Although Canada, like the United States, also operates under a federal system, because jurisdiction over private contracts is delegated to the provinces pursuant to section 92 of the Constitution Act, 1867, 30 & 31 Vict., c 3 (Can.), unlike the United States, there is not, nor is there expected to ever be, a federal law related to franchising.

20. Some Canadian franchise lawyers attribute a fourth element to Canadian Franchise Legislation, which mandates that the laws of the province will apply to any claim under the relevant statute, that a franchisee cannot be forced to have its proceeding heard outside the province regardless of what the franchise agreement might state, and that a franchisee cannot waive prospectively any of the rights afforded to it.

- an obligation on the part of the franchisor to make detailed disclosure about itself and the franchise opportunity to the prospective franchisee by delivery of the CFDD,²¹ coupled with a right of the franchisee to (1) rescind the franchise agreement if proper disclosure is not made;²² (2) sue for rescission damages if payment is not made by the franchisor and/or the franchisor's associates,²³ and/or (3) sue for damages for a failure to comply with the disclosure obligation or a misrepresentation;²⁴
- the imposition of a duty of fair dealing on all parties to the franchise agreement;²⁵ and
- a right on the part of franchisees to associate with one another without interference from the franchisor.²⁶

The main policy goals of Canadian Franchise Legislation are to provide prospective franchisees with the information that they need to make an informed decision about purchasing a franchise, as well as to create a commercial framework that governs the relationship of the parties.²⁷ Canadian Franchise Legislation is remedial legislation, enacted to redress a perceived imbalance of power favoring the franchisor, and the courts have generally given it a liberal interpretation.²⁸

21. See R.S.O. 2000, c 3, s. 5 (Can. Ont.); R.S.B.C. 2015, c 35, s. 4 (Can. B.C.); C.C.S.M. 2012, c F156, s. 5 (Can. Man.); R.S.N.B. 2014, c 111, s. 5 (Can. N.B.); R.S.A. 2000, c F-23, s. 4 (Can. Alta.); R.S.P.E.I. 1988, c F-14.1, s. 5 (Can. P.E.I.).

22. See, e.g., R.S.O. 2000, c 3, ss. 6(1), 6(2) (Can. Ont.); R.S.B.C. 2015, c 35, ss. 6(1), 6(2) (Can. B.C.); R.S.A. 2000, c F-23, s. 13 (Can. Alta.); C.C.S.M. 2012, c F156, ss. 6(1), 6(2) (Can. Man.); R.S.N.B. 2014, c 111, ss. 6(1), 6(2) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, ss. 6(1), 6(2) (Can. P.E.I.).

23. See, e.g., R.S.O. 2000, c 3, s. 6(6) (Can. Ont.); R.S.B.C. 2015, c 35, s. 6(5) (Can. B.C.); R.S.A. 2000, c F-23, ss. 11, 14(2) (Can. Alta.); C.C.S.M. 2012, c F156, s. 6(5) (Can. Man.); R.S.N.B. 2014, c 111, s. 6(6) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 6(6) (Can. P.E.I.).

24. See, e.g., R.S.O. 2000, c 3, s. 7(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 7(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 7(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 7(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 7(1) (Can. P.E.I.). In addition, R.S.A. 2000, c F-23, s. 9(1) (Can. Alta.) contains a right of action for damages in favor of the franchisee where it suffers a loss because of a misrepresentation contained in the franchisor's disclosure document or any statement of material change, or because of the franchisor's failure to comply in any way with its disclosure obligations under R.S.O. 2000, c 3 (Can. Ont.) (or equivalent). A right of action lies not just against the franchisor and the franchisor's associates, but also against its agents, brokers, and every person who signed the disclosure document, thereby potentially imposing personal liability on the directors or officers who certified the disclosure document and expanding liability beyond the persons who would otherwise be liable without regard to R.S.O. 2000, c 3 (Can. Ont.) (or equivalent) or regulations. See *infra* Section IIA(3)–(4).

25. See, e.g., R.S.O. 2000, c 3, s. 3(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 3(2) (Can. B.C.); R.S.A. 2000, c F-23, s. 7 (Can. Alta.); C.C.S.M. 2012, c F156, s. 3(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 3(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 3(1) (Can. P.E.I.).

26. See, e.g., R.S.O. 2000, c 3, s. 4(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 4(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 4(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 4(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 4(1) (Can. P.E.I.).

27. ONTARIO MINISTRY OF CONSUMER & COMMERCIAL RELATIONS, ONTARIO FRANCHISE DISCLOSURE LEGISLATION: A CONSULTATION PAPER (June 1998).

28. See, e.g., 1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd., [2004] O.J. No. 3008 (Can. Ont. Sup. Ct. J.) (QL), *appeal dismissed*, 2005 CanLII 25181 (Can. Ont. C.A.); 1518628 Ontario Inc. v. Tutor Time Learning Centres LLC, 2006 CanLII 25276 (Can. Ont. Sup. Ct. J.); Hi Hotel Ltd. P'ship v. Holiday Hosp. Franchising Inc., [2008] A.J. No. 892 (Can. Alta. C.A.).

Unlike the United States, Canadian provinces do not require that franchisors be registered, nor for their Canadian Franchise Documentation to be filed with any government agency. In fact, no regulatory authority in any Canadian province currently has responsibility for enforcing applicable franchise statutes or regulations.

To incentivize franchisors to comply with their obligations under Canadian Franchise Legislation, Canadian franchisees have, in addition to the remedies set forth above, statutory remedies arising from a breach of a franchisor's obligations. Canadian Franchise Legislation provides that a breach by a franchisor of its statutory duty of fair dealing, or interfering with a franchisee's right of association, affords the franchisee a right of action for damages against the franchisor.²⁹

As a first step, it is necessary, therefore, to understand how Canadian Franchise Legislation defines a franchise to determine whether or not Canadian Franchise Legislation applies to a particular business relationship. Canadian Franchise Legislation can be broken down into the following nine elements.

1. What Is a Franchise?

The Ontario Act defines a *franchise* as follows:

“franchise” means a right to engage in a business where the franchisee is required by contract or otherwise to make a payment or continuing payments, whether direct or indirect, or a commitment to make such payment or payments, to the franchisor, or the franchisor's associate, in the course of operating the business or as a condition of acquiring the franchise or commencing operations and,

(a) In which,

(i) the franchisor grants the franchisee the right to sell, offer for sale or distribute goods or services that are substantially associated with a trademark, trade name, logo or advertising or other commercial symbol that is owned by or licensed to the franchisor or the franchisor's associate, and

(ii) the franchisor or the franchisor's associate has the right to exercise or exercises significant control over, or has the right to provide or provides significant assistance in, the franchisee's method of operation, including building design and furnishings, locations, business organization, marketing techniques or training, or

(b) in which,

(i) the franchisor, or the franchisor's associate, grants the franchisee the representational or distribution rights, whether or not a trademark, trade name,

(QL); Sovereignty Inv. Holdings, Inc. v. 9127-6907 Quebec Inc., 2008 CanLII 57450 (Can. Ont. Sup. Ct. J.); 6792341 Canada Inc. v. Dollar It Ltd., 2009 CanLII 385 (Can. Ont. C.A.).

29. Regarding breaches of the duty of fair dealing, see, for example, R.S.O. 2000, c 3, s. 3(2) (Can. Ont.); R.S.B.C. 2015, c 35, s. 3(2) (Can. B.C.); C.C.S.M. 2012, c F156, s. 3(2) (Can. Man.); R.S.N.B. 2014, c 111, s. 3(2) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 3(2) (Can. P.E.I.). Regarding breaches of a franchisee's right to associate, see, for example, R.S.O. 2000, c 3, s. 4(5) (Can. Ont.); R.S.B.C. 2015, c 35, s. 4(5) (Can. B.C.); C.C.S.M. 2012, c F156, s. 4(5) (Can. Man.); R.S.N.B. 2014, c 111, s. 4(5) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 4(5) (Can. P.E.I.); see also R.S.A. 2000, c F-23, s. 11 (Can. Alta.).

logo or advertising or other commercial symbol is involved, to sell, offer for sale or distribute goods or services supplied by the franchisor or a supplier designated by the franchisor, and

(ii) the franchisor, or the franchisor's associate, or a third person designated by the franchisor, provides location assistance, including securing retail outlets or accounts for the goods or services to be sold, offered for sale or distributed or securing locations or sites for vending machines, display racks or other product sales displays used by the franchisee. . . .³⁰

Under this definition, any business that involves the sale or distribution of branded goods or services is potentially a “franchise” for the purposes of the Ontario Act. Unlike Alberta and Ontario, the other regulated provinces in Canada provide an exception to their franchise statutes for the purchase of reasonable amounts of inventory at bona fide wholesale prices or reasonable amounts of services at reasonable prices.³¹

Canadian Franchise Legislation does not define what the word “significant” means for the purpose of determining whether a party has the right to, or exercises “significant control” or has the right to or provides “significant assistance” under the second part of the definition. There are, however, now several cases which have examined how much control or assistance will be considered “significant.”³²

30. See, e.g., R.S.O. 2000, c 3, s. 1(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 1(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 1(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 1(1) (Can. N.B.); R.S.A. 2000, c F-23, s. 1(1)(d) (Can. Alta.); R.S.P.E.I. 1988, c F-14.1, s. 1(1)(b) (Can. P.E.I.).

31. See, e.g., R.S.B.C. 2015, c 35, s. 2(3)(g) (Can. B.C.); C.C.S.M. 2012, c F156, s. 2(3)(i) (Can. Man.); R.S.N.B. 2014, c 111, s. 2(3)(g) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 2(3)(g) (Can. P.E.I.); see also discussion *infra* Section III.A(a).

32. The exercise of either control or assistance, is not a bright line test but arises from a combination of factors determined by an inquiry into the facts and evidence. See *Beer v. Pers. Serv. Coffee Corp.*, 2005 CanLII 25180 (Can. Ont. C.A.) (endorsing the following factors as indicia of substantial control or assistance: (a) control over how the franchisee represents itself and how it uses the trademark; (b) control over standards for the identification of all users of the trademark; (c) requirements to purchase or lease equipment through the franchisor or with the franchisor's consent; (d) requirements to attend initial and ongoing training and meetings; (e) ability to inspect samples of the uses of the trademark and the method of performance of the franchisee's services in order to control the character and quality of the goods/services offered; (f) requirements to provide purchase and sale information upon request; (g) control over promotional pricing; (h) requirements to obtain insurance and name the franchisor as an additional insured; (i) the right for the franchisor to change or modify the system, products, or trademark without notice or consent; (j) the right to set quotas or minimum sale requirements; and (k) significant assistance in training, sales presentations and demonstrations, non-financial advertising assistance, and provision of printed materials such as brochures and pamphlets). Another relevant case is *Di Stefano v. Energy Automated Sytem, Inc.*, [2010] O.J. No. 385 (Can. Ont. Sup. Ct. J.) (QL), in which a motion to stay an action was brought by ten individuals who claimed to be franchisees under agreements that they had signed with the corporate defendant. The court found that the agreement met the first and second elements of the definition, being the payment and the right to sell goods or services. There was no evidence that the corporate defendant exercised significant control over the individuals' method of operation. As such, the only issue was whether the five-day training course amounted to significant assistance for the purposes of the definition of a “franchise.” In this regard, Justice Code stated:

This slender thread is not “a reasonable basis” on which to assert that EAST's contracts with the Plaintiffs are “franchise agreements” for a number of reasons. First, the five-day training program is a condition precedent to obtaining an EAST

It also does not matter that the parties to a given commercial arrangement may have not intended to engage in franchising (instead, believing their relationship is a mere license or distributorship). It is well established that what the parties choose to call their arrangement is irrelevant.³³ So, if their commercial arrangement meets the statutory definition of a “franchise,” franchise legislation applies.

The Ontario Act also provides for an alternate definition of “franchise,” which expressly brings product distribution schemes—such as sales from

dealership. It is not ongoing assistance during the pendency of the agreement. The statute uses the verbs “exercises” and “offers,” in the present tense, in relation to the elements of “control” and “assistance.” It does not refer to a one-time training program undertaken and completed in the past. Second, the offer of assistance must relate to the business “method of operation.” The five-day training program, in substance, relates to learning about the products rather than learning about any particular “method of operation.” Third, the statute sets out six examples of what it means by “method of operation”—building design, furnishings, locations, business organization, marketing techniques and training. The first five are clearly inapplicable and the “training” offered does not, in its real substance, relate to “method of operation.”

Finally, the result of the Plaintiffs’ submission, if correct, would be that any company selling a sophisticated product, and offering advance training about that product to its nascent distributors, would in law be a “franchisor.” It is unlikely the Legislature intended this result.

Id. para. 27. The court therefore concluded that the Wishart Act had no application to the relationships between the parties. *Id.*; see also 2287913 Ontario. ERSP Int’l Enters. Ltd., 2021 CanLII 6756 (Can. Ont. Sup. Ct. J.) (following *Di Stefano* and finding that the provision of a Dealer Manual, which was a document explaining how to close sales and the organizing and hosting of dealer advisory meetings, conferences, and training seminars did not constitute “significant control or assistance.”); *Chadarova v. Staffing Exch. Inc.* [2016] O.J. No. 1310 (Can. Ont. Sup. Ct. J.) (QL), *reversed in part*, [2016] O.J. No. 5911 (Can. Ont. C.A.) (QL) (holding that a training agreement that included a fee for training and for certain software, hardware, and other services, together with a Brokerage License Agreement, constituted a franchise). Further, in *Business Blossoms Inc. v. Blossoms Fresh Fruit Arrangements Ltd.*, 2016 ABQB 275 (Can. Alta. Q.B.), the court held that, while the licensor provided significant advice and recommendations, such information was not *prescribed* and, accordingly, did not constitute control. Although the court did find that the only control exercised by the licensor over the licensee related to use by the licensee of the licensor’s trademarks giving the licensor a right to terminate the license agreement, but not the right to exercise control over the operation of the business. *Id.* As such, the court held that the business relationship was not a franchise for purposes of the Alberta Act. *Id.*; see also *Fyfe v. Vardy (Dial A Bottle)*, 2018 CanLII 5066 (Can. Ont. Sup. Ct. J.) (holding that the taking of orders and referring those orders to the plaintiff (franchisee), as well as control over the logo, marketing materials, and web design, was sufficient to establish control); *Canstar Restorations Ltd. P’ship v. DKI Canada Ltd.*, 2021 CanLII 951 (Can. B.C.) (holding that it did not matter whether the party claiming that the relationship was not a franchise actually exercised control or provided assistance but only required that the party had the right, or obligation, to do so, and finding that the right to terminate the agreement if the other party did not comply with policies was sufficient to establish significant control).

33. See 1706228 Ontario Ltd. v. Grill It Up Holdings Inc., 2011 CanLII 2735 (Can. Ont. Sup. Ct. J.) (holding that the definition of franchise agreement includes collectively the license agreement, asset purchase agreement, and sublease signed by the parties even though no formal franchise agreement was yet signed); see also *Fyfe v. Vardy (Dial A Bottle)*, 2018 CanLII 5066 (Can. Ont. Sup. Ct. J.) (holding that the title of the document, in this case an exclusivity agreement, was irrelevant for the purposes of determining whether the business was a franchise); *Chadarova v. Staffing Exch. Inc.* [2016] O.J. No. 1310 (Can. Ont. Sup. Ct. J.) (QL), *reversed in part*, [2016] O.J. No. 5911 (Can. Ont. C.A.) (QL) (holding that a training agreement that included a fee for training and for certain software, hardware and other services, together with a Brokerage License Agreement, constituted a franchise).

vending machines and display racks—under the purview of the Ontario Act. Pursuant to Section 1(1)(b) of the Ontario Act, “franchise” also means a right to engage in a business where the franchisee is required to make a payment or continuing payments in which representational or distribution rights are granted to sell, offer for sale, or distribute goods or services supplied by the franchisor or its designated supplier, or where the franchisor (or its associate or designee) provides location assistance.³⁴ Under this definition, there is no need for association with the franchisor’s trademarks or other intellectual property, nor is there any requirement for significant control or assistance.³⁵

Master franchises are expressly included within the scope of all Canadian Franchise Legislation.³⁶

2. Disclosure

Under the Ontario Act, a franchisor must deliver to each prospective franchisee a disclosure document compliant with the Ontario Act and the detailed requirements set forth in regulations³⁷ promulgated under the Ontario Act (Regulations).³⁸

The franchisor must provide the disclosure document to prospective franchisees no later than fourteen days before the earlier of the franchisee (1) signing the franchise agreement or any other agreement relating to the franchise; or (2) paying any consideration relating to the franchise.³⁹

In addition, the Regulations require the CFDD to be certified as true and complete.⁴⁰ A statutory certificate must be appended to the CFDD and usually signed by two officers or directors of the franchisor.⁴¹ The Ontario Act further states that a disclosure document shall contain the following:

34. Except Alberta. *See* R.S.O. 2000, c 3, s. 1(1)(b) (Can. Ont.); R.S.B.C. 2015, c 35, s. 1(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 1(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 1(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 1(1)(b) (Can. P.E.I.).

35. Except Alberta. *See, e.g.*, R.S.O. 2000, c 3, s. 1(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 1(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 1(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 1(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 1(1)(b) (Can. P.E.I.).

36. *See, e.g.*, R.S.O. 2000, c 3, s. 1(2) (Can. Ont.); R.S.B.C. 2015, c 35, s. 1(2) (Can. B.C.); R.S.N.B. 2014, c 111, s. 1(2) (Can. N.B.); R.S.A. 2000, c F-23, s. 1(1)(d)(iii)(B) (Can. Alta.); R.S.P.E.I. 1988, c F-14.1, s. 1(2) (Can. P.E.I.).

37. *See* R.S.O. 2000, c 3, s. 5(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 4(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(1) (Can. N.B.); R.S.A. 2000, c F-23, s. 4(1), 4(2) (Can. Alta.); R.S.P.E.I. 1988, c F-14.1, s. 5(1) (Can. P.E.I.).

38. *See* General, O. Reg. 581/00 (Can.); Franchise Regulation, B.C. Reg. 238/2016 (Can.); Alberta Regulation, 240/95 (Can.); Franchises Regulation, 29/2012 (Can. Man.); Disclosure Document Regulation, N.B. Reg. 2020-92 (Can.); Regulations, Chapter F-14.1 (Can. P.E.I.).

39. *See, e.g.*, R.S.O. 2000, c 3, s. 5(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(1) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 4(1), 4(2) (Can. Alta.).

40. *See* General, O. Reg. 581/100, s. 7(1) (Can.); Franchise Regulation, B.C. Reg. 238/2016 (Can.); Alberta Regulation, 240/95, s. 7(1), sched. 2, cl. (a) (Can.); Franchises Regulation, 29/2012, s. 2(3), Sch. B, Form 1(a), (b) (Can. Man.); Disclosure Document Regulation, 2020-92, s. 6(1), Form 1(a) (b), (c) (Can. N.B.); Regulations, Chapter F-14.1, sched. II, Form 1(a), (b) (Can. P.E.I.).

41. *See* General, O. Reg. 581/100, ss. 7(2), 7(3) (Can.); Franchise Regulation, B.C. Reg. 238/2016 (Can.); Alberta Regulation, 240/95, ss. 7(2), 7(3) (Can.); Franchises Regulation,

- (i) all material facts,⁴² including material facts as prescribed by the Regulations;⁴³
- (ii) financial statements as prescribed;⁴⁴
- (iii) copies of all proposed agreements;⁴⁵
- (iv) the prescribed statements (these are found at the beginning of the disclosure document); and
- (v) other information and copies of documents as prescribed.⁴⁶

There are also certain formal requirements that the franchisor must meet, including the delivery of the CFFD “as one document at one time,”⁴⁷ that the information in a CFDD is “accurately, clearly and concisely set out,”⁴⁸ and that certain statements and other information are presented together, in some cases in specific locations, within the CFDD.⁴⁹

The disclosure process begins when a franchisor provides a prospective franchisee with the CFDD and ends when the prospective franchisee signs the franchise agreement.⁵⁰ The time between those two events must be at

29/2012, ss. 2(3), 2(4) (Can. Man.); Disclosure Document Regulation, 2020-92, s. 6(2) (Can. N.B.); and Regulations, chap. F-14.1, s. 4(3) (Can. P.E.I.).

42. A “material fact” is defined as including any information about the business, operations, capital, or control of the franchisor or the franchisor’s associate, or about the franchise system, that would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the decision to acquire the franchise. See R.S.O. 2000, c 3, s. 1(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 1(1) (Can. B.C.); R.S.A. 2000, c F-23, s. 1(1)(o) (Can. Alta.); C.C.S.M. 2012, c F156, s. 1(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 1(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 1(1)(l) (Can. P.E.I.).

43. There is a long list of other information set forth in the Regulations that must be contained in the disclosure document, including the business background of the franchisor, its finances, its bankruptcy and insolvency history, the expected costs to the franchisee associated with establishing the franchise, copies of all agreements relating to the franchise, and contact particulars for both current and former franchisees. The items identified in the regulations should not be viewed as exhaustive. See *infra* Section III(A).

44. The financial statements must be either audited financial statements or review engagement financial statements, in either case, in accordance with the reporting standards set out in the *Canadian Institute of Chartered Accountants Handbook*. Certain exemptions from the delivery of these financial statements are available to mature franchisors. The financial statements must be for the franchisor’s last fiscal year-end; however, if 180 days have not yet passed since the end of the most recently completed fiscal year and a financial statement has not been prepared and reported for that year, the disclosure document shall include a financial statement for the previous fiscal year that is prepared in accordance with the foregoing requirements.

45. See R.S.O. 2000, c 3, s. 5(4)(c) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(4)(b) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(5)(c) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(4)(b) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(4)(c) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 4(3)(b) (Can. Alta.).

46. See R.S.O. 2000, c 3, s. 5(4)(e) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(4)(e) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(5)(f) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(4)(e) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(4)(e) (Can. P.E.I.).

47. See R.S.O. 2000, c 3, s. 5(3) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(3) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(3) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(3) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(3) (Can. P.E.I.).

48. See R.S.O. 2000, c 3, s. 5(6) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(7) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(9) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(7) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(6) (Can. P.E.I.).

49. See Disclosure Document Regulation, 2020-92, s. 5 (Can. N.B.); Regulations, Chapter F-14.1, s. 3(1) (Can. P.E.I.).

50. A “franchise agreement” is defined in the Act as any agreement between a franchisor or a franchisor’s associate, and a franchisee, which includes not only what is normally considered a

least fourteen days but could continue for additional weeks or months. If during the intervening period there are any material changes⁵¹ to the information provided or that should have been provided in the CFDD, the franchisor must provide the prospective franchisee with a statement of material change as soon as practicable after the material change has occurred. Further, the franchisor must supply the statement of material change before the prospective franchisee signs the franchise agreement or any other agreement related to the franchise and before the payment of any consideration by or on behalf of the prospective franchisee to the franchisor or the franchisor's associate relating to the franchise.⁵²

3. Rescission

The Ontario Act provides that a franchisee may rescind the franchise agreement no later than sixty days after receiving the disclosure document if: (1) the franchisor fails to provide the disclosure document or statement of material change within the time requirements; (2) the contents do not meet the requirements of the Ontario Act but would otherwise not be so deficient so as to permit rescission under section 6(2) of the Ontario Act; or (3) where an intermediate step is taken by a prospective franchisee (*i.e.*, the payment of a deposit or the signing of a letter of intent), who does not receive a disclosure document until after having taken this step.⁵³ A franchisee also

franchise agreement but also could include other agreements like sublease agreements. Several court decisions have held that an asset purchase agreement was a franchise agreement, thus triggering a disclosure obligation, the failure of which triggered the right to rescind. *See Bekah v. Three for One Pizza*, 2003 CanLII 64302 (Can. Ont. Sup. Ct. J.); *1706228 Ontario Ltd. v. Grill It Up Holdings Inc.*, 2011 CanLII 2735 (Can. Ont. Sup. Ct. J.); *see also Chavdarova v. Staffing Exch. Inc.*, 2016 CanLII 1822 (Can. Ont. Sup. Ct. J.) (holding a training agreement dealing certain payments by the franchisee, training, the use of certain hardware and software in the operation of the business, and a brokerage agreement relating to the split of commissions to be paid to the franchisee, was deemed to be a franchise agreement).

51. Defined as “a change in the business, operations, capital, or control of the franchisor . . . , a change in the franchise system or a prescribed change, that would reasonably be expected to have a significant adverse effect on the value or price of the franchise to be granted or on the decision to acquire the franchise and includes a decision to implement such a change made by the board of directors of the franchisor . . . or by senior management of the franchisor . . . who believe that confirmation of the decision by the board of directors is probable.” *See R.S.O.* 2000, c 3, s. 1(1) (Can. Ont.); *R.S.B.C.* 2015, c 35, s. 1(1) (Can. B.C.); *R.S.A.* 2000, c F-23, s. 1(1)(h) (Can. Alta.); *C.C.S.M.* 2012, c F156, s. 1(1) (Can. Man.); *R.S.N.B.* 2014, c 111, s. 1(1) (Can. N.B.); *R.S.P.E.I.* 1988, c F-14.1, s. 1(1)(k) (Can. P.E.I.).

52. *See R.S.O.* 2000, c 3, s. 5(5) (Can. Ont.); *R.S.B.C.* 2015, c 35, s. 5(6) (Can. B.C.); *R.S.A.* 2000, c F-23, s. 4(4)(5) (Can. Alta.); *C.C.S.M.* 2012, c F156, s. 5(7) (Can. Man.); *R.S.N.B.* 2014, c 111, s. 5(6) (Can. N.B.); *R.S.P.E.I.* 1988, c F-14.1, s. 5(5) (Can. P.E.I.).

53. *See R.S.O.* 2000, c 3, s. 6(1) (Can. Ont.); *R.S.B.C.* 2015, c 35, s. 6(1) (Can. B.C.); *C.C.S.M.* 2012, c F156, s. 6(1) (Can. Man.); *R.S.N.B.* 2014, c 111, s. 6(1) (Can. N.B.); *R.S.P.E.I.* 1988, c F-14.1, s. 6(1) (Can. P.E.I.); *R.S.A.* 2000, c F-23, s. 13 (Can. Alta.). In Alberta, the franchisor's obligation is to compensate the franchisee for “net losses” as compared with Ontario, which (a) itemizes certain payment obligations; and (b) requires compensation for losses (as opposed to net losses). The impact of the difference in wording is demonstrated by *2122994 Ontario Inc. v. Lettieri*, 2016 CanLII 6209 (Can. Ont. Sup. Ct. J.), *appeal dismissed*, 2017 CanLII 830 (Can. Ont. C.A.), where the court held that it was irrelevant whether the franchisee had to repay monies owing to the bank, which were used by the franchisee to pay the franchisor. Whatever

is entitled to rescind the franchise agreement no later than two years after signing the franchise agreement if the franchisor never provided a CFDD.⁵⁴ Notice of rescission must be in writing and must be delivered to the *franchisor* personally by registered mail, by fax, or by any other method identified in the Regulations.⁵⁵

In the event of a rescission, the Ontario Act⁵⁶ requires the franchisor and those parties deemed to be a franchisor's associate,⁵⁷ within sixty days of the effective date of the rescission, to

- (i) refund to the franchisee any money received from or on behalf of the franchisee, other than money for inventory, supplies, or equipment;
- (ii) purchase from the franchisee any inventory that the franchisee had purchased pursuant to the franchise agreement and remaining at the effective date of rescission, at a price equal to the purchase price paid by the franchisee;
- (iii) purchase from the franchisee any supplies and equipment that the franchisee had purchased pursuant to the franchise agreement, at a price equal to the purchase price paid by the franchisee; and
- (iv) compensate the franchisee for any losses that the franchisee incurred in acquiring, setting up and operating the franchise, less the amounts set out in (i) to (iii).⁵⁸

4. Damages for Misrepresentation or a Failure to Comply with Section 5 of the Ontario Act

If a franchisee suffers a loss because of a misrepresentation⁵⁹ contained in the disclosure document or a statement of material change, or as a result

monies were paid to the franchisor by the franchisee must be repaid back to the franchisee. The court contrasted this to Alberta and noted that "Ontario has a specific legislated payback scheme. It is not a 'net loss' regime." *Id.* para. 5.

54. See R.S.O. 2000, c 3, s. 6(2) (Can. Ont.); R.S.B.C. 2015, c 35, s. 6(2) (Can. B.C.); C.C.S.M. 2012, c F156, s. 6(2) (Can. Man.); R.S.N.B. 2014, c 111, s. 6(2) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 6(2) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 13(b) (Can. Alta.).

55. See R.S.O. 2000, c 3, s. 6(3) (Can. Ont.); R.S.B.C. 2015, c 35, s. 6(2) (Can. B.C.); C.C.S.M. 2012, c F156, s. 6(2) (Can. Man.); R.S.N.B. 2014, c 111, s. 6(2) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 6(2) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 13(b) (Can. Alta.).

56. See R.S.O. 2000, c 3, s. 6(6) (Can. Ont.); R.S.B.C. 2015, c 35, s. 6(5) (Can. B.C.); C.C.S.M. 2012, c F156, s. 6(5) (Can. Man.); R.S.N.B. 2014, c 111, s. 6(6) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 6(6) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 14(2) (Can. Alta.).

57. In *2483038 Ontario Inc. v. 2082100 Ontario Inc.*, 2020 CanLII 475 (Can. Ont. Sup. Ct. J.), the court held that the person identified as the sole director, officer, and controlling shareholder was a franchisor's associate, rendering him personally liable for rescission damages because he made representations to the prospective franchisees by signing certain pages in the disclosure document, despite not signing the certificate page.

58. See R.S.O. 2000, c 3, s. 6(6) (Can. Ont.); R.S.B.C. 2015, c 35, s. 6(5) (Can. B.C.); C.C.S.M. 2012, c F156, s. 6(5) (Can. Man.); R.S.N.B. 2014, c 111, s. 6(6) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 6(6) (Can. P.E.I.).

59. A "misrepresentation" is defined in R.S.O. 2000, c 3, s. 1(1) (Can. Ont.) as (a) an untrue statement of a material fact; or (b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made. See R.S.B.C. 2015, c 35, s. 1(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 1(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 1(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 1(1)(m) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 1(1)(q) (Can. Alta.).

of the franchisor's failure to comply with the requirements of Section 5 of the Ontario Act, the franchisee has a right of action for damages against the franchisor, the franchisor's agent, the franchisor's broker (being a person other than the franchisor, franchisor's associate, franchisor's agent or franchisee, who grants, markets, or otherwise offers to grant a franchise, or who arranges for the grant of a franchise), the franchisor's associate, and any person who signed the disclosure document or statement of material change.⁶⁰ The Ontario Act deems that the franchisee has relied on the misrepresentation.⁶¹

5. Exemptions

The Ontario Act specifically excludes certain relationships from its application, including employer-employee relationships, partnerships, membership in a prescribed co-operative association, and certain types of commercial or leasing arrangements, namely arrangements for the evaluation, testing, or certification of goods or services, concessions, oral agreements, and contracts with the government itself.⁶²

In addition, there are several exemptions from the disclosure obligations under the Ontario Act.⁶³ For example:

- grants of additional franchises to existing franchisees, provided that the additional franchises are substantially the same as the existing franchise and there has been no "material change" since the existing franchise agreement was entered [additional grant exemption];⁶⁴
- grants to directors or officers of the franchisor;⁶⁵
- grants of a franchise where the total sales relating to the franchise do not exceed a certain percentage of the total sales of the business, which

60. See R.S.O. 2000, c 3, s. 7(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 7(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 7(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 7(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 7(1) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 9(1) (Can. Alta.).

61. See R.S.O. 2000, c 3, s. 7(2), (3) (Can. Ont.); R.S.B.C. 2015, c 35, s. 7(2), (3) (Can. B.C.); C.C.S.M. 2012, c F156, s. 7(2), (3) (Can. Man.); R.S.N.B. 2014, c 111, s. 7(2), (3) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 7(2), (3) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 9(2) (Can. Alta.).

62. See R.S.O. 2000, c 3, s. 2(3) (Can. Ont.); R.S.B.C. 2015, c 35, s. 2(3) (Can. B.C.); C.C.S.M. 2012, c F156, s. 2(3) (Can. Man.); R.S.N.B. 2014, c 111, s. 2(4) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 2(3) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 9(1) (Can. Alta.). Alberta does not have any exemptions from the application of the Alberta Act to a franchise relationship.

63. See R.S.O. 2000, c 3, s. 5(7) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(8) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(11) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(8) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(7) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 5(1) (Can. Alta.). There are various qualifications to the exemptions, which are a trap for the unwary.

64. See R.S.O. 2000, c 3, s. 5(7)(c) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(8)(c) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(11)(c) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(8)(c) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(7)(c) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 5(1)(c) (Can. Alta.).

65. See R.S.O. 2000, c 3, s. 5(7)(b) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(8)(b) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(11)(b) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(8)(b) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(7)(b) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 5(1)(b) (Can. Alta.).

is currently prescribed by regulation to be twenty percent (sometimes known as “fractional franchises”);⁶⁶

- renewals or extensions of a franchise agreement where there has been no interruption in the operation of the business and there has been no “material change” since the franchise agreement or latest renewal or extension of the agreement was entered [renewal or extension exemption];⁶⁷
- grants by a franchisee, for the franchisee’s own account, where the grant is not affected by or through the franchisor;⁶⁸ and
- grants where:
 - the franchisee’s total annual investment to acquire and operate the franchise is less than C\$15,000;⁶⁹
 - the franchise agreement is not valid for more than one year and does not involve the payment of a non-refundable initial franchise fee;⁷⁰ or
 - the franchisee will make an initial investment of more than C\$3,000,000 for the acquisition of the franchise.⁷¹

There are, however, various qualifications to these exemptions, which are a trap for the unwary. For the additional grant exemption, there is the qualification that there has been no material change since the date of the last franchise agreement. For the renewal or extension exemption,⁷² there are two qualifications: (1) there is no interruption in the operation of the business by the franchisee; and (2) there has been no material change.⁷³ In either case, it would be hard to imagine that no material changes have taken place since the last time that the parties entered into a franchise agreement. Additionally, the resale exemption requires that the franchisor not be involved in

66. See R.S.O. 2000, c 3, s. 5(7)(e) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(8)(e) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(11)(e) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(8)(e) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(7)(e) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 5(1)(h) (Can. Alta.).

67. See R.S.O. 2000, c 3, s. 5(7)(f) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(8)(f) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(11)(f) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(8)(f) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(7)(f) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 5(1)(d) (Can. Alta.).

68. See R.S.O. 2000, c 3, s. 5(7)(a) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(8)(a) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(11)(a) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(8)(a) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(7)(a) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 5(1)(a) (Can. Alta.).

69. See R.S.O. 2000, c 3, s. 5(7)(g)(i) (Can. Ont.); C.C.S.M. 2012, c F156, s. 5(11)(g) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(8)(g) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(7)(g) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 5(1)(e) (Can. Alta.). No exemption is available in British Columbia.

70. See R.S.O. 2000, c 3, s. 5(7)(g)(ii) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(8)(g) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(11)(h) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(8)(b) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(7)(b) (Can. P.E.I.). No exemption is available in Alberta.

71. See R.S.O. 2000, c 3, s. 5(7)(h) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(8)(i) (Can. B.C.). No exemption is available in Alberta, Manitoba, New Brunswick, or Prince Edward Island.

72. See R.S.O. 2000, c 3, s. 2(3) (Can. Ont.); R.S.B.C. 2015, c 35, s. 2(3) (Can. B.C.); C.C.S.M. 2012, c F156, s. 2(3) (Can. Man.); R.S.N.B. 2014, c 111, s. 2(4) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 2(3) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 9(1) (Can. Alta.). Alberta does not have any exemptions from the application of the Alberta Act to a franchise relationship.

73. See R.S.B.C. 2015, c 35, s. 1(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 1(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 1(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 1(1)(m) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 1(1)(q) (Can. Alta.).

the grant in any manner (apart from the right to approve or disapprove the grant or to require the payment of a transfer fee in the amount set forth in the franchise agreement or an amount that does not exceed the reasonable actual costs of the franchisor to process the grant).⁷⁴ Various court decisions permit franchisees the right to rescind their franchise agreements, thereby disallowing the franchisor's claim to the exemption.⁷⁵

6. Governing Law and Venue Restrictions

Issues of the franchise agreement's governing law and the venue for resolving disputes often arise where the franchisor is from outside the country, or a province with franchise legislation, and understandably would prefer to have the agreement interpreted and adjudicated under the law of its home jurisdiction. Although nothing in the Ontario Act, per se, prevents a foreign franchisor from stating that the courts and laws of its own jurisdiction are to govern, Section 10 of the Ontario Act provides that "[a]ny provision in a franchise agreement purporting to restrict the application of the law of Ontario or to restrict jurisdiction or venue to a forum outside Ontario is void with respect to a claim otherwise enforceable under this Ontario Act in Ontario."⁷⁶

Franchisors in Ontario historically would designate Ontario law as governing the franchise agreement, even for those franchisees operating outside of Ontario, not expecting that the Ontario Act would apply to those outside Ontario. That is because Section 2 of the Ontario Act states that the Ontario Act applies only to those franchises being operated *wholly or partially in Ontario*.⁷⁷ At least one court has reached the opposite conclusion. The Ontario Court of Appeal held in *405341 Ontario Ltd. v. Midas Canada Inc.*⁷⁸ that when the franchise agreement specifies Ontario law is to govern, the Ontario Act applies to franchisees operating outside of Ontario. While a decision of the Ontario Court of Appeal is not binding on lower or appeal courts in other provinces, it is highly persuasive, and so it is likely those courts will follow *Midas* and find that their own provincial franchise legislation applies to franchises operating outside of their province if the franchise agreement chooses a particular provincial law.

74. See R.S.O. 2000, c 3, s. 5(8) (Can. Ont.); R.S.B.C. 2015, c 35, s. 5(9) (Can. B.C.); C.C.S.M. 2012, c F156, s. 5(16) (Can. Man.); R.S.N.B. 2014, c 111, s. 5(10) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 5(8) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 5(2) (Can. Alta.).

75. See, e.g., 2256306 Ontario Inc. v. Dakin News Sys. Inc., [2015] O.J. No. 370 (Can. Ont. Sup. Ct. J.) (QL), *aff'd*, 2016 CanLII 74 (Can. Ont. C.A.); 2189205 Ontario Inc. v. Springdale Pizza Depot Ltd., [2010] O.J. No. 3071 (Can. Ont. Sup. Ct. J.) (QL), *aff'd*, 2011 CanLII 467 (Can. Ont. C.A.); 2240802 Ontario Inc. v. Springdale Pizza Depot Ltd., 2015 CanLII 236 (Can. Ont. C.A.); MAA Diners Inc. v. 3 for 1 Pizza & Wings (Canada) Inc., 2003 CanLII 10615 (Can. Ont. Sup. Ct. J.), *aff'd*, 2004 CanLII 19240 (Can. Ont. C.A.).

76. See R.S.O. 2000, c 3, s. 10 (Can. Ont.); R.S.B.C. 2015, c 35, s. 12 (Can. B.C.); C.C.S.M. 2012, c F156, s. 10(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 11(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 11 (Can. P.E.I.); R.S.A. 2000, c F-23, s. 17 (Can. Alta.).

77. See R.S.O. 2000, c 3, s. 2(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 2(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 2(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 2(2) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 2(1) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 3(1) (Can. Alta.).

78. 405341 Ontario Ltd. v. Midas Canada Inc., 2010 CanLII 478 (Can. Ont. C.A.).

7. Fair Dealing

Section 3 of the Ontario Act imposes a duty of “fair dealing” on all parties to a franchise agreement in the performance and enforcement of the franchise agreement. Subsection 3(3) of the Ontario Act defines the duty of fair dealing to include a duty to act in good faith and in accordance with reasonable commercial standards.⁷⁹

Canadian courts have held that the Ontario Act merely codifies the common law duties owed by parties to act in good faith to each other⁸⁰ and that this duty would not normally be characterized as “fiduciary” in nature.⁸¹ While the manner in which courts have applied the duty of fair dealing is largely beyond the scope of this article, courts have generally held that it at least requires a party to consider the commercial interests of the other in making decisions and exercising any discretion that it has.⁸² The courts have also found franchisors breach this duty where the franchisor establishes a competing system and uses scarce resources to favor one group of franchisees at the expense of another;⁸³ where the franchisor professes its support for the franchisee one moment, and then “turn[s] its back on the franchisee when the latter need[s] it most;”⁸⁴ and where the franchisor deliberately keeps the franchisee “in the dark about its intentions, . . . actively . . . keep[s] the franchisee from finding out what was going on, . . . [and] deliberately with[o]lds critical information and d[oes] not return phone calls.”⁸⁵ In view of the Supreme Court of Canada’s decision in *Bhasin v. Hrynew*,⁸⁶ good faith has now been established as a fundamental organizing principle applicable to contractual performance generally by both franchisors and franchisees across all common law provinces.

8. The Right to Associate

Section 4 of the Ontario Act guarantees franchisees the right to associate with one another without interference or fear of reprisal by the franchisor.⁸⁷

79. See R.S.O. 2000, c 3, s. 3(3) (Can. Ont.); R.S.B.C. 2015, c 35, s. 3(3) (Can. B.C.); C.C.S.M. 2012, c F156, s. 3(3) (Can. Man.); R.S.N.B. 2014, c 111, s. 3(3) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 3(3) (Can. P.E.I.).

80. See *Spina v. Shoppers Drug Mart Inc.*, 2012 CanLII 5563 (Can. Ont. Sup. Ct. J.); *Landsbridge Auto Corp. v. Midas Canada Inc.*, 2009 CanLII 13628 (Can. Ont. Sup. Ct. J.); 1117304 Ontario Inc. v. Cara Operations Ltd., 2008 CanLII 56704 (Can. Ont. Sup. Ct. J.); *Fairview Donut Inc. v. TDL Group Corp.*, 2012 CanLII 1252 (Can. Ont. Sup. Ct. J.).

81. See *Shelanu Inc. v. Print Three Franchising Corp.*, [2000] O.J. No. 4129 (Can. Ont. Sup. Ct. J.) (QL), *rev'd*, [2003] O.J. No. 1919 (Can. Ont. C.A.) (QL); *Spina v. Shoppers Drug Mart Inc.*, 2012 CanLII 5563 (Can. Ont. Sup. Ct. J.); *TDL Group Ltd. v. Zabco Holdings Inc.*, 2007 CanLII 303 (Can. Man. Q. B.), *appeal dismissed as abandoned*, 2009 CanLII 116 (Can. Man. C.A.).

82. *Id.*

83. See *Shelanu Inc. v. Print Three Franchising Corp.*, [2000] O.J. No. 4129 (Can. Ont. Sup. Ct. J.) (QL), *rev'd*, [2003] O.J. No. 1919 (Can. Ont. C.A.) (QL).

84. See *Country Style Food Servs. Inc. v. 1304271 Ontario Ltd.*, [2005] O.J. No. 2730 (Can. Ont. C.A.) (QL).

85. See *Salah v. Timothy’s Coffees of the World Inc.*, [2010] O.J. No. 4336 (Can. Ont. C.A.) (QL).

86. *Bhasin v. Hrynew*, [2014] 3 S.C.R. 494 (Can.).

87. R.S.O. 2000, c 3, s. 4 (Can. Ont.).

9. Other Common Law Rights

In addition to their rights and obligations under the Ontario Act, franchisees and franchisors retain all other legal rights at common law, including to commence proceedings and claim damages for, among other things, breach of contract, interference with economic relations, and misrepresentation.⁸⁸

B. Interpretation of a Franchisor's Statutory Obligations by Canadian Courts

To date, the courts in Ontario, including the Ontario Court of Appeal, have held that the sixty-day right of rescission applies where a prospective franchisee pays consideration (money) before receiving the CFDD.

In addition to circumstances where a franchisor never provided a CFDD at all, the appellate courts in Ontario and Alberta both have held that the two-year right of rescission applies in circumstances where the CFDD was so deficient that it was as if the franchisor did not provide it at all. Circumstances to date have included any one of the following:

1. The franchisor failed to include a signed and dated certificate in the appropriate form signed by the required number of officers or directors of the franchisor;
2. The franchisor failed to provide financial statements; financial statements in the required form; auditor's notes; or provided stale dated (not current) financial statements;
3. The franchisor failed to provide a statement of material change in circumstances where it was required;
4. The disclosure document was provided in successive stages and not as one document at one time;
5. The disclosure document omitted material facts;
6. The disclosure document did not contain copies of all agreements that the prospective franchisee was required to sign; and
7. The disclosure document did not disclose the existence of the agreement to lease and the fact that the head lease had not yet been entered.⁸⁹

A relatively recent decision of the Ontario Court of Appeal in *Raibex Canada Ltd. v. ASWR Franchising Corp.*⁹⁰—which denied a franchisee's rescission claim after concluding that the two-year limitation period set forth in subsection 6(2) of the Ontario Act is for situations where there is a “complete failure to provide a disclosure document”—does provide franchisors with some respite.⁹¹ Although in the *Raibex* decision the Ontario Court of

88. See R.S.O. 2000, c 3, s. 9 (Can. Ont.); R.S.B.C. 2015, c 35, s. 11 (Can. B.C.); C.C.S.M. 2012, c F156, s. 9 (Can. Man.); R.S.N.B. 2014, c 111, s. 10 (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 10 (Can. P.E.I.); R.S.A. 2000, c F-23, s. 15 (Can. Alta.).

89. See 2611707 Ontario Inc. v. Freshly Squeezed Franchise Juice Corp., 2021 CanLII 2323 (Can. Ont. Sup. Ct. J.).

90. *Raibex Canada Ltd. v. ASWR Franchising Corp.*, 2018 CanLII 62 (Can. Ont. C.A.).

91. See *id.*, para. 46.

Appeal did affirm its previous rulings that a disclosure document may be so deficient that it effectively amounts to a complete lack of disclosure, ultimately the Ontario Court of Appeal stated that the inquiry into whether disclosure deficiencies justify rescission under subsection 6(2) of the Ontario Act depends upon whether the franchisee “can make a properly informed decision about whether or not to invest in a franchise.”⁹² As such, the test for determining whether a franchisee has a right to rescind may have changed.

Various decisions since *Raibex* indicate that fatal deficiencies in a CFDD will still afford a franchisee with the right to rescind within two years of signing the franchise agreement regardless of whether the franchisee was otherwise able to make a properly informed decision.⁹³ However in another case, the court held that “piecemeal disclosure” will no longer constitute a fatal deficiency in and of itself, but, instead, following *Raibex*, the fundamental inquiry is whether the franchisee was deprived of the opportunity to make an informed investment decision.⁹⁴

III. Comparing/Contrasting U.S. and Canadian Franchise Disclosure

A. Differences Between the Canadian and the U.S. Franchise Regimes with Respect to Franchise Disclosure Documents

1. Definition of Franchise

As indicated, the definition of “franchise” under the Ontario Act uses the phrase “continuing payments” as opposed to “continuing financial obligations,” which is found in a multitude of other jurisdictions. Further, the definition of “franchise” in all Canadian jurisdictions outside of Ontario and Alberta, as well as at the state and federal level in the United States, specifically excludes from the definition of “continuing financial obligations” the purchase of a reasonable amount of goods or services at reasonable bona fide wholesale prices. In Ontario, it is possible that any form of payment to the franchisor or the franchisor’s associate could be deemed sufficient to meet this consideration element, including payment for the purchase of inventory.

Furthermore, under the Ontario Act, the definition of “franchise” includes not only what is normally described as business format franchises, but also what is commonly known as product distribution franchises. Under the second part of the definition, a business relationship is also deemed to be a

92. See *id.*, para. 49.

93. 2483038 *Ontario Inc. v. 2082100 Ontario Inc.*, 2020 CanLII 475 (Can. Ont. Sup. Ct. J.) confirms that an unsigned certificate continues to constitute a fatal flaw which affords a franchisee with a right to rescind within two years of signing the franchise agreement. See also 2611707 *Ontario Inc. v. Freshly Squeezed Franchise Juice Corp.*, 2021 CanLII 2323 (Can. Ont. Sup. Ct. J.) (applying *Raibex* to find that a franchisor’s failure to include the agreement to lease, and the fact that a head lease had not yet been entered, constituted a material deficiency. As well, because the financial statements were missing the notes, the disclosure document was also materially deficient for this reason).

94. See *New Vision Renaissance MX Ltd. v. Symposium Café Inc.*, 2020 CanLII 1119 (Can. Ont. Sup. Ct. J.).

franchise if (1) the goods and services that are being sold, offered for sale, or distributed are supplied by the franchisor, or a supplier designated by the franchisor; and (2) the franchisor, franchisor's associate, or a third person designated by the franchisor provides location assistance to the franchisee, which includes "securing retail outlets or accounts for the goods or services to be sold, offered for sale or distributed or securing locations or sites for vending machines, display racks or other product sales displays used by the franchisee."⁹⁵

The effect of the foregoing is that the definition of "franchise," at least in Ontario, is quite broad and potentially imposes disclosure obligations on unsuspecting parties. This is different than how product distribution franchises are treated in the United States by the various federal and state business opportunity laws and regulations. In the United States, although prospective purchasers of a business opportunity must also be provided with a disclosure document,⁹⁶ that document is much simpler than the U.S. FDD delivered for a franchise sale. Thus, unlike Canada, in the United States many business opportunities are treated differently than franchise sales.

2. Material Facts

As indicated earlier, although Canadian Franchise Legislation uses several concepts developed in the United States and there are numerous similarities in the disclosure obligations, there are nevertheless numerous differences regarding the scope of CFDDs. The most important difference is how the obligation that a CFDD must contain all material facts applied and interpreted. There are several aspects to this difference. First, what constitutes a material fact is an amorphous concept in Canada. For franchisors delivering a disclosure document to a prospective franchisee in any Canadian Franchise Legislation province, this disclosure requires a broad and comprehensive assessment of the franchise system to ensure that all material facts are included. Conversely, the FTC Rule prescribes a finite list of information to include (and franchisors cannot include any other information outside of the finite list).

Second, unlike U.S. FDDs, which are often prepared once per year (unless certain material changes requiring disclosure arise), CFDDs are living, breathing documents and must contain all material facts as at the date that the CFDD is delivered to the prospective franchisee.⁹⁷

Third, material facts⁹⁸ would necessarily include any site or franchise-specific material facts. Depending on the franchise system, site, or franchise, material facts (1) could be present when a prospective franchisee buys a new

95. R.S.O. 2000, c 3, ss. 1(1) (a), (b) (Can. Ont.); R.S.B.C. 2015, c 35, ss. 1(1)(a), (b) (Can. B.C.); C.C.S.M. 2012, c F156, ss. 1(1)(a), (b) (Can. Man.); R.S.N.B. 2014, c 111, ss. 1(1)(a), (b) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, ss. 1(b)(i), (ii) (Can. P.E.I.).

96. See 16 C.F.R. § 437.

97. See discussion *supra* Section II.A(1), (2).

98. See discussion *supra* Section II.A(1) and (2).

franchise from the franchisor; and (2) are always present when a prospective franchise buys an existing franchise from the franchisor.

Site or franchise-specific material facts are also always present when the franchise is being sold by an existing franchise. In this circumstance, if the franchisor is unable to meet the disclosure exemption for not being involved in the grant and only requiring payment of a transfer fee,⁹⁹ then, to the extent known to the franchisor or any of its affiliates, the CFDD would have to include (to the extent applicable) various material facts. These material facts, could include: (1) information about, and a copy of, the lease; (2) information about financial performance of the franchised business, including the quantum of royalties, advertising contributions, and other payments received by the franchisor or its affiliate over a number of years, as well as the franchisee's financial statements (to the extent that the franchisor is possessed of same); (3) to the extent that a franchisor ordinarily provides them, information and qualifications about the financial performance of the franchise system, whether or not such performance related to resale franchises or otherwise; and (4) a copy of the agreement of purchase and sale.

Finally, as discussed earlier,¹⁰⁰ if there have been any material changes to the information provided (or that should have been provided in the CFDD), the franchisor must provide the prospective franchisee with a statement of material change, which includes the requisite information and/or documentation, as soon as practicable after the material change has occurred. The updated disclosure must occur before the prospective franchisee signs the franchise agreement or any other agreement related to the franchise or pays any consideration to the franchisor or the franchisor's associate, relating to the franchise.

3. Financial Statements

Canadian Franchise Legislation uniformly only requires that the financial statements satisfy, at a minimum, a review engagement standard set forth in the Canadian Institute of Chartered Accountant's Handbook or be audited, which is the same as the U.S. standard. Financial statements prepared on a lesser Notice to Reader standard, or internally by management or others, cannot be included in a CFDD.¹⁰¹ As of the time of writing, Ontario and British Columbia are the only provinces which expressly permit U.S. review engagement or audited financial statements that comply with the Auditing Standards Board of the American Institute of Certified Public Accountants or the U.S. Public Company Accounting Oversight Board, or by the International Auditing and Assurance Standards Board (IAASB).¹⁰² For Canadian

99. See discussion *supra* Section II.A(5).

100. See discussion *supra* Section II.A(2).

101. See discussion *supra* Section II.A(2), n.44.

102. General, O. Reg. 581/00, ss. 3(1)(a)(ii), (iii), (b)(ii), (iii) (Can.). Note that British Columbia also expressly permits the use of review engagement or audited financial statements that meet IAASB standards. See Franchises Regulation, B.C. Reg. 238/2016, ss. 5(2)(a), (b) (Can.).

Franchise Legislation other than Ontario and British Columbia, the use of the franchisor's review engagement or audited financial statements would likely be acceptable provided they are reviewed by a qualified Canadian CPA and the relevant notes are added so as to ensure that the financial statements are at least equivalent to Canadian generally accepted accounting principles.¹⁰³

In the United States, the FTC Rule also permits the use of an affiliated company's financial statements if the affiliated company unconditionally guarantees the franchisor's duties and obligations under the franchise agreement, as well as use of consolidated financial statements.¹⁰⁴ There is no equivalent permission in the Canadian Franchise Legislation.¹⁰⁵ So, although no court in Canada has made a judicial determination, it is likely that neither of these forms of financial statements would be accepted in Canada. In addition to them not being permitted, under Canadian tax laws, each corporation is taxed as a separate entity,¹⁰⁶ and thus neither a parent's consolidated financial statement nor an affiliate's financial statements would be treated as those of the franchisor. Also, the FTC Rule permits the use of unaudited financial statements for interim periods provided that they meet U.S. general accepted accounting principles.¹⁰⁷ Canadian Franchise Legislation does not allow for the use of interim financial statements.¹⁰⁸

Courts have confirmed that the failure to include proper financial statements in a CFDD amounts to a fatal deficiency and is like the delivery of no CFDD at all, providing the franchisee with an absolute right for two years to rescind the franchise agreement.¹⁰⁹

4. Circumstances Surrounding the Delivery of an FDD in Canada

As set out earlier, although Canadian Franchise Legislation provides various exemptions from the obligation to deliver a CFDD to a prospective franchisee, often a franchisor's ability to avail itself of the exemption is very

103. See discussion *supra* Section II.A(b), note 44.

104. 16 C.F.R. § 436.5(u)(iii).

105. See discussion *supra* Section II.A(b), note 44.

106. Income Tax Act (R.S.C. 1985, c 1 (5th)) s. 2, 3. Section 2(1) sets forth the general charging provision stating that "An income tax shall be paid, as required by this Act, on the taxable income for each taxation year of every person resident in Canada at any time in the year." The reference is to "every person" (*i.e.*, not a group). Subsection 3 indicates that the income of a taxpayer for a taxation year is determined by a number of rules which refer to the taxpayer's income. Again, there is no reference here to a group filing.

107. 16 C.F.R. § 436.5(u)(2).

108. See discussion *supra* Section II.A(b), note 44.

109. See, for example, the recent case of *2611707 Ontario Inc. v. Freshly Squeezed Franchise Juice Corp.*, 2021 CanLII 2323 (Can. Ont. Sup. Ct. J.), where the court held that the absence of auditor's notes in the financial statements that were included in the disclosure document was a material deficiency justifying rescission on this issue alone. See also *6792341 Canada Inc. v. Dollar It Ltd.*, 2009 CanLII 385 (Can. Ont. C.A.); *2240802 Ontario Inc. v. Springdale Pizza Depot Ltd.*, 2015 CanLII 236 (Can. Ont. C.A.); *Mendoza v. Active Tire & Auto Inc.*, 2017 CanLII 471 (Can. Ont. C.A.). In *Mendoza*, the financial statements were stale by only two weeks, although there were also other deficiencies that were the basis of the rescission.

limited.¹¹⁰ Given these limitations, if a franchisor is unable to avail itself of an exemption, it is then incumbent upon the franchisor to provide the franchisee, or prospective franchisee, with a disclosure document that contains all material facts relevant to the business that is the subject of the franchise agreement. This would include, for example, for a sale by another franchisee,¹¹¹ a copy of the agreement of purchase and sale, the information relating to the lease, a copy of the lease, information about the sales reported by the vendor franchisee, and copies of financial statements of the vendor franchisee (if in the franchisor's possession). In the context of the purchase of an additional franchise, or the renewal of a franchise agreement, the disclosure requirement includes any information and/or documentation that will impose a future financial obligation on the franchisee (*i.e.*, monthly lease payments, any renovation obligations, etc.). The foregoing is different than the FTC Rule, which does not impose any further obligation on the franchisor.

5. Remedies

As stated earlier in the paper, a franchisee who is owed a CFDD under Canadian Franchise Legislation has a right to rescind the franchise agreement if the franchisee never received the CFDD or it is materially deficient.¹¹² Further, franchisees can commence legal proceedings against the franchisor, and others liable under the relevant statute, if there is a failure to comply with the disclosure obligations set forth in franchise legislation or if there was a misrepresentation.¹¹³

Under Canadian Franchise Legislation, the burden of proof depends somewhat upon the reason for the rescission. For a rescission under section 6(1) of the Ontario Act, or under section 6(2) of the Ontario Act where the franchisee asserts that s/he never received a CFDD, the franchisor has the burden of proving that the CFDD was delivered, because this type of rescission claim involves technical compliance with the delivery regulations.¹¹⁴ For claims that a CFDD was so deficient so as to prevent the franchisee from making an informed investment decision, the franchisee first must assert the reasons for the rescission in a notice of rescission, but the franchisor bears the burden to prove that the CFDD did permit the franchisee to make an informed investment decision.¹¹⁵ For a misrepresentation claim, Canadian

110. See discussion *supra* Section II.A(5).

111. See discussion *supra* Section III.A(2).

112. See discussion *supra* Section II.A(3).

113. See R.S.O. 2000, c 3, s.7(1) (Can. Ont.); R.S.B.C. 2015, c 35, s. 7(1) (Can. B.C.); C.C.S.M. 2012, c F156, s. 7(1) (Can. Man.); R.S.N.B. 2014, c 111, s. 7(1) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, s. 7(1) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 9(1) (Can. Alta.).

114. See 4287975 Canada Inc. v. Imvescor Rests. Inc., 2009 CanLII 308 (Ont. C.A.), *leave to appeal to S.C.C. refused*, [2009] S.C.C.A. No. 244 (Can.) (QL); see also Rocha v. Panda Flowers (1999) Ltd., [2005] A.J. No. 1098 (Can. Alta. Q.B.) (QL); 1490664 Ontario Inc. v. Dig This Garden Retailers Ltd., [2005] O.J. No. 3040 (Can. Ont. C.A.) (QL).

115. 7799975 Ontario Ltd. v. Mmmuffins Canada Corp., [2009] O.J. No. 2357 (Can. Ont. Sup. Ct. J.) (QL).

Franchise Legislation deems the franchisee to have relied on the misrepresentation once the misrepresentation has been established.¹¹⁶

In the United States, franchisors are only required to provide evidence that they complied with the FTC Rule by having furnished a U.S. FDD.¹¹⁷ The burden of proving that the U.S. FDD did not comply with the FTC Rules falls either to the franchisee or the administrative body.¹¹⁸ As stated above, this statutory burden is different from the one imposed on franchisors under Canadian Franchise Legislation.

B. Differences Between Canadian Franchise Agreements and U.S. Franchise Agreements

Although Canadian and U.S. cultural and business practices are very similar, enough differences exist to justify the need to prepare Canadian Franchise Documentation specifically for use in Canada.¹¹⁹ Depending on the structure of the franchise system, other documents may be integral to the legal relationship between the franchisor and the franchisee and therefore need to be specifically referenced in the CFDD. Below are some of the issues that should be addressed in a Canadian Franchise Agreement.

1. Franchisor Involvement in the Development and/or the Lease of the Premises

In many brick and mortar franchise systems, a Canadian franchisor will act as the general contractor to profit on the build-out of the location. Canadian franchisors also seem to prefer leasing premises directly from the landlord and then subleasing the premises to the franchisee in order to control the lease. These circumstances result into differences in how the franchisor negotiates the acquisition of the premises, with Canadian franchisors often signing binding offers to lease and then subsequently negotiating the lease based on the landlord's standard form of lease. In either case, particular legal issues must be clearly articulated as part of the franchise agreement and the CFDD, and separate documentation needs to be prepared and referenced in

116. See R.S.O. 2000, c 3, ss. 7(2), 7(3) (Can. Ont.); R.S.B.C. 2015, c 35, ss. 7(2), 7(3) (Can. B.C.); C.C.S.M. 2012, c F156, ss. 7(2), 7(3) (Can. Man.); R.S.N.B. 2014, c 111, ss. 7(2), 7(3) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, ss. 7(2), 7(3) (Can. P.E.I.); R.S.A. 2000, c F-23, s. 9(2) (Can. Alta.).

117. 16 C.F.R. § 436.2(a).

118. This is a well-established principle of common law, absent some statutory burden shifting not present in the FTC Franchise Rule. The principle arises from the concept that *semper necessitas probandi incumbit ei qui agit*, which is Latin for "the necessity of proof always lies with the person who lays charges."

119. A fulsome discussion of a U.S. franchisor's expansion into Canada is beyond the scope of this paper. However, see Andraya Frith, Judy Rost, & Larry Weinberg, *Fundamentals of Franchising – Canada*, ABA 40TH ANN. FORUM ON FRANCHISING W-23 (2017); Joseph Adler, Michael Lindsey & Ramiro Rangel, *Franchise Expansion Across Our Borders: Canada and Mexico*, ABA 35TH ANN. FORUM ON FRANCHISING W-24 (2012).

the franchise agreement and CFDD, depending on whether the premises are subleased or leased directly by the franchisee.¹²⁰

2. Currency and Withholding Taxes

If a U.S. franchisor establishes a Canadian subsidiary to act as franchisor, then the Canadian subsidiary would most often receive payments from Canadian franchisees in Canadian dollars, and the Canadian subsidiary would also remit taxes to the Canadian government. However, if the U.S. franchisor is directly granting franchises to Canadian franchisees, then the U.S. franchisor can collect payments in either U.S. or Canadian dollars. If collecting in U.S. dollars, the U.S. franchisor must consider not only the economics of the proposed franchisor payments, but also the impact of exchange rates because the Canadian franchisee is earning its revenues in Canadian dollars. Further, the U.S. franchisor will need to ensure that the Canadian franchisee is required to withhold and remit withholding taxes to Canadian tax authorities.¹²¹

3. Non-Compete Provisions

Under Canadian law, non-compete provisions are prima facie void and unenforceable.¹²² To determine whether a restrictive covenant is enforceable, a court will assess, on a balance of probabilities, whether the non-compete provision is:

- (a) as a threshold issue, sufficiently precise to provide certainty to the parties. If there is ambiguity that cannot be resolved by the principles of contractual interpretation, the clause is per se unenforceable;
- (b) assuming the above threshold issue is satisfied, if the term is reasonable. This requires an assessment of the scope of the clause (*i.e.*, whether the geographic area, time, and subject matter are necessary for the protection of the franchisor's legitimate interests). The franchisor has the onus of establishing that the non-compete provision is reasonable; and
- (c) contrary to the public interest or otherwise offends public policy, for which the onus to prove falls on the franchisee.¹²³

120. These legal issues include the following: (a) who is preparing the architectural and mechanical drawings; (b) who is responsible for building out the premises; (c) who is dealing with the landlord in order to obtain approval; (d) who is obtaining the building permit; (e) if the franchisee is leasing directly, then the right of the franchisor to acquire the premises pursuant to some agreement; and (f) if the franchisor is leasing the premises, then the sublease agreement. As well, to the extent that the premises are known at the time that the CFDD is delivered, the CFDD must include the relevant details about the lease including a copy of the offer to lease, or lease. *See* 2611707 Ontario Inc. v. Freshly Squeezed Franchise Juice Corp., 2021 CanLII 2323 (Can. Ont. Sup. Ct. J.) (applying *Raibex* to find that a franchisor's failure to include the agreement to lease, and the fact that a head lease had not yet been entered, constituted a material deficiency).

121. Income Tax Act, R.S.C. 1985, c 1 (5th Supp.) (Can); Income Tax Regulations, C.R.C. c 945, s. 105 (Can.).

122. *KRG Ins. Brokers (W.) Inc. v. Shafron*, [2009] 1 S.C.R. 157 (Can.).

123. *Id.*

Generally speaking, Canadian courts will neither narrow, nor blue-pencil, a non-compete provision so as to render it enforceable.¹²⁴

4. Interest Rates

It is a criminal offense in Canada to charge anyone an effective interest rate of more than sixty percent. The consequences upon conviction include a fine of up to C\$25,000.00 and/or six months in prison for a summary conviction offense (less serious) or up to five years in prison for an indictable offense (more serious).¹²⁵

5. Forum and Governing Law

In almost every U.S. franchise agreement, the laws and courts of the franchisor's state are contractually chosen to govern the franchise relationship (with some notable exceptions in the franchise laws of some states). In Canada, the application of these laws, along with the jurisdiction of the franchisor's state court, is unenforceable. Canadian Franchise Legislation renders any attempt in a franchise agreement to restrict the application of the laws of the province or to restrict jurisdiction or venue to a forum outside of that province as being void, with respect to a claim otherwise enforceable under Canadian Franchise Legislation.¹²⁶ Given the statutory duty of fair dealing imposed by Canadian Franchise Legislation on both parties to the franchise agreement, almost every scenario which serves as the basis for a claim would be intertwined with a claim for the breach of such duty.¹²⁷

6. References to U.S. Statutes

In the drafting of a CFDD, it is perhaps trite, but nonetheless important, to state that any references to U.S. statutes would need to be deleted.

IV. Ethical Standards Required in the United States

A. ABA Model Rules

1. Competence—Model Rule 1.1

*A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.*¹²⁸

124. *Id.* For an excellent discussion of the treatment of restrictive covenants in Canadian franchise agreements, see Jennifer Dolman, Adam Ship, Rebecca Hall-McGuire & Tyler Wentzel, *Governing Principles & Recent Trends in the Enforcement of Restrictive Covenants in Franchise Agreements*, 43 *ADVOCATES Q.* 448 (2014).

125. Criminal Code, R.S.C., 1985 c C-46, s. 347 (Can.).

126. See, e.g., R.S.O. 2000, c 3, s. 10 (Can. Ont.); R.S.B.C. 2015, c 35, ss. 12, 12(3) (Can. B.C.); R.S.A. 2000, c F-23, s. 17 (Can. Alta.); C.C.S.M. 2012, c F156, s. 10(1) (Can. Man.); R.S.N.B. 2014, c 111, ss. 11(1), 11(2) (Can. N.B.); R.S.P.E.I. 1988, c F-14.1, ss. 11(1), 6(2) (Can. P.E.I.).

127. See *supra* text accompanying note 15.

128. MODEL RULES OF PROF. CONDUCT r. 1.1 (AM. BAR ASS'N 2020).

Competence is the fundamental requirement of Rule 1.1 of the ABA Model Rules of Professional Conduct (Model Rules). It is the first ethical duty in the Model Rules for a reason. Clients are entitled to representation by a lawyer who can provide competent representation. A lawyer's obligation of competence is determined by analysis of the lawyer's knowledge and skill in a particular matter, including an awareness of the complexity and specialized nature of the matter, general experience, and training and experience in the field.¹²⁹

This requirement is especially important with clients who, without the benefit of a law degree, generally lack knowledge sufficient to judge the quality of a practitioner. Hence, this rule gives rise to the need for licensure and professional self-regulation, such as state bars and ethics committees. It is for this reason that the legal profession has long justified its monopoly over the practice of law and its right to self-regulation; no one is more qualified to judge the competency of a lawyer than those within the profession.

The reason for prohibiting the practice of law by those who have not been examined and found qualified to practice is frequently misunderstood. It is not done to aid or protect members of the legal profession either in creating or maintaining a monopoly or closed shop. It is done to protect the public from being advised and represented in legal matters by unqualified persons over whom the judicial department can exercise little, if any, control.¹³⁰

The Model Rule does not require that each attorney be an expert or have specialized training or experience to handle any particular type of problem. Rather, "a lawyer can provide adequate representation in a wholly novel field through necessary study,"¹³¹ and "[c]ompetent representation can also be provided through the association of a lawyer of established competence in the field in question."¹³² For those U.S. attorneys who read this requirement and think that they can achieve the requisite competence through study or with the aid of a Canadian attorney, it is important to realize that another Model Rule places additional roadblocks to such representation. That is the rule regarding the unauthorized practice of law.

2. Unauthorized Practice of Law—Model Rule 5.5

*A lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction, or assist another in doing so.*¹³³

Every state, except Arizona, has an "unauthorized practice of law" statute. Arizona, instead, grants its Supreme Court jurisdiction over those who practice law without authority and subjects them to costs, administrative

129. *Id.* cmt. 1.

130. *State v. Sperry*, 140 So. 2d 587, 595 (Fla. 1962).

131. MODEL RULES OF PROF. CONDUCT r. 1.1, cmt. 2 (AM. BAR ASS'N 2020).

132. *Id.*

133. *Id.* r. 5.5. Many states have imposed on attorneys restrictions prohibiting the unauthorized practice of law that are similar to, or identical with, the ABA. See John R. F. Baer & Rupert Barkoff, *Ethics Issues in a Multijurisdictional Franchise Practice*, ABA 31ST ANN. FORUM ON FRANCHISING W-17 (2008).

expenses, and cease and desist orders.¹³⁴ Therefore, each state protects its own citizens (and its bar members) from unauthorized attorneys providing legal services in their states. Canada and her provinces also prohibit the unauthorized practice of law, thus disqualifying those who have not been properly permitted to practice within its jurisdictions.¹³⁵

What is the practice of law? The ABA Task Force on the Model Definition of Practice of Law has attempted to create a model definition of the term, proposing to define “practice of law” as the “application of legal principles and judgment with regard to the circumstances or objectives of a person that require the knowledge and skill of a person trained in the law.”¹³⁶

A person is presumed to be practicing law when engaged in the following conduct on behalf of another: (1) giving advice or counsel to persons as to their legal rights or responsibilities or to those of others; (2) selecting, drafting, or completing legal documents or agreements that affect the legal rights of a person; (3) representing a person before an adjudicative body, including but not limited to, preparing or filing documents or conducting discovery; or (4) negotiating legal rights or responsibilities on behalf of a person.¹³⁷

A review of various state prohibitions against the unauthorized practice of law generally includes those four factors in its definition as well as additional factors to include representing oneself as an attorney authorized to practice in the state or as a member of a state’s bar association.¹³⁸ The process of obtaining authorization is, therefore, deemed an integral part of the practice of law.

In its commentary to the Court Rules of the District of Columbia Court of Appeals regarding the unauthorized practice of law, the court articulated the essential elements of the practice of law:

[There are] two essential elements of the practice of law: The provision of legal advice or service, and a client relationship of trust or reliance. Where one provides such advice or services within such a relationship, there is an implicit representation that the provider is authorized or competent to provide them; just as one who provides any service requiring special skill gives an implied warranty that they are provided in a good and workmanlike manner.¹³⁹

134. ARIZ. R. SUP. CT. 42, E.R. 5.5.

135. Solicitors Act, R.S.O. 1990, c S.15 (Can. Ont.); Legal Profession Act, S.B.C. 1988, c 9 (Can. B.C.); Legal Profession Act, R.S.A. 2000, c L-8 (Can. Alta.); Legal Profession Act, C.C.S.M., c L.107 (Can. Man.); Law Society Act, S.N.B. 1996, c 89 (Can. N.B.); Legal Profession Act, S.P.E.I. 1992, c 39 (Can. P.E.I.).

136. AM. BAR ASS’N, TASK FORCE ON THE MODEL DEFINITION OF THE PRACTICE OF LAW (Sept. 18, 2002), https://www.americanbar.org/groups/professional_responsibility/task_force_model_definition_practice_law/model_definition_definition.

137. *Id.*

138. This paper is not intended to provide an exhaustive analysis of state laws related to the unauthorized practice of law, but, for those desiring such an analysis, the ABA provides a state-by-state list of definitions online. https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/model-def_migrated/model_def_statutes.pdf.

139. D.C. APP. R. 49.

Where the hurdle of competence may be successfully surmounted by study and practice, the barrier of practicing law in a jurisdiction in which one is not authorized to do so is not easily overcome.

V. Risks of Unauthorized Practice of Law

A. *Legal Exposure for Unauthorized Practice of Law*

Where the ethical impediments above are unconvincing to a practitioner, the risks faced for unauthorized practice of law may prove more persuasive. Not only can a lawyer face the loss or suspension of their license, they may also face fines, restitution obligations, and incarceration.

The unauthorized practice of law is, in many states, a misdemeanor punishable by up to one year in jail and a fine of \$1,000 to \$5,000, depending on the state.¹⁴⁰ And if one is found to be a repeat offender, they could face a felony with potential prison time up to ten years. In addition to the possible jail time and fines, lawyers may be brought before their state disciplinary bodies and face suspension or, in the case of repeated offenders, disbarment. They may also be ordered to make restitution to any former clients.

Another concern for lawyers should be coverage under their lawyer's professional liability insurance. Most insurance policies in the United States do not cover deliberately wrongful or criminal acts. Where a lawyer is found to be guilty of a criminal act, those acts will not be covered by the lawyer's malpractice insurance, nor will deliberately practicing law in a jurisdiction for which the lawyer is not licensed to practice be covered. Therefore, the lawyer or law firm engaged in such activities will bear the burden of defense costs, fines, and restitution obligations without the benefit of insurance.

B. *The Unauthorized Practice of Law in Ontario*

The practice of law in Ontario is governed by the Solicitors Act,¹⁴¹ which lays out who can provide legal services in Ontario and covers certain matters related to billing and compensation. This is in addition to The Law Society Act, which gives the Law Society of Ontario the power to regulate the legal profession. Regarding the provision of legal services, sections 1(5) and (6) of the Law Society Act¹⁴² state as follows:

Provision of legal services

(5) For the purposes of this Act, a person provides legal services if the person engages in conduct that involves the application of legal principles and legal judgment with regard to the circumstances or objectives of a person.

140. Victor D. López, *Unauthorized Practice of Law in The U.S.: A Survey and Brief Analysis of the Law*, 22 N.E. J. LEGAL STUD. 4 (2011); see also AM. BAR ASS'N, LEGAL INNOVATION REGULATORY SURVEY (2020), www.legalinnovationregulatorysurvey.info.

141. R.S.O. 1990, c S.15 (Can. Ont.); Legal Profession Act, S.B.C. 1988, c 9 (Can. B.C.); Legal Profession Act, R.S.A. 2000, c L-8 (Can. Alta.); Legal Profession Act, C.C.S.M., c L.107 (Can. Man.); Law Society Act, S.N.B. 1996, c 89 (Can. N.B.); Legal Profession Act, S.P.E.I. 1992, c 39 (Can. P.E.I.).

142. R.S.O. 1990, c L-8 (Can. Ont.).

(6) Without limiting the generality of subsection (5), a person provides legal services if the person does any of the following:

1. Gives a person advice with respect to the legal interests, rights or responsibilities of the person or of another person.
2. Selects, drafts, completes or revises, on behalf of a person,
 - i. a document that affects a person's interests in or rights to or in real or personal property, ...
 - vi. a document that affects the legal interests, rights or responsibilities of a person, other than the legal interests, rights or responsibilities referred to in subparagraphs i to v, or ...
4. Negotiates the legal interests, rights or responsibilities of a person.¹⁴³

Similar to the Model Rules, the foregoing excludes in-house counsel. Subsection 1(8) of the Law Society Act provides as follows:

Not practising law or providing legal services

(8) For the purposes of this Act, the following persons shall be deemed not to be practising law or providing legal services:

2. An employee or officer of a corporation who selects, drafts, completes or revises a document for the use of the corporation or to which the corporation is a party.¹⁴⁴

Foreign lawyers who want to provide legal advice in Ontario must apply for a Foreign Legal Consultant (FLC) permit.¹⁴⁵ The authors are unaware of any instances in which the LSO has issued cease and desist orders, or obtained injunctive relief, against U.S. lawyers.

VI. Practice Issues Arising from the Preparation of Canadian FDDS by U.S. Lawyers

Two practice issues arise regarding the preparation of Canadian Franchise Documentation by U.S. lawyers. The first issue is whether they are engaging in the unauthorized practice of law in contravention of not only provincial legislation governing who has the right to engage in the practice of law but also the Model Rules and state laws, which prohibit practicing law in a

143. *Id.*, ss. 1(5), 1(6).

144. *Id.*, s. 1(8).

145. *See, e.g.*, Bylaw 14, made by the Law Society of Ontario, pursuant to the Law Society Act, R.S.O. 1990, c L.8. Lawyers who are licensed to practice law in a province are also entitled to practice law outside of their home province provided that they are compliant with the National Mobility Agreement of the Federation of Law Societies of Canada 2013. FEDERATION OF LAW SOCIETIES OF CANADA/FEDERATION DES ORDERS PROFESSIONNELS DE JURISTS DU CANADA, <https://flsc.ca/wp-content/uploads/2014/10/mobility1.pdf>. This permission appears to be consistent with the permissions found in the Model Rules.

jurisdiction where doing so violates the regulation of the legal profession in that jurisdiction.

The second issue relates to whether a U.S. lawyer is competent to prepare Canadian Franchise Documentation given that the lawyer would have to understand how the respective rights and obligations of franchisors and franchisees under Canadian Franchise Legislation have been interpreted by Canadian case law.

Based on the analysis presented in this paper, the authors submit that by preparing Canadian Franchise Documentation, a U.S. lawyer would be (1) in violation of both the Model Rules and the lawyer's own state's laws; and (2) performing work for which the lawyer was not competent. While the authors acknowledge that U.S. lawyers can achieve the requisite competence through ongoing study of Canadian Franchise Legislation and case law, the barrier to practicing in Canada remains limited by failure to achieve the necessary approvals pursuant to the licensing process as a Foreign Legal Consultant. It is, as demonstrated below, both professionally and financially dangerous for attorneys not authorized by the governing bodies to practice law outside of their own jurisdictions.

VII. Liability of Lawyers Under Rescission Claims

A. Risk of Blame

With respect to a lawyer licensed to practice law in Canada, the consequences of not properly advising a franchise client of its respective rights and obligations under Canadian Franchise Legislation could result in a finding of negligence against the lawyer and exposure for substantial damages.¹⁴⁶ Most often when the lawyer finds out that his/her advice to a franchise client was negligent, the damages have already been suffered and cannot be rectified. The payouts on lawyer's negligence claims have historically arisen due to a franchisee's entitlement to post-rescission damages under Canadian Franchise Legislation, and some examples include the following circumstances:¹⁴⁷

- A) The lawyer did not advise the client of its obligation under Canadian Franchise Legislation to provide a compliant FDD to a prospective franchisee, and the franchisee subsequently rescinds its franchise agreement and claims rescission damages from the franchisor, resulting in the franchisor making a claim against its (former) lawyer for negligence and indemnification for the post-rescission damages claim. This circumstance could arise because of the lawyer not properly advising the client, such as (1) the business relationship

146. Whether a lawyer is or is not negligent is an analysis to determine whether the lawyer breached the common law duty of care and can be framed as an action in either tort or a breach of contract law. See *Central Trust Co. v. Rafuse*, [1986] 2 S.C.R. 147 (Can.).

147. It can also occur where the lawyer acts for a franchisee who either has not received an FDD or has received a non-compliant FDD fails to advise the franchisee of its rights arising under Canadian franchise legislation, which results in the franchisee missing the opportunity to rescind its franchise agreement within the time provided under franchise legislation. In this circumstance, the lawyer may be directly liable for the post-rescission damages that the franchisee would otherwise have been able to claim against the franchisor.

between the parties to the agreement was a franchise relationship as defined under Canadian Franchise Legislation; (2) an exemption from Canadian Franchise Legislation was available when it was not; or (3) an exemption from the delivery of an FDD was available when it was not.¹⁴⁸

- B) The lawyer prepared an FDD for its franchisor client that failed to comply with the requirements of Canadian Franchise Legislation.¹⁴⁹ Similar to the earlier scenario, the franchisee who received the deficient FDD rescinds its franchise agreement and claims rescission damages from the franchisor, who claims against the lawyer for negligence and indemnification for the post-rescission damages claim.¹⁵⁰

B. Implications for Lawyers' Insurance

In Ontario, the three practice areas with the largest overall negligence claim payments by insurers per year, as well as the number of claims per year, over the ten-year period from 2009 to 2019 were (1) Litigation; (2) Real Estate; and (3) Corporate Commercial (these rankings are reversed in terms of the average payment per claim).¹⁵¹ In Ontario, there were approximately 180 corporate commercial claims per year, with an average total annual claims cost of C\$10,100,000.00, being an average of roughly C\$56,000.00 per claim; there were approximately 632 real estate claims per year, with an average total annual claims cost of C\$21,500,000.00, with an average cost of roughly C\$34,000.00 per claim; and there were approximately 744 litigation claims per year, with an average total annual claims cost of C\$22,700,000.00, or an average cost of roughly C\$30,400.00 per claim.

Over the same ten-year period, while there were on average only approximately nine franchise law claims per year (included in the Corporate/Commercial rankings), the average total annual claims cost was C\$1,400,000.00, with an average cost of roughly C\$155,000.00 per claim.¹⁵² Given the foregoing, franchise law claims provided a significantly larger payout per claim than any other practice area. The reason for the significant difference is that a franchisee will only rescind if s/he is losing money. Under that circumstance, damages have already been suffered and, unlike most other areas of

148. See discussion *supra* Section II.A(5).

149. R.S.O. 1990, c S.15 (Can. Ont.); Legal Profession Act, S.B.C. 1988, c 9 (Can. B.C.); Legal Profession Act, R.S.A. 2000, c L-8 (Can. Alta.); Legal Profession Act, C.C.S.M., c L.107 (Can. Man.); Law Society Act, S.N.B. 1996, c 89 (Can. N.B.); Legal Profession Act, S.P.E.I. 1992, c 39 (Can. P.E.I.).

150. See Charles S. Marion & Ari N. Stern, "But They Were Not My Client": The Prospect of a Franchisor's Outside Counsel Being Liable to an Aggrieved Franchisee, 41 *FRANCHISE L.J.* 63 (2021) (providing a discussion of potential legal liability of franchisor counsel to a franchisee for an improperly drafted disclosure document).

151. *Litigation Malpractice Claims Fact Sheet*, PRACTICE PRO (June 21, 2017), <https://www.practicepro.ca/wp-content/uploads/2020/05/Litigation-Claims-Fact-Sheet.pdf>; *LAWPRO, Real Estate Malpractice Fact Sheet*, PRACTICE PRO (July 19, 2017), <https://www.practicepro.ca/wp-content/uploads/2020/04/Real-Estate-Claims-Fact-Sheet.pdf>; *LAWPRO, Corporate/Commercial Malpractice Claims Fact Sheet*, PRACTICE PRO (July 19, 2017), <https://www.practicepro.ca/wp-content/uploads/2020/04/Corporate-Commercial-Claims-Fact-Sheet.pdf>.

152. *LAWPRO, Franchise Law Malpractice Claims Fact Sheet*, *supra* note 151.

law, cannot be rectified. Once the lawyer finds out about the claim, it is most often too late to take, or attempt to take, any remedial action.

Although lawyers in the United States may be covered for claims made in Canada (which obviously depends on the applicable insurance policy and exclusions), coverage may be denied if the U.S. lawyer was not competent to perform the legal work in the first place. The issue of coverage would likely result in a subjective assessment of whether the U.S. lawyer was competent to prepare the Canadian Franchise Documentation given that it did not meet the requirements of Canadian Franchise Legislation.

VIII. Conclusion

It is not surprising or uncommon for clients to ask their lawyers to “just make our FDD okay for Canada.” It is difficult to tell a long-time client that you cannot give them what they want, and it is surely difficult to tell your partners that you turned down billable hours. However, understanding the risks involved to your client, yourself, and your practice will make these hard decisions easier.

Lawyers have many ethical obligations that they must navigate. The duty to the client to ensure that they are fully competent to provide counsel, as well as the obligation to comply with the laws and rules of professional responsibility, create a minefield of problems for the lawyer who intentionally practices law in Canada when not competent to do so, or without a license.

In addition to the duty to the client, franchise law claims far exceed the typical damages claim for other areas of law, and, unlike other areas of law in which the errors made by the lawyer can often be rectified or mitigated, claims against a franchise lawyer involving Canadian Franchise Legislation will only arise after the franchisee has rescinded the franchise agreement. Once this occurs, it is too late to rectify or mitigate the damages suffered by the franchisee and the lawyer’s franchisor client. The only remedy, therefore, is a claim against the lawyer. And, by then, liability is rather easy to determine, and it is only the quantum of damages really in dispute.

The very real possibility exists for significant and costly claims against lawyers intentionally practicing law in a venue for which they are not licensed, and for which insurance will likely be unavailable, placing themselves and their firms in great financial jeopardy. Most insurance policies in the United States do not cover deliberately wrongful or criminal acts. Where a lawyer is found to be guilty of a criminal act, those acts will neither typically be covered by malpractice insurance, nor will deliberately practicing law in a jurisdiction for which the U.S. lawyer is not licensed to practice be covered. Therefore, the lawyer or law firm engaged in such activities will bear the burden of defense costs, fines, and restitution obligations without the benefit of insurance.

Franchising in Russia—A Primer

*Katya Logunov & Sergey Medvedev**

I. Introduction¹

Russia, or the Russian Federation, is the largest country by area in the world, extending across the whole of northern Asia and the eastern third of Europe, and spanning eleven time zones.² Described as “a land of superlatives” by the *Encyclopedia Britannica*,³ Russia is known for its rich arts and culture, long and eventful history, abundant natural resources, technological ingenuity, and the mysterious “Russian soul,” which cannot be comprehended.⁴



Ms. Logunov



Mr. Medvedev

Even after the dissolution of the Union of Soviet Socialist Republics, Russia remained a significant economic player in Eurasia. With a population of over 140 million people and low unemployment rate,⁵ Russia is the

1. This article was submitted to publication just as the Russian military activity taking place in the Ukraine began. It is beyond the scope of this article to address all of the potential effects that the conflict with Ukraine could have on the Russian economy, franchise systems in Russia, or expansion into Russia. This article is meant to address the state of the law in a non-wartime setting.

2. Richar Taruskin et al., *Russia*, ENCYCLOPEDIA BRITANNICA, <https://www.britannica.com/place/Russia> (last visited on Sept. 14, 2021).

3. *Id.*

4. See, e.g., Robert C. Williams, *The Russian Soul: A Study in European Thought and Non-European Nationalism*, 31 J. HIST. IDEAS 573 (1970); Andrei Nesterov, *Russian Mini Lesson: The Russian Soul and Related Russian Vocabulary*, FOLKWAYS (Mar. 17, 2019), <https://folkways.today/language-russian-soul-lesson>; see also N. A. BERDYAEV (BERDIAEV), *THE PSYCHOLOGY OF THE RUSSIAN PEOPLE—THE SOUL OF RUSSIA / THE FATE OF RUSSIA*, § I, ch. 1.

5. *Russia: Unemployment Rate from 1999 to 2020*, STATISTA, <https://www.statista.com/statistics/263712/unemployment-in-russia> (last visited Aug. 23, 2021).

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world's eleventh largest economy by GDP (as of 2020, it had GDP of \$1.48 trillion).⁶ As a political and economic leader among the post-Soviet countries, Russia often serves as an anchor to the broader expansion in the region.

Its franchise industry, while relatively young, is developing rapidly. Even the pandemic did not seem to stop the growth of the franchise industry in Russia. By the end of 2020, the number of franchised units in the country grew by 5.1%.⁷ Overall, more than 2,700 franchises operate in Russia.⁸ Yet, foreign franchisors, with the exception of some major brands like McDonald's and Papa John's Pizza, seem to remain cautious about expanding their systems to Russia.

Western businesses have expressed concerns about the rule of law and protection of property rights in Russia. Those concerns are rooted in the political, economic, and legal turmoil of the early 1990s, which followed the collapse of the Soviet Union and the country's legal system and institutions. However, as Russia continues to develop its legal system and institutions, the legal risks of doing business in Russia significantly decrease. Russia currently ranks twenty-eighth overall in the Ease of Doing Business rating by the World Bank, just ahead of Japan (twenty-ninth) and China (thirty-first), and its rank is even higher—twenty-first—in the Enforcing Contracts category.⁹ In recent decades, the country took major steps to enact modern laws and regulations, stabilize its financial system, and improve the accessibility and reliability of courts.

As a result, expanding a franchise business to Russia is no longer nearly as risky for a foreigner as it is used to be a couple of decades ago. This article provides an introduction to the Russian regulation of franchises and franchise relationships. First, it supplies an overview of the Russian legal system and courts. Second, it discusses the regulatory framework applicable specifically to franchises and explores whether franchise disclosure is necessary in Russia, even in the absence of the franchise disclosure statute. Finally, it discusses franchise agreements and enforcement of those agreements in Russia, respectively.

II. The Russian Legal System

Russia is a civil law jurisdiction with a code-based legal system. Historically, it belongs to the continental European legal family, except, during the Soviet era, Russia had a socialist legal system. After the collapse of the Soviet Union and the accompanying socialist legal system, new Russian codes and laws

6. Caleb Silber, *The Top 25 World Economies*, INVESTOPEDIA, <https://www.investopedia.com/insights/worlds-top-economies> (last visited Jan. 25, 2022) (citing World Bank's "World Development Indicators").

7. Nikita Shchurenkov & Alexander Osipov, *Franchising Has Outgrew Crisis*, NEWSPAPER KOMMERSANT, Apr. 20, 2021, at 10.

8. *Id.*

9. *Doing Business*, WORLD BANK GRP., <https://www.doingbusiness.org/en/rankings> (last visited Aug. 23, 2021) (benchmarked to May 2019).

were developed, often based on Western European precedents. For example, the Russian Civil Code, enacted in several installments in 1994, 1996, 2001, and 2006, was heavily influenced by the classical civil codes of Germany and Switzerland, and by one of the newest civil codifications in Europe, the Dutch Civil Code.¹⁰

In terms of territorial structure, Russia is a federation comprised of eighty-five constituent entities (called “federal subjects”). The eighty-five entities include the Crimea and the city of Sevastopol, incorporated as federal subjects in 2014; this recent addition was quite controversial, remains unrecognized by many countries, and has resulted in a number of economic sanctions imposed on Russia by the Western countries.¹¹

The federal level of government has its own set of powers prescribed by the Constitution; in addition, the federal government and the governments of the subjects of the federation share responsibilities for certain issues, such as protection of human rights, healthcare, and protection of the environment.¹² Everything that is not included in these two heads of power is considered a residual power of the federal subjects.¹³ This article focuses on federal laws that are applicable to franchising.

The Constitution of the Russian Federation is the highest source of law, but is rarely applied directly to business relations. The sources of federal law applicable to economic relations, in descending hierarchical order, are the federal constitutional laws, federal laws, decrees of the President, resolutions by the Government, and directives of the executive governmental bodies. International treaties signed and ratified by Russia are also considered a source of law and take precedence if a provision of the treaty contradicts a provision of a Russian statute.¹⁴

The Russian Civil Code is the foundation and the main source of law for economic relations. The general principles enumerated in Section 1 of the Civil Code¹⁵ serve as a basis for interpretation and “filling the gaps” when no specific code section is applicable to a legal issue. A variety of federal laws supplement the Civil Code on specific matters, such as corporate and securities statutes, anti-monopoly statutes, privacy and cybersecurity legislation, and industry-specific legislation.

10. Asya Ostroukh, *Russian Society and Its Civil Codes: A Long Way to Civilian Civil Law*, 6 J. CIV. L. STUD. 394 (2013).

11. *See, e.g.*, Exec. Order No. 13660, 3 C.F.R. 589 (2014); Exec. Order No. 13661, 3 C.F.R. 589 (2014); Exec. Order No. 13685, 3 C.F.R. 589 (2014); Exec. Order No. 13694, 3 C.F.R. 589 (2015); Exec. Order No. 13757, 3 C.F.R. 589 (2016).

12. THE CONSTITUTION OF THE RUSSIAN FEDERATION arts. 71, 72.

13. *Id.* art. 73.

14. *Id.* art. 15.4.

15. CIVIL CODE (PART I) arts. 1–16.1.

Court System

The Russian court system includes the Constitutional Court, which is a separate judicial body dealing with disputes concerning the constitutionality of legislation and certain legal acts, and federal and regional courts.¹⁶

Federal courts include “arbitrazh” courts that hear commercial and economic disputes, and courts of general jurisdiction handling all other cases.¹⁷

Regional courts systems consist of the magistrates’ courts resolving minor matters, and the constitutional (statutory) courts of the federal subjects, which handle cases concerning the federal subjects’ constitutions (statutes).¹⁸

The Supreme Court of the Russian Federation is the highest judicial body overseeing both federal and regional courts. It mainly serves as the court of cassation (second-tier) handling appeals and challenges of judicial acts of the lower courts; however, it also has original jurisdiction in certain cases, such as challenges to individual acts of the Parliament or presidential decrees.¹⁹

As in other Western European countries (except the United Kingdom), a judicial decision of a court is not binding on other courts. The highest courts, such as the Constitutional Court and the Supreme Court, have the authority to issue decisions and opinions that are, practically speaking, binding on lower courts.²⁰ This carryover ensures the uniformity of the interpretation and application of the law throughout the country. In practice, legal practitioners often pay attention to judicial rulings, even if these decisions do not get cited in legal arguments filed with the courts.

Contractual Drafting

Traditionally in Russia, commercial contracts are more concise and shorter than common-law counterparts. This is because, among other things, the parties are used to relying on general principles and specific rules set forth in the Civil Code.²¹ However, as the Russian economy became more intertwined with the Western world and detailed, comprehensive common-law contracts became familiar to Russian lawyers and businesspeople, some of the common-law drafting techniques have found their way into Russian contracts. In franchising, in particular, the use of detailed, comprehensive

16. FEDERAL CONSTITUTIONAL LAW No.1-FKZ ON THE JUDICIAL SYSTEM OF THE RUSSIAN FEDERATION, 2016, art. 4; FEDERAL CONSTITUTIONAL LAW No.1-FKZ ON THE CONSTITUTIONAL COURT OF THE RUSSIAN FEDERATION, 1994, art. 3.

17. FEDERAL CONSTITUTIONAL LAW ON THE JUDICIAL SYSTEM OF THE RUSSIAN FEDERATION arts. 19.1–21, 24–25.

18. *Id.* arts. 27–28; FEDERAL LAW No. 188-FZ ON THE MAGISTRATE COURTS OF THE RUSSIAN FEDERATION art. 3.

19. FEDERAL CONSTITUTIONAL LAW ON THE JUDICIAL SYSTEM OF THE RUSSIAN FEDERATION art. 19; FEDERAL CONSTITUTIONAL LAW No.3-FKZ ON THE SUPREME COURT OF THE RUSSIAN FEDERATION, 2014, art. 2.

20. FEDERAL CONSTITUTIONAL LAW ON THE SUPREME COURT OF THE RUSSIAN FEDERATION arts. 2(2), 5(3); FEDERAL CONSTITUTIONAL LAW ON THE CONSTITUTIONAL COURT OF THE RUSSIAN FEDERATION art. 79.

21. Kenneth A. Adams & Jan Asmus Bischoff, *Common-Law Drafting in Civil-Law Jurisdictions*, AM. BAR ASS’N BUS. L. SEC. (Dec. 20, 2019), <https://businesslawtoday.org/2019/12/common-law-drafting-civil-law-jurisdictions>.

franchise agreements is common due to the complexity of the franchise relationship.

Restrictions on Foreign Investments

Russia is generally open to foreign investment. The Federal Law “On Foreign Investments in the Russian Federation” provides that, subject to federal laws, foreign investors enjoy the same treatment and protections in Russia as domestic businesses.²² Currently, the law restricts foreign investment in certain “strategic” businesses (including natural resources, defence and national security, telecommunications, and railway transportation).²³ Foreign entities are prohibited from setting up mass media²⁴ and obtaining rights of exploration and exploitation to subsoil blocks of federal importance.²⁵ Foreign persons also cannot own certain lands that are located near the border.²⁶ Russian law does not restrict foreign investment in franchises or franchise systems.

III. Regulatory Framework

Chapter 54 of the Civil Code is dedicated to franchising. This chapter contains fourteen sections specifically dealing with franchising, including the franchise agreement, form and registration of the franchise, subfranchising, the parties’ obligations, the franchisor’s liability, and amendment and termination of franchise agreements.²⁷ Other sections of the Civil Code also relate to franchising in that they regulate the formation of legal persons, the principal obligations of the parties, and the general principles of conduct of their business.²⁸ There are also certain specific local regulations governing individual aspects of intellectual property and licensing.²⁹

In Russia, the principal rule of franchising is that the parties to a contract must be commercial entities.³⁰ Non-commercial companies or governmental agencies may not enter into franchise agreements. Therefore, franchisors and franchisees must incorporate in order to enter into a franchise agreement, usually in the form of a limited liability company. Sometimes, joint-stock companies are used in complex franchise transactions involving joint ventures.

The franchisor must be the registered and valid trademark and intellectual property owner, meaning that it owns and is free to license a set of exclusive intellectual property rights in favor of the franchisee in return for specific

22. FEDERAL LAW NO. 160-FZ ON FOREIGN INVESTMENTS IN THE RUSSIAN FEDERATION art. 4.1.

23. FEDERAL LAW NO. 57-FZ ON THE PROCEDURE OF MAKING FOREIGN INVESTMENTS IN COMPANIES OF STRATEGIC IMPORTANCE FOR NATIONAL DEFENCE AND STATE SECURITY.

24. FEDERAL LAW NO. 2124-1 ON MASS MEDIA art.19.1.

25. FEDERAL LAW NO. 2395-1 ON SUBSOIL art. 17.1.

26. LAND CODE OF THE RUSSIAN FEDERATION art. 15.

27. CIVIL CODE (PART II) ch. 54.

28. CIVIL CODE (PART I) art. 1 (General Terms), art. 3 (General Part—Law of Obligations).

29. CIVIL CODE (PART IV).

30. CIVIL CODE (PART II) art. 1027.3.

compensation (i.e., the franchise fee).³¹ Otherwise, the franchisor must have a valid and proper license to franchise the granted rights to a franchisee.

Franchise Agreement—Legal Definition

Russian law does not define the term “franchise.” Instead, the law uses the term “commercial concession” to define the relationship of the parties to a franchise.³²

According to Article 1027 of the Civil Code, under a contract of commercial concession, one party (rights holder) shall grant the other party (user), for a compensation and for a definite or indefinite term, the right to use in the business of the user a set of intellectual property (IP) rights owned by the rights holder, including trademark rights, service mark rights, and other intellectual property rights, in particular, trade name and secrets of production (know-how).³³

The key element of a contract of commercial concession (hereinafter “franchise agreement” or “franchise”) is a trademark. Other IP rights, including but not limited to trade names, copyrights, patents, and know-how, may be included in the scope of the franchise in addition to the trademark, but not instead of the same.³⁴

Trademarks

Trademark registration will be the very first and key element for every franchise transaction targeted at Russia.

Trademarks may be protected on a national or international basis. National marks have to be filed and registered with Rospatent.³⁵ Russia is a signatory to the Madrid Agreement and the Madrid Protocol; therefore, an international trademark registration (designating Russia) will also be protected in Russia.³⁶ The duration of the national trademark registration procedure is approximately one year. The examination procedure includes formal and substantive examination. In the course of substantive examination, Rospatent runs absolute and relative grounds tests to allow or refuse trademark registration.³⁷

Any words, pictures, three-dimensional configurations, and other marks may be registered as trademarks.³⁸ The registration of non-traditional marks, such as sounds, colors, and smells, is also permitted.³⁹ To be registered, a mark must be new and distinctive. Distinctiveness may be inherent

31. *Id.* art. 1027.1.

32. CIVIL CODE (PART II) ch. 54.

33. *Id.* art. 1027.1.

34. CIVIL CODE (PART II) art. 1027.1.

35. CIVIL CODE (PART IV) art. 1492.1.

36. *Id.* arts. 1231.1, 1479.

37. *Id.* art. 1483.

38. *Id.* art. 1482.

39. *Id.* art. 1482.1.

or acquired. A trademark can acquire distinctive character through intensive and actual use in commerce.⁴⁰

In general, use of the mark does not have to be claimed before registration.⁴¹ Further, no proof of use has to be submitted before the trademark application is filed.⁴² At the same time, the owner must start using the trademark within three years of registration.⁴³ If the mark is not used during any three-year term following trademark registration, any interested person may apply for cancellation of the trademark protection on the grounds of its non-use.⁴⁴

When the trademark is registered, it is entered into the Russian Trademark Register and will be valid for ten years.⁴⁵ Trademark registrations can be renewed for ten-year periods an unlimited number of times.⁴⁶

Copyright

Most often, franchisees will be granted access to certain business standards, operations manuals, and proprietary software. As a result, copyright vested in these works may be included (along with trademarks) in the content of the underlying franchise agreement.

Copyright subsists in scientific, literary, and artistic works fixed in any tangible medium of expression, regardless of benefits, purposes, or methods of their expression.⁴⁷ To be copyrightable, a work of authorship must satisfy two fundamental criteria. It must (1) represent a result of creative input,⁴⁸ and (2) be fixed in any tangible medium of expression (e.g., paper, CD-ROM).⁴⁹

Generally, the following examples of works of authorship can obtain copyright protection in Russia:

- (a) literary works;
- (b) dramatic works;
- (c) musical works;
- (d) choreographic works and pantomimes;
- (e) audio-visual works;
- (f) sculptural, graphic and design works;
- (g) photographic works;
- (h) architectural works;

40. *Id.* art. 1483.

41. *Id.* art. 1486.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* art. 1491.1.

46. *Id.* art. 1491.2.

47. *Id.* art. 1259.1.

48. *Id.* art. 1257.

49. *Id.* art. 1259.3.

- (i) pictorial works;
- (j) computer programs; and
- (k) databases.⁵⁰

Essentially, copyright vests in a work of authorship from the moment of its creation. There is no need to register or comply with any other formalities to acquire, exercise, transact, franchise, protect, or enforce copyright in Russia.⁵¹ However, a unique national system of registration is available for computer programs and databases. This registration may give an “irrebuttable” presumption of copyright ownership and protection.⁵²

The standard duration of copyright protection, which is applicable to all works of authorship, is the lifetime of the author plus seventy years after her or his death.⁵³

Know-How

Many franchise agreements incorporate know-how licences, as the transfer of proprietary and confidential information is usually regarded as the most critical aspect of every franchise business.

Any piece of confidential information may be protected as know-how. Know-how is not to be registered or deposited; nevertheless, the owner must undertake certain reasonable measures to maintain the confidentiality of the relevant data.⁵⁴ If these measures are not implemented, know-how protection will not be afforded to the confidential information.

One of the legal ways to acquire know-how protection would be to set up a “trade-secrets regime,” as it is described in the law.⁵⁵ More specifically, the owner must properly identify and list the confidential information, limit access to the confidential information by establishing an appropriate procedure for dealings with the same, affix the notice “trade secret” to the medium in which the confidential information is stored (along with the owner’s details), and follow up with other required steps.⁵⁶ If one of these steps is ignored or omitted by the owner of the confidential information, the trade secrets regime will not be considered as having been introduced and, as a result, the know-how protection will not be afforded to the information. At the same time, other reasonable measures can be undertaken in due course to achieve know-how protection.⁵⁷

Know-how will be protected for as long as it is kept secret by its owner.⁵⁸ When the confidentiality is lost, the exclusive rights lapse immediately.⁵⁹

50. *Id.* art. 1260.2.

51. *Id.* art. 1259.4.

52. *Id.* art. 1262.

53. *Id.* art. 1281.1.

54. *Id.* art. 1465.

55. FEDERAL LAW NO. 98-FZ (AS AMENDED) ON TRADE SECRETS, 2004, art. 10.1.

56. *Id.*

57. CIVIL CODE (PART IV) art. 1465.1.

58. *Id.* art. 1467.

59. *Id.*

Franchise Registration

Every franchise agreement must be made in writing.⁶⁰ In addition, the grant of franchise contemplated by the underlying franchise agreement must be registered with Rospatent.⁶¹ A franchise that is not registered with Rospatent will be invalid.⁶² As a result, the parties will not be able to enforce the contracted rights or obligations against third parties in the event of a non-registered franchise grant. Therefore, registration shall not be waived or omitted, whether in the context of domestic or cross-border franchising.

Russian law does not set a specific limitation period within which the franchise grant has to be registered with Rospatent. Unless there is an agreement to the contrary, the registration obligation vests with the franchisor, who must prepare and file the appropriate set of documents with Rospatent.⁶³

There are various options regarding documents that may be submitted to Rospatent in support of the concluded transaction in addition to the power of attorney authorizing the local representative (e.g., a trademark attorney) to make the filing. It is, therefore, possible to provide (1) the original franchise agreement; (2) a notarised excerpt from the same; or (3) the statement of franchise (notification), executed by the parties.⁶⁴ Before filing, it is essential to ensure that the original franchise agreement, as well as the document that has been chosen for submission to Rospatent, contains all essential elements (mandatory clauses) required by Russian law and dictated by local practice. Importantly, if the parties do not wish to disclose the original contract along with stated financial information or any other sensitive data, the best option would be to make and file an excerpt from the agreement, or present the notification.

In practice, the registration process may take about two to three months in the absence of office actions or Rospatent inquiries.

Antimonopoly Issues and Competition

Competition is regulated by the Law on Protection of Competition.⁶⁵ This law prevents monopolistic (anti-competitive) activities, including cartels, and prohibits the abuse of dominance as well as unfair competition.⁶⁶ The law prohibits unfair competition, including the dissemination of false information that may damage the operating business entity.⁶⁷ It prohibits fraud or misrepresentation, as well as the marketing of goods if IP subject matters

60. CIVIL CODE (PART II) art. 1028.1.

61. *Id.* art. 1028.

62. *Id.* art. 1028(2).

63. *Id.* art. 1031.2.

64. *Id.* art. 1032.3.

65. FEDERAL LAW No. 135-FZ (AS AMENDED) ON PROTECTION OF COMPETITION, 2006.

66. *Id.* arts. 10, 11, 11.1.

67. *Id.* art. 14.1.

are unlawfully or illegally used.⁶⁸ It also prohibits unfair competition in cases when other persons acquire and use IP rights in bad faith.⁶⁹

The law permits vertical agreements, including franchise contracts.⁷⁰ The law may be applied both to franchise agreements concluded between domestic and foreign parties and to their actions if they impact competition in the Russian territory.⁷¹

The franchise agreement may contain different restrictive covenants imposed on the franchisee, as allowed under the Russian law.⁷² The scope of the same will usually depend on the parties' negotiations and arrangements. More specifically, the franchisor may elect for the following covenants to be incorporated into the contract: (1) the franchisee's covenant not to compete with the franchisor in the franchised territory in relation to the franchised business and franchised set of IP rights; (2) the franchisee's refusal to accept analogous rights under franchise agreements from competitors (potential competitors) of the franchisor; (3) the franchisee's covenant to distribute and sell the manufactured or purchased goods, perform work or provide services by using the franchised rights and applying the prices fixed by the franchisor; (4) the franchisee's covenant to refrain from distribution of analogous goods, performing analogous works, and providing analogous services using the trademarks or trade names of other franchisors; (5) the franchisee's covenant to sell goods, perform work or provide services exclusively within the boundaries of certain territory; and (6) the franchisee's covenant to obtain approval from the franchisor for the location (as well as the exterior or interior design) of the commercial premises used for implementation of the franchised rights under the contract.⁷³

Standard contractual restrictions and covenants on parties that are provided in franchise agreements and made in line with the Civil Code are generally acceptable from an antitrust perspective. Theoretically, these covenants, to the extent they are incorporated in the franchise agreement, may be declared invalid by the Federal Antimonopoly Service (FAS) (or other interested person) if they are found to be contradictory to anti-monopoly laws, subject to the relevant market conditions and economic status of the parties.⁷⁴

Data Protection and Privacy

In the context of franchising, if the parties deal with processing of personal data, especially in relation to Russian individuals (data subjects), the applicable data protection law must be considered.

68. *Id.* art. 14.5.

69. *Id.* arts. 14.1–14.8.

70. *Id.* art. 12.1.

71. *Id.*

72. CIVIL CODE (PART II) art. 1033(1).

73. CIVIL CODE (PART II) art. 1033.1.

74. CIVIL CODE (PART II) art. 1033.3.

More specifically, both the franchisor and the franchisee (as applicable) can be considered the data operator (data controller); otherwise, franchisee can be considered as data operator and franchisor can stand as the data processor (a person acting and processing data under the instructions of the data operator) under certain circumstances.⁷⁵

If the franchisee outsources data processing to a franchisor, for example, both parties must enter into a data-processing agreement, conditional on the data subject's consent.⁷⁶ If the franchisor would like to use the data of a franchisee's clients for certain advertising or marketing purposes, the consent of the respective data subjects (addressees) must also be obtained.⁷⁷

In general, the data subject's consent must be specific, informed, and conscious.⁷⁸ Unless otherwise provided by the law, the data subject's consent can be obtained in any form, including online. In cases where the law requires the data subject's consent to be given in writing (e.g., biometric data), implied or inferred consent will not be regarded as valid.⁷⁹ The burden of proof that the data subject's consent has been received remains with the data operator.⁸⁰ In addition, a data operator that is processing Russian individuals' personal data must notify the Russian IT regulator (Roskomnadzor), provided that it is not exempt from the notification obligation.⁸¹ The notification can be submitted by the data operator on paper or electronically.⁸²

In the event of crossborder data flow, it is essential to ensure that the rights and interests of data subjects are fully protected in an adequate manner in the corresponding foreign jurisdiction. International data transfer to a country that does not provide a level of adequate protection is only permitted if the written consent of the data subject concerned has been obtained, or the data transfer is made for the performance of a contract to which the data subject is a party (e.g., user agreement).⁸³

Importantly, if the franchisee (as the data operator) collects, systematizes, and accumulates any personally identifiable information on Russian citizens, that data must be stored in data centers or databases located in Russia. Such data localization requirement is strict and applies to all cases where Russian data is collected, including online.⁸⁴

Finally, the data operator must take necessary and sufficient measures, including from the technical, organizational, and legal perspectives, to protect personal data that is being processed from unauthorized disclosure, access, use, distribution, or theft. Roskomnadzor reserves the right to inspect

75. FEDERAL LAW No. 135-FZ (AS AMENDED) ON PERSONAL DATA, 2006, arts. 3.2, 6.3.

76. *Id.* arts. 6.3, 9.

77. *Id.* art. 15.

78. *Id.* art. 9.1.

79. *Id.* art. 11.1.

80. *Id.* art. 9.3.

81. *Id.* art. 22.1.

82. *Id.* art. 22.3.

83. *Id.* arts. 12.1, 12.4.

84. *Id.* art. 18.5.

data operators and check them for compliance. Inspections may be random or planned.⁸⁵

Real Estate and Commercial Lease

The Civil Code and the Land Code primarily govern real estate issues and relevant transactions, including commercial leases.⁸⁶ Real estate transactions, such as acquisitions, leases, and security interests, are subject to registration with the Unified State Register of Real Estate.⁸⁷ Details about valid real estate owners and their rights, titles, and interests are kept in the Register and are available to the public.

Non-Russian individuals and legal entities are restricted from acquiring certain types of real estate in specific instances—for example, in agricultural sphere.⁸⁸ Domestic individuals and legal entities have more freedom to operate in the Russian real estate market.

Russian law requires that transactions with real estate located in Russia shall be governed by Russian law.⁸⁹

IV. The Debate About Disclosure

It is often said that there is a power imbalance present in a franchise relationship: franchisors are usually more sophisticated and hold considerably more negotiating power than their franchisees.⁹⁰ Franchisors own the business model, trademarks, and trade secrets, often have some degree of control over operations and supplies, and generally prescribe the content of the franchise agreements. While this is not necessarily true for any and all franchise relationships (there are plenty of large, multi-unit franchisees that can wield much more negotiating power than their franchisor, for example), this imbalance is present in many instances. One of the ways to cure this imbalance is to require franchisors to disclose information to potential candidates that is necessary to make an informed decision about whether to join the franchise system. Some jurisdictions (the United States, several Canadian provinces, China, Australia, Sweden, Italy, and France, among others) have passed franchise-specific legislation requiring disclosure; others choose to rely on the general principles applicable to negotiations and contract performance.

85. *Id.* art. 23.

86. CIVIL CODE (PART II) arts. 650–655, arts. 549–558; LAND CODE arts. 22, 37.

87. FEDERAL LAW NO. 218-FZ (AS AMENDED) ON STATE REGISTRATION OF REAL ESTATE, 2015, art. 14.

88. FEDERAL LAW NO. 101-FZ (AS AMENDED) ON TURNOVER OF AGRICULTURAL LANDS, 2002, art. 3.

89. CIVIL CODE (PART III), art. 1213.

90. See, e.g., *Franchise Act Backgrounder*, B.C. L. INST. (2014), https://www.bcli.org/sites/default/files/Franchise_Act_Backgrounder.pdf; Shelle Staff & Hanna Psomoulis, *Rebalancing the 'Power Imbalance'—2021 Changes to the Franchising Code of Conduct*, LEXOLOGY (July 23 2021); Chad Finkelstein, *Balancing the Imbalance in a Franchise Relationship*, FIN. POST (Aug. 14, 2012), <https://financialpost.com/entrepreneur/balancing-the-imbalance-in-a-franchise-relationship>.

The preceding section mentions nothing about a law on pre-sale franchise disclosure in Russia. Indeed, Chapter 54 of the Civil Code does not mandate a franchisor to provide a franchise disclosure document to the franchisee prior to signing the franchise agreement, or register any kind of information circular with a governmental body. However, that chapter does not necessarily mean there is no duty to disclose *some* information to a potential franchisee under Russian law.

Duty to Negotiate in Good Faith

The doctrine of good faith is one of the general principles of civil law.⁹¹ In addition to the duty to perform a contract in good faith, some jurisdictions (primarily civil law ones) also require the parties to a potential deal to negotiate in good faith (“*culpa in contrabendo*,” which can be translated from Latin as “fault in contracting”). The duty to negotiate in good faith can be found in civil codes of Belgium,⁹² Germany,⁹³ Italy,⁹⁴ Brazil,⁹⁵ Quebec,⁹⁶ and China,⁹⁷ among others. This approach is different from the one of the common law tradition, where the doctrine of *caveat emptor* (“buyer beware”) governs.

The duty to negotiate in good faith generally encompasses an obligation not to mislead the other party in the negotiation process, thus creating an expectation that cannot be realized; as well as an obligation not to break off negotiations arbitrarily if the other party reasonably believes that an agreement is imminent. In addition, some jurisdictions recognize an obligation to disclose certain information to the counterparty as part of the duty to negotiate in good faith, including in the franchising context. Such jurisdictions include Quebec,⁹⁸ Germany,⁹⁹ Austria,¹⁰⁰ Switzerland,¹⁰¹ and Hungary.¹⁰²

Failure to comply with the disclosure requirement under the duty to negotiate in good faith generally results in the franchisee being able to claim compensation from the franchisor. The doctrine of *culpa in contrabendo* requires that the aggrieved party must be put in the position that they would

91. CIVIL CODE (PART I) art. 3.

92. CIVIL CODE art. 1382 (Bel.).

93. CIVIL CODE §§ 242, 311(2) (Ger.) (translation provided by the Langenscheidt Translation Service).

94. CIVIL CODE, art. 1337, 1338 (It.).

95. CIVIL CODE, Law 10.406 of Jan. 10, 2002, art. 422 (Braz.).

96. CIVIL CODE art. 1375 (Can. S.Q.).

97. CIVIL CODE OF THE PEOPLE’S REPUBLIC OF CHINA, art. 500.

98. 9145-5055 Québec Inc. (Rest. au Vieux Duluth LaSalle) v. Rests. au Vieux Duluth Inc., 2020 QCCS 4365 (Can. Q.B.).

99. Stephane Teasdale & Marco Hero, *How to Prepare a Franchise System for Expansion to Europe*, AM. BAR ASS’N 32ND FORUM ON FRANCHISING, W-19, at 9 (2009).

100. *Id.*; Hubertus Thum, *Austria: Franchise Laws and Regulations*, in INTERNATIONAL COMPARATIVE LEGAL GUIDE—FRANCHISE LAWS AND REGULATIONS (2021).

101. CIVIL CODE art. 2 (Switz.); Jeannette Wibmer, *Franchise Agreements Pre-Contractual Information Requirements*, BADERTSCHER RECHTSANWÄLTE AG (July 28, 2015), <https://www.b-legal.ch/en/franchise-agreements-pre-contractual-information-requirements>.

102. CIVIL CODE § 205 (Hung.).

have been in had the franchisor complied with its disclosure obligation.¹⁰³ Compensation may include refund of the franchise fees and reimbursement of the investments made into the franchise.¹⁰⁴ Additionally, the franchise agreement may be annulled if the franchisee would not have entered into the agreement but for the insufficient or defective disclosure.¹⁰⁵

In Russia, the obligation to negotiate in good faith was introduced in the Civil Code in 2015. It reads as follows (with the English translation is courtesy of the legal research service Garant):

Article 434.1. Talks Concerning the Conclusion of a Contract

1. If not otherwise provided for by law or contract, citizens and legal entities shall be free to hold talks on making a contract, shall independently bear the expenses connected with their holding and shall not be held liable if it has not been agreed.

2. When entering into the talks on making a contract, in the course of them and upon their completion the parties are bound to act in good faith, in particular not to enter into the talks about making the contract or to continue them, if it is clear that the other party has no intention of reaching an agreement. The following shall be deemed unfair actions in holding talks:

1) provision by either party of incomplete or unreliable information, in particular *non-disclosure of the circumstances, which by virtue of the nature of a contract, must be brought to the knowledge of the other party*;

2) abrupt and unjustified termination of talks on making a contract under the circumstances when the other party to the talks has no reasonable grounds to expect it.¹⁰⁶

To date, the authors are not aware of any court decisions applying the disclosure requirement under paragraph 2(1) of Article 434.1 to a franchisor. However, the disclosure requirement has been applied by courts to numerous other relationships, including insurance,¹⁰⁷ banking,¹⁰⁸ purchase of a business,¹⁰⁹ and sale of goods.¹¹⁰

There is no reason to conclude that a Russian court would not apply the disclosure requirement to a franchise relationship. The authors believe that a successful franchise relationship depends on the franchisee entering into the agreement fully informed about the nature of the franchise and the kinds of

103. Stephane Teasdale & Marco Hero, *How to Prepare a Franchise System for Expansion to Europe*, AM. BAR ASS'N 32ND FORUM ON FRANCHISING, W-19, at 11, 21 (2009); Wibmer, *supra* note 101.

104. Teasdale & Hero, *supra* note 103.

105. *Id.*

106. Legal Information System Garant, <https://base.garant.ru/510164072/890aac22679248865b9b25e60e334081> (emphasis added).

107. Appellate Ruling of the Altai Regional Court, No. 33-5703/2017 (May 31, 2017).

108. Appellate Ruling of the Irkutsk Regional Court, No. 33-8378/2019 (Oct. 14, 2019).

109. Ruling of the Judicial Panel on Economic Disputes of the Supreme Court of the Russian Federation, No. 305-C19-19395 (Jan. 29, 2020).

110. Ruling of the 16th Arbitral Appellate Court, No. 16AII-3497/2018 (Apr. 4, 2019).

efforts required to make the franchise business profitable. A franchise agreement usually contains many obligations and duties on the part of the franchisee, which the franchisee may not be able to perform if he or she lacks information about either the franchise system or the franchise unit(s) that he or she agrees to operate. Naturally, the necessary disclosure will be different from case to case.

For example, many franchise agreements of brick-and-mortar units require the franchisee to operate the franchise for a set number of years in a specific location set out in the agreement. If the franchisor sells an existing unit to a new franchisee, usually the existing lease is assigned or sublet to the franchisee. In these circumstances, a franchisee should be informed about terms and restrictions of the lease in order to be able to operate the franchise at the leased premises.

If the franchisee is assigned an exclusive territory, usually the franchisor would set certain performance criteria which the franchisee will have to meet to maintain exclusivity. The franchise's success in an exclusive territory may depend on many factors, including the demographic composition of the territory, pedestrian traffic, accessibility by various means of transportation, and competing businesses. Therefore, the franchisee should be informed about the criteria used in drawing the boundaries of their exclusive territory to ascertain the likelihood of success of the proposed franchise.

Similar to other jurisdictions noted above, failure to abide by the duty of good faith in conducting negotiations can result in compensation to the aggrieved party. Paragraph 3 of Article 434.1 states:

3. The party that holds and unfairly interrupts talks on making a contract is bound to compensate for the losses caused by it to the other party.

The losses to be compensated by an unfair party shall be deemed borne by the other party in connection with holding talks about making a contract, as well as in connection with the loss of the possibility to make a contract with a third person.¹¹¹

Compensation under paragraph 3 of Article 434.1 may include costs incurred during the negotiations and preparation for signing, as well as damages resulting from loss of opportunity to enter into a contract with a third party.¹¹²

The Plenary Session of the Supreme Court of the Russian Federation in its summary of jurisprudence regarding liability for breach of obligations noted that, while generally, the burden of proof that a party acted in bad faith rests with the plaintiff, there is a presumption that the defendant acted in bad faith if any of the circumstances set out in paragraph 2 of Article 434.1 are present.¹¹³ As such, if a franchisee brings a lawsuit against the

111. Legal Information System Garant, *supra* note 106.

112. Ruling of the Plenary Session of the Supreme Court of the Russian Federation No. 7, ¶ 20 (Mar. 24, 2016).

113. *Id.* ¶ 19.

franchisor claiming that the franchisor acted in bad faith by not disclosing information to the franchisee prior to the signing of the franchise agreement, the franchisor will have to prove that it has not acted in bad faith by failing to disclose that information.

Moreover, the Plenary Session specifically indicated that failure to comply with the disclosure obligation under paragraph 2(1) of Article 434.1 may lead to the agreement concluded between the parties being declared void.¹¹⁴ Generally, franchise agreements rarely allow franchisees to terminate their agreements early or otherwise exit the franchise before its term runs out. Therefore, franchisors should strongly consider providing disclosure to their potential Russian franchisees to mitigate the risk of the franchisee rescinding the agreement for lack of disclosure required by Article 434.1.

It is worth noting that the franchising industry in Russia is experiencing some growing pains. As reported by the reputable business newspaper *Kommersant*, only about twenty percent of the franchisors on the market offer well-supported, profitable systems.¹¹⁵ A considerable number of franchise offerings are not adequately supported by their franchisors, have weak or no trademarks, or otherwise offer little value to the franchisees. As a result, the number of disputes initiated by franchisees against their franchisors has increased, although most of them are settled out of court as franchisors generally try to avoid negative publicity.¹¹⁶

To the best of the authors' knowledge, a franchise law requiring disclosure is not yet on the agenda of the Russian parliament. As such, it remains quite possible that the disclosure requirement under the duty of good faith would eventually be interpreted by courts to require pre-sale franchise disclosure, unless the parliament intervenes by passing a law requiring disclosure to potential franchisees, or other regulatory (or self-regulatory) tools are employed to protect potential franchisees against bad faith franchisors.

V. Ongoing Franchise Relationship

In general, the offering and selling of franchises, as well as the ongoing franchise relationship, is regulated by the civil law principles in the same way as other commercial deals are usually regulated. In other words, the basic principles of good faith, fair dealing, and reasonable action will apply.

Major Points and Mandatory Clauses

The franchise agreement may contain various terms and conditions depending on the transaction structure and the parties' negotiations.

In general, a franchise agreement will usually contain a section on the parties and a statement of their intentions, definitions and interpretation,

114. *Id.* ¶ 21.

115. Nikita Shchurenkov & Alexandra Mertsalova, *Franchisophrenia. What Can the Popularity of the Partnership Business Model Lead To*, NEWSPAPER KOMMERSANT, Feb. 14, 2020, at 10.

116. *Id.*

the franchise or licence grant, term and renewal, franchise fees and payment order, the franchisor's and franchisee's duties, site selection or construction and approval, training and education, inspections and audits, accounting and records, advertising and promotion, protection of franchised assets and confidential information, default and termination, the franchisee's rights and obligations upon termination, franchise transfer and sub-franchising, and governing law and dispute resolution, as well as other general clauses.

As to Russian law and registration, the franchise agreement must address the following essential elements:

- (a) parties (i.e., corporate names and addresses);
- (b) subject matter (i.e., registration numbers of the franchised trademarks and description of the other franchised IP rights (e.g., copyrights, know-how));
- (c) franchised products (i.e., goods or services for which the licensed trademark is protected and licensed);
- (d) scope of franchised rights (i.e., permitted manners of IP use and distribution of franchised goods or services);
- (e) consideration (i.e., franchise entrance fee, lump sum, royalties, etc.);
- (f) type of franchise (i.e., sole versus exclusive versus non-exclusive);
- (g) term (i.e., term of protection of franchised IP or certain specific period);
- (h) territory (i.e., whole of Russia or certain specific areas);
- (i) sub-franchising (i.e., permitted or prohibited, how many versus to whom, etc.);
- (j) franchise renewal (i.e., franchisee's right of first refusal);
- (k) termination (i.e., mutual or unilateral, for cause or convenience, etc.); and
- (l) signatures (i.e., names and titles of signees).¹¹⁷

Default and Termination

The franchisor and franchisee are free to use the wording of Article 1037 of the Civil Code to create a valid termination clause in the franchise agreement.

More specifically, according to Russian law, any party may terminate a contract at any time if the franchise agreement has been concluded for an indefinite term.¹¹⁸ Six months' prior written notice is required in this case, unless the contract indicates a longer term for the advance termination notice. If the contract provides for a specific period of validity, the parties shall be guided by the terms of the franchise agreement.¹¹⁹

117. CIVIL CODE (PART II) art. 1027, CIVIL CODE (PART IV) arts. 1232.3, 1235.

118. CIVIL CODE (PART II) art. 1037.1.

119. *Id.*

Either of the parties to the contract concluded for a definite or indefinite term may terminate the franchise agreement by sending a written notice to the other party thirty days in advance. This option will be available only if the contract provides for the release of certain monetary compensation.¹²⁰

The franchisor may terminate the franchise agreement if the franchisee produces goods of inferior quality, or the quality of its services does not correspond to what has been set out in the contract. The franchisor may also repudiate the franchise agreement if the franchisee does not follow the franchisor's instructions and guidance aimed at ensuring compliance with the contractual provisions related to the terms and conditions of use of the franchised set of IP rights. Finally, the franchisor may cancel the franchise agreement if the franchisee fails to pay the franchise fees according to the terms set out by the contract.¹²¹

Termination by the franchisor is available if the franchisee has failed to remedy the breach within a reasonable term, or has committed another breach within a year of receipt of the written notice from the franchisor.¹²²

If the franchisor's right to the franchised trademark or franchised trade name (included in the franchised set of IP rights) is lost for any reason, the franchise agreement will be terminated, unless any similar (effective) IP asset is granted (substituted) by the franchisor.¹²³

If the franchisor or the franchisee becomes insolvent (bankrupt), the franchise agreement shall be dissolved.¹²⁴

Termination of the franchise agreement is subject to registration with Rospatent. In the absence of registration, the termination will not be effective.¹²⁵

Renewal and Refusal to Renew

Renewals are usually agreed on between the parties. Renewals are subject to registration and must be filed before the expiry of the initial terms, as agreed between the parties.¹²⁶ Upon the expiration of the initial contract, the parties may enter into a new contract.

The franchisor may refuse to renew the franchise agreement with the franchisee if its performance has not complied with the terms of the contract. The franchisor may also refuse to extend the term of the franchise agreement at any time and without explanation. However, in this case, the franchisor should not conclude a franchise agreement on the same terms with another party for one year. Otherwise, the former franchisee may demand that the new franchise agreement be transferred in its favor along with the reimbursement of damages or a claim for damages. Generally, the

120. *Id.*

121. *Id.* art. 1037.1.1.

122. *Id.*

123. *Id.* art. 1037.3.

124. *Id.* art. 1037.4.

125. *Id.* art. 1036.

126. *Id.*

franchisee that has been duly performing its obligations under the franchise agreement has a pre-emptive right to renew the expired contract.¹²⁷

Fees and Foreign Exchange Control

The Civil Code provides that payments under the franchise agreement can be made in any manner, including as lump sums or periodic payments (royalties), or otherwise, as agreed by the parties.¹²⁸ The parties may agree on the amount of franchise fees in any applicable way, but such fees should be based on the appropriate market value of the franchised intellectual property in question.

A franchisee is not restricted by law from making payments of franchise fees to a foreign franchisor. The only requirement is that the franchisee must have an appropriate currency account with a Russian bank to transfer monies in a foreign currency.¹²⁹ The franchise must be also registered with Rospatent.¹³⁰ Without registration, the competent bank will not record and account the contract at issue, and, without such bank recording, monies cannot be wired overseas. Bank recordal is required in cross-border franchising transactions amounting to or exceeding three million rubles or six million rubles (import versus export contracts).¹³¹

Good-Faith Obligation

As discussed in detail above, the Civil Code provides that the parties, while exercising their rights and performing their duties, should act in good faith.¹³² There is also a general civil law principle that the actions of private persons and legal entities are not allowed if they are carried out with the sole purpose of causing damages to other persons.¹³³ Neither abuse of rights nor unfair competition is allowed.¹³⁴ This norm is widely supported in franchising.

VI. Dispute Resolution, Remedies, Enforcement, and ADR

Generally, franchise-related claims, unfair competition conflicts, and IP infringement disputes that involve the Russian market, or are targeted at Russia, tend to be litigated through local courts. The system of commercial courts has basically four tiers: (1) the first instance courts, (2) the appellate courts, (3) the cassation courts, and (4) the Supreme Court. There is also a specialized Intellectual Property Court operating as the court of first

127. *Id.* art. 1035.

128. *Id.* art. 1030.

129. FEDERAL LAW NO. 173-FZ (AS AMENDED) ON CURRENCY REGULATION AND CURRENCY CONTROL, 2003, arts. 6, 7, 8, 11.

130. CIVIL CODE (PART II) art. 1028.2.

131. INSTRUCTIONS OF CENTRAL BANK OF RUSSIA NO. 181-I, 2016, arts. 4.1, 4.2.

132. CIVIL CODE (PART I) art. 10.5

133. *Id.* art. 10.1.

134. *Id.*

instance or court of cassation and empowered to hear IP-related cases, conflicts arising out of IP contracts (e.g., license agreements), and unfair-competition disputes. Franchising disputes may fall under the jurisdiction of the IP Court at the cassation stage (i.e., third level).¹³⁵

Remedies can include preliminary and permanent injunctive relief, as well as monetary relief (e.g., statutory damages). To obtain statutory damages, it is sufficient to prove that IP infringement has occurred.¹³⁶ To obtain lost profits, it is necessary to demonstrate the following: (1) the amount of the damages, (2) the method of calculation of the asserted damages, and (3) the nexus between damages claimed and the illegal activities of the respondent.¹³⁷

Cases may be settled at any stage of the civil procedure. A settlement agreement must be approved by the competent court and will receive such approval if the agreed provisions do not affect the rights and legitimate interests of third parties.¹³⁸ Attorney fees are recoverable from the losing party.¹³⁹ If the case is being settled, the parties are free to allocate attorney's fees in whatever proportions they wish.

The general limitation period for a case to be brought to trial is three years, and the same period applies for the commencement of the enforcement procedure, when the court decision becomes effective.¹⁴⁰

Instead of resorting to litigation in local courts, the franchisee and franchisor can contractually agree on arbitration. Arbitration may be conducted in any jurisdiction and by any forum chosen by the parties. If there is no arbitration clause in the contract, the contract may not be submitted to arbitration.¹⁴¹

Russia is a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (dated 1958) (the New York Convention).¹⁴² Hence, an arbitral award received from another jurisdiction that is a signatory to the New York Convention may be enforceable in Russia.

The local courts will also enforce orders granted by foreign courts. Indeed, a court judgment issued by another jurisdiction may be enforceable in Russia provided that recognition and enforcement of the foreign court judgment is stipulated by the relevant international treaty, and to which Russia is a party, and the federal law.¹⁴³ Russia is a signatory to many multilateral and bilateral international treaties for recognition and enforcement of

135. COMMERCIAL PROCEDURE CODE, art. 34.4.

136. CIVIL CODE (PART IV), art. 1252.3.

137. CIVIL CODE (PART I), art. 15.2.

138. COMMERCIAL PROCEDURE CODE art. 139.4.

139. *Id.* arts. 110.1, 110.2.

140. *Id.* art. 321.1.

141. FEDERAL LAW NO. 382-FZ ON ARBITRATION, Dec. 29, 2015, art. 7.

142. *Contracting States*, NEW YORK ARB. CONVENTION, <https://www.newyorkconvention.org/countries> (last visited Mar. 23, 2022).

143. COMMERCIAL PROCEDURE CODE art. 241.1.

foreign judgments; however, there is currently no such treaty between Russia and the United States.

The Russian Civil (Commercial) Procedure Code provides certain formal or mandatory requirements for recognition and enforcement of foreign judgments.¹⁴⁴ These include, *inter alia*, the following significant aspects: (1) effectiveness of the court judgment under the law of the jurisdiction in the territory on which it has been issued; (2) compliance with the statutory three-year term for filing a motion for recognition and enforcement of the foreign court judgment; and (3) consistency of the foreign court judgment with Russian public policy.¹⁴⁵ If these requirements are not met, a Russian court may refuse to recognize and enforce a foreign judgment.

In the absence of a relevant international treaty, a Russian court may recognize and enforce a foreign judgment on the basis of the international principle of reciprocity and comity (*comitas gentium*).¹⁴⁶ Although not in the franchising sphere, in at least a couple of successful landmark cases, foreign judgments were enforced on the basis of the *comitas gentium* principle in Russia.¹⁴⁷

Mediation is also available as an alternative method of dispute resolution. Franchising conflicts are rarely mediated in Russia, but this may change in the future.

VII. Conclusion

As noted above, the Russian legal system has already adopted certain elements from the global franchise practice and currently provides great, legitimate investment opportunities for market participants and their brands, technologies, systems, business reputation, and other valuable assets. There have already been several packages of civil law amendments recently submitted, discussed, and implemented by the Russian government to “close gaps” in certain areas of national contract law, including franchise law. With these amendments in force and with Chapter 54 of the Civil Code, Russia is now welcoming new international franchise business models to the country.

144. *Id.* art. 244.

145. *Id.*

146. *Id.* art. 256.9.

147. Decision of Commercial Court of Saint-Petersburg and Leningradskiy District, No. A56-48129/2014 (Feb. 9, 2015); Ruling of Supreme Commercial Court No. BAC-6580/12 (July 26, 2012).



An Overview of Legal Issues and Regulations Affecting CBD-Based Franchise Systems

Aly Conwell & Caroline B. Fichter

I. Introduction

Buying hemp-derived cannabidiol (CBD)¹ products is as easy as buying a cup of coffee in many parts of the country. In fact, in Oregon and Florida, consumers can purchase CBD in their coffee.² Following declassification of hemp as a Schedule I drug, a recent Gallup poll found that one in seven Americans use hemp-derived CBD products (although CBD derived from marijuana is still illegal under federal law and will not be addressed here). CBD experts have dubbed CBD “the new avocado toast.”³ CBD



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1. It is important to distinguish CBD products from marijuana products. For purposes of this article, the term “cannabis” industry will refer to the growth, production, and sale of products derived from the cannabis plant, including hemp and non-hemp cannabis plants. “Marijuana” will refer to cannabis products that are high in THC and are not derived from hemp plants. “CBD” will refer to cannabis products that are below 0.3% THC, high in CBD, and are derived from the hemp plant. “Hemp biomass” will refer to the harvested hemp plants from which the CBD is processed.

2. Nicole Danna, *Jibby’s Coffee’s CBD-Infused Cold Brew: A New Way to Refuel*, MIAMI NEW TIMES (June 1, 2021), <https://www.miaminewtimes.com/restaurants/miami-based-jibby-coffee-makes-cold-brew-infused-with-cbd-12259619>; Elise Herron, *Oregon Is Now the Only State on the West Coast Where Consumers Can Buy CBD Products at Grocery Stores*, WILLAMETTE WK. (Sept. 4, 2019), <https://www.wweek.com/news/2019/09/04/oregon-is-now-the-only-state-on-the-west-coast-where-consumers-can-buy-cbd-products-at-grocery-stores-here-are-8-of-the-most-bizarre-and-bougie-products-on-offer>.

3. Nicola James, *Should Give Your Kid CBD?*, N.Y. TIMES (Apr. 30 2020), <https://www.nytimes.com/2020/04/30/parenting/cbd-oil-children.html>. Today, the largest consumers of CBD products are millennials and baby boomers. Megan E. Sheehan & Samantha L. Roy, *CBD Is Legal ... Right? The Complex Federal and State Legal Framework of Cannabidiol*, 68 R.I. Bar J. 15, 15 (Jan./Feb. 2020).

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products are available at a variety of mainstream retailers including CVS, Walgreens, GNC, Kroger, Ulta Beauty, Abercrombie & Fitch, and American Eagle Outfitters.⁴ Industry research firms estimate that by 2024, CBD sales will exceed twenty billion dollars in the United States.⁵ Another study projects a twenty-five percent compound annual growth rate in the CBD edible market between 2020 and 2027.⁶

Many consumers rely on CBD to treat anxiety, pain, and insomnia.⁷ Other common usages include over-the-counter treatment for depression, muscle contractions, skin conditions, and digestive concerns.⁸ A third of pet owners have purchased CBD-infused treats, food, or other items for their cats and dogs, and purchases of CBD pet products are rapidly increasing as pet owners begin to return to the office following the nationwide lifting of COVID-19 restrictions.⁹

Considering this clear market demand and the likelihood that states will continue to ease restrictions on sale of CBD and other hemp-derived related products, franchisors may find entering the CBD market an irresistible opportunity—either through creating a new franchised system that primarily sells CBD products or by adding them as a new or additional product line in an existing system. In either scenario, franchisors and franchisees should carefully consider the risks and rewards of entering this popular,

4. Angelica LaVito, *Kroger to Sell CBD Products in Nearly 1,000 Stores*, CNBC (July 11, 2019), www.cnn.com/amp/2019/06/11/kroger-to-sell-cbd-products-in-nearly-1000-stores.html; Erin Lukas, *Kristen Bell Has the Best Hack for Moms Who Need Time Alone*, INSTYLE (Mar. 4, 2021), <https://www.instyle.com/beauty/skin/kristen-bell-happy-dance-cbd-ultra-interview>; Lauren Thomas, *American Eagle Becomes the Latest Retailer to Sell Green Growth Brands' CBD Products*, CNBC (July 11, 2019), www.cnn.com/amp/2019/07/11/american-eagle-to-sell-green-growth-brands-cbd-products-in-500-stores.html. Popularity and high demand have even resulted in celebrities launching their own CBD lines. For example, Martha Stewart is launching Martha Stewart CBD products, which will be sold at Vitamin Shoppe and will include CBD supplements and a pet product line influenced by Stewart's most celebrated recipes including "the French confections, pate de fruits, rather than the sticky, overly sweet versions you might find elsewhere." *Canopy Growth Corporation (CGC) Partner with Martha Stewart and Marquee Brands*, MKT. WATCH (Sept. 10, 2020), <https://www.marketwatch.com/press-release/canopy-growth-corporation-cgc-partner-with-martha-stewart-and-marquee-brands-2020-09-10>; Katie Shapiro, *Martha Stewart CBD Goes Coast-to-Coast with First National Retail Expansion*, FORBES (Dec. 9, 2020), <https://www.forbes.com/sites/katishapiro/2020/12/09/martha-stewart-cbd-goes-coast-to-coast-with-first-national-retail-expansion/?sh=5eb6621a41cb>.

5. *Market for CBD Infused Products Could Surpass \$20 Billion by 2024*, MKT. WATCH (Sept. 10, 2020), <https://www.marketwatch.com/press-release/market-for-cbd-infused-products-could-surpass-20-billion-by-2024-2020-09-10>.

6. *Id.*

7. David H. Freedman, *Pop Culture Says CBD Cures Everything—Here's What Scientists Say*, NEWSWEEK (Aug. 29, 2019), <https://www.newsweek.com/2019/09/06/cbd-oil-miracle-drug-science-1456629.html>.

8. Freedman, *supra* note 7; Sammi Caramela, *How to Start a CBD Business*, BUS. NEWS DAILY (July 3, 2020), <https://www.businessnewsdaily.com/15052-how-to-start-a-cbd-business.html>.

9. Freedman, *supra* note 7; Alayna Alvarez, *Pet CBD Sales Soar as Owners Return to Work*, YAHOO!LIFE (June 9, 2021), <https://www.yahoo.com/lifestyle/pet-cbd-sales-soar-owners-100027202.html>.

but relatively unregulated and evolving industry. Indeed, those entering the industry half-baked may quickly find themselves in significant legal jeopardy.

The first two sections of this article explore the historical roots of CBD use and review the complex, shifting regulatory landscape of CBD products. Section III then examines the benefits of using a franchise business model to develop a CBD business. Finally, Section IV addresses many of the unique challenges associated with franchises selling CBD and proposes best practices for both franchisors and franchisees.

II. The History of Cannabis, THC, and CBD

Cannabis has been used globally for medical and religious purposes for centuries.¹⁰ The ancient Greeks used it for medicine, and, according to Hindu legend, the god Shiva ate cannabis for energy.¹¹ The cannabis sativa plant contains chemical compounds called cannabinoids including tetrahydrocannabinol (THC), which produces the intoxicating, psychoactive “high,” and cannabidiol (CBD), which may have therapeutic properties but will not produce a “high.”¹² Cannabis sativa played an important role in European folk remedies for treating fevers, burns, headaches, and wounds.¹³ Given the low levels of THC in the European varieties of cannabis, it is likely that these folk remedies were based on the therapeutic properties of CBD.¹⁴ Between 1850 and 1942, physicians prescribed cannabis for ailments such as pain relief, bronchitis, rheumatism, and postpartum depression.¹⁵ However, the dominant strains of cannabis at the time contained both THC and CBD, which made it impossible to determine which pharmacologic property related to which chemical. The chemical compound of CBD was first discovered in the late 1800s, isolated in the 1930s, and its chemical structure identified in 1963.¹⁶ Once the scientific community identified the chemical structures of CBD, and later THC, scientists could separate the effects of CBD from those of THC.

By the early 1910s, cannabis medicine was widely accepted in the United States. But Harry Anslinger, Director of the Federal Bureau of Narcotics from 1930 to 1962, deliberately “eschewed references to the benign-sounding cannabis and hemp, while calling for a federal ban on marijuana.”¹⁷ Anslinger and his supporters used the exotic sounding “marijuana” and

10. Roger G. Pertwee, *Cannabinoid Pharmacology: The First 66 Years*, 147 *BRIT. J. PHARMACOLOGY* 147, 147 (2006).

11. Linda E. Klumpers & David Thacker, *A Brief Background on Cannabis: From Plant to Medical Indications*, 102 *J. OF AOAC INT'L* 412, 412 (2019).

12. Lauren Silva, *CBD vs. THC: What's the Difference?*, *FORBES* (Jan. 10, 2022), <https://www.forbes.com/health/body/cbd-vs-thc/>.

13. MARTIN A. LEE, *SMOKE SIGNALS: A SOCIAL HISTORY OF MARIJUANA: MEDICAL, RECREATIONAL, AND SCIENTIFIC* 21 (2013).

14. *Id.* at 20.

15. *Id.* at 26.

16. Pertwee, *supra* note 10.

17. Lee, *supra* note 13, at 51.

blatantly racist scare tactics—including movies like the 1936 now cult classic *Tell Your Children* (also known as *Reefer Madness*)—to turn public opinion against cannabis.¹⁸ Anslinger claimed that “50 percent of violent crimes committed in districts occupied by Mexicans, Greeks, Turks, Filipinos, Spaniards, Latin Americans, and [African-Americans] may be traced to marijuana” and that it caused “white women to seek relations with [African-Americans].”¹⁹

Influenced by Anslinger and others with similar views throughout the United States,²⁰ in 1937 Congress passed the Marijuana Tax Act, which imposed a registration tax and substantial record-keeping requirements on individuals and businesses selling cannabis for medical use. The onerous licensing restrictions led doctors to stop prescribing and pharmaceutical companies to stop manufacturing and marketing cannabis-based medications.²¹ In 1970 (and likely partially in response to the counterculture movement of the late 1960s), Congress enacted the Controlled Substances Act (CSA), which classifies cannabis as a Schedule I drug with “high abuse potential and no acceptable medical use.”²² After its criminalization, the marijuana industry moved underground. This transition, in turn, led cannabis growers to selectively bred strains that were low in CBD because CBD does not produce the “high” that most illicit marijuana users were seeking.²³

Because marijuana high in CBD content was not appealing to illegal cannabis users, there was little interest in CBD until the concept of medical marijuana became mainstream. As the movement to legalize medical marijuana grew in the 1990s, medical and cannabis researchers and long-time cannabis growers discovered that cannabis strains with more CBD than THC could offer the possible therapeutic benefits of cannabis without the “buzz.”²⁴ Dr. Geoffrey Guy, founder of the British CBD-based pharmaceutical company GW Pharmaceuticals, explained that synthesized THC may cause nausea and drowsiness, which poses an issue for many prospective cannabis users who desire to avoid a high from THC because they “don’t want to replace one disability for another. They don’t want to get high.”²⁵ Guy believed a cannabis product with low levels of THC but high levels of CBD would be appealing for these users.²⁶ By the late 1990s, several Northern California cannabis growers were cultivating high CBD/low THC strains

18. *Id.* at 53.

19. *Id.* at 51–52.

20. Cydney Adams, *The Man Behind the Marijuana Ban for All the Wrong Reasons*, CBS News (Nov. 17, 2016), <https://www.cbsnews.com/news/harry-anslinger-the-man-behind-the-marijuana-ban>.

21. Lee, *supra* note 13, at 56; see also Marijuana Tax Act of 1937, Pub. L. No. 75-238, 50 Stat. 551.

22. Controlled Substances Act of 1970, Pub. L. No. 91-513, 84 Stat. 1236 (codified as amended at 21 U.S.C. § 812).

23. Amanda Chicago Lewis, *The Hidden Origin Story of CBD*, N.Y. TIMES (May 23, 2020), <https://www.nytimes.com/2020/05/23/sunday-review/coronavirus-cbd-oil.html>.

24. Eric Bailey, *British Firm Holds Hope for Users of Medical Pot*, L.A. TIMES (Feb. 1, 2004), <https://www.latimes.com/archives/la-xpm-2004-feb-01-me-medpot1-story.html>.

25. *Id.*

26. *Id.*

and distributing both the seeds and their research about its effects at marijuana shops and fairs on the West Coast.²⁷ In 2010, a group of medical marijuana researchers and cannabis growers founded Project CBD, a nonprofit corporation with the goal of collecting and promoting medical research regarding the benefits of CBD.²⁸

In August 2013, CNN aired Dr. Sanjay Gupta's documentary *Weed*, which contained a segment describing the successful use of a CBD oil developed by the Stanley Brothers, called "Charlotte's Web," to reduce seizures in five-year old Charlotte Figi.²⁹ After the segment, the wait list for the oil grew to 15,000 people, families moved to Colorado with the hope of using the oil, and the Food and Drug Administration fast-tracked trials of GW Pharmaceutical's CBD-based medication, Epidiolex.³⁰ Popular culture acceptance and demand for CBD has continued to increase in the last decade.

III. CBD Law and Developments

While the public acceptance and demand for CBD increased, the outright federal prohibition of cultivation, production, distribution, or sale of cannabis remained. As *Newsweek* noted, "[A]ll cannabis sativa—whether grown to ease chronic pain, get stoned or make rope—is a Schedule I controlled substance."³¹ That began to change in 2013, when Kentucky Senators Rand Paul and Mitch McConnell advocated for the inclusion of a pilot program to test and regulate the production of hemp in what would eventually become the Agricultural Act of 2014 (2014 Farm Bill).³² The support of two Republicans for hemp products was likely driven by many Kentucky farmers seeing hemp as a replacement for the state's other highly regulated cash crop, tobacco.³³ Congress enacted the 2014 Farm Bill on February 7, 2014, which authorized states to develop a legal framework to authorize the legal cultivation of "industrial hemp."³⁴ After decades of prohibition, hemp could be legally grown in the United States but only by universities and research institutions.³⁵ The Agricultural Act of 2018 (2018 Farm Bill) cleared the way for private hemp production and sale by distinguishing hemp from marijuana, removing hemp from the CSA, and declaring that hemp or products derived from hemp would not be subject to any federal restrictions on its

27. Lewis, *supra* note 23.

28. *Id.*

29. *Id.*

30. *Id.*, *Legacy and Vision*, STANLEY BROTHERS (2020), <https://www.stanleybrothers.com/our-company/our-history> (last visited May 18, 2021).

31. Jessica Firger, *The Great Kentucky Hemp Experiment*, NEWSWEEK (Oct. 23, 2015), <https://www.newsweek.com/2015/10/23/great-kentucky-hemp-experiment-381870.html>.

32. *Id.*

33. *Id.*

34. Agricultural Act of 2014, Pub. L. No. 113-79, 128 Stat. 649.

35. *Id.*

sale, transport, or possession.³⁶As of the date of publication of this article, hemp-derived CBD is legal in every state but CBD products are still subject to extensive and often contradictory federal, state, and county regulations.

A. *Laws and Regulations Regarding Hemp Biomass*

1. 2014 and 2018 Farm Bills

The 2014 Farm Bill permitted growing and cultivation of hemp, but only under tightly regulated pilot programs in states where hemp growth and cultivation was legal under state law.³⁷ Under the 2014 Farm Bill, hemp could only be grown for research purposes by colleges, by state departments of agriculture, or through a state-regulated pilot program. Two years later, the United States Department of Agriculture (USDA), the Drug Enforcement Administration (DEA), and Food and Drug Administration (FDA) issued a joint statement stressing that hemp products could only be sold in states where it was legal, that hemp products were not for “general commercial activity,” and that industrial hemp and hemp seeds could not be transported across state lines.³⁸ Most importantly, the joint statement clarified that the authorization of the hemp pilot programs in the 2014 Farm Bill did not alter the status of hemp-derived cannabis as a Schedule I controlled substance under the CSA.³⁹

In 2018, Congress enacted the Agricultural Act of 2018 (2018 Farm Bill), which for the first time created a legal distinction between hemp and marijuana under federal law. Under the 2018 Farm Bill, cannabis biomass that contains less than 0.3% THC can be classified as hemp.⁴⁰ Farmers seeking to grow hemp may apply for a license either through a state or federally managed program.⁴¹ The law also authorized the USDA to initiate a rule-making process to establish licensing, recording keeping, and testing requirements for hemp growers.⁴² At the federal level, hemp produced by licensed growers in accordance with a hemp regulatory program is neither subject to any restrictions on its sale, transport, or possession, nor are any of its derivative products.⁴³ Importantly, under the 2018 Farm Bill, hemp is treated like other agricultural commodities, and hemp producers are entitled to federal crop insurance for their harvest.⁴⁴

36. Agricultural Improvement Act of 2018, Pub. L. No. 115-334 (codified as amended in scattered sections of 7 U.S.C. and 21 U.S.C.) [hereinafter 2018 Farm Bill].

37. John Hudak, *The Farm Bill, Hemp Legalization, and the Status of CBD: An Explainer*, BROOKINGS INST. (Dec. 14, 2018), <https://www.brookings.edu/blog/fixgov/2018/12/14/the-farm-bill-hemp-and-cbd-explainer>.

38. Statement of Principles on Industrial Hemp, 81 Fed. Reg. 53395 (Aug. 12, 2016).

39. *Id.* at 53396.

40. Agric. Improvement Act of 2018, Pub. L. No. 115-334 (codified as amended in scattered sections of 7 U.S.C. and 21 U.S.C.).

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

For consumers, the 2018 Farm Bill removed CBD from Schedule I status under the CSA, but only for CBD (1) derived from hemp grown by properly licensed growers; (2) produced in accordance with a hemp regulatory program; and (3) containing less than 0.3% THC.⁴⁵ Any CBD produced in a manner that does not strictly comply with these standards remains a Schedule I controlled substance.⁴⁶

2. 2019 Hemp Production Interim Rule

The 2018 Farm Bill directed the USDA to develop a regulatory framework for hemp production in the United States.⁴⁷ On October 31, 2019, the USDA published the Interim Final Rule on Hemp Production (Interim Hemp Rule).⁴⁸ The Interim Hemp Rule proposed a process for how the USDA will approve state or tribal hemp production plans and provides a hemp production plan for states or tribal authorities who chose not to develop their own plan. The Interim Hemp Rule set forth strict sampling and testing requirements for hemp biomass that required hemp producers to dispose of hemp biomass with THC levels between 0.3% and 0.5%.⁴⁹ The Interim Final Rule authorized states to create stricter hemp production laws and allowed producers in states where hemp was legal, but where the state did not have a USDA-approved state production plan, to produce hemp under a USDA hemp producer license.⁵⁰ The Interim Hemp Rule barred state and tribal authorities from prohibiting the interstate transportation of hemp or hemp productions produced in accordance the USDA-approved plan or license.⁵¹

3. Hemp Production Final Rule

On January 15, 2021, the USDA announced a final rule regarding hemp production in the United States (Final Hemp Rule), effective March 22, 2021.⁵² The Final Hemp Rule regulates several aspects of hemp production, including (1) licensing and record-keeping requirements for hemp producers;⁵³ (2) procedures for testing THC content and disposing of non-compliant hemp;⁵⁴ and (3) designating authority for regulating the growth of hemp on tribal lands.⁵⁵

45. *Id.*

46. *Id.*

47. *Id.*

48. Establishment of a Domestic Hemp Production Program, 84 Fed. Reg. 58522 (Oct. 31, 2019).

49. 7 C.F.R. § 990.27(a).

50. *Id.* § 990.3(b)(1).

51. Establishment of a Domestic Hemp Production Program, 84 Fed. Reg. 58522 (Oct. 31, 2019).

52. Establishment of a Domestic Hemp Production Program, 86 Fed. Reg. 5596 (Jan. 19, 2021) (to be codified at 7 C.F.R. § 990).

53. *Id.* at 5599.

54. *Id.* at 5600.

55. *Id.* at 5599.

The Final Hemp Rule retains the requirements of the 2019 Interim Rule that only hemp with a THC concentration of 0.3% or less qualifies as 2018 Farm Bill-compliant hemp and that all labs performing testing on hemp for THC levels must have a license from the DEA.⁵⁶ However, after feedback from the public and relevant stakeholders, the Final Hemp Rule offered two major concessions to hemp farmers in the areas of testing and setting the negligence threshold for license violations.

First, in promulgating the Final Hemp Rule, the USDA acknowledged that the current demand for hemp biomass testing exceeds the supply of certified laboratories. The agency stressed the need for testing facilities to be both USDA certified and registered with the DEA because any hemp biomass that tests above 0.3% THC is “by definition, a controlled substance.”⁵⁷ However, the USDA noted that “since most hemp in a given region is harvested at the same time, sampling must be completed within a very short time by only a few individuals.”⁵⁸ The USDA thus delayed the requirement only licensed laboratories may perform bio-mass testing until December 31, 2022.⁵⁹

Second, the Final Hemp Rule raised the standard for a negligence violation from 0.5% THC to 1% THC. Any hemp biomass that tests above the 0.3% limit must be destroyed; however, any hemp biomass that tests above the negligence standard may be given a violation notice by the USDA, and multiple violation notices could result in a forfeiture of the farmer’s license.⁶⁰ During the rulemaking process, hemp farmers argued that permissible amount of THC in hemp biomass should be increased from the Interim Hemp Rule limit of 0.3% to 1% because it was difficult to grow hemp biomass that complied with the interim standard, and a higher threshold would allow for the cultivation of better varieties.⁶¹ Additionally, they argued, a hemp farmer who negligently produces a “hot” crop may not be able to claim crop insurance for the destroyed harvest or could lose the ability to access credit for subsequent crops. Hemp biomass is grown from cannabis plants that are bred to be low in THC, but hemp farmers argued that, because the amount of THC in a harvest can vary widely based on factors beyond the growers’ control (like unexpectedly hot weather), a higher threshold was necessary.⁶²

56. It is an open issue whether the USDA actually had the authority to alter the THC negligence standard set by Congress.

57. 86 Fed. Reg. 5596, 5610.

58. *Id.* at 5610.

59. *Id.* at 5602.

60. *Id.* at 5606.

61. Theresa Bennet, *Update: USDA Issues Final Rule on Hemp*, HEMP GROWER (Jan. 15, 2021), <https://www.hempgrower.com/article/usda-issues-final-rule-hemp/>.

62. *Id.*

B. Laws and Regulations Regarding Selling and Marketing CBD Products

1. FDA Regulations

Despite the plethora of health benefits touted by CBD advocates, the FDA prohibits the sale of CBD in any unapproved health product, dietary supplement, or product for human or animal consumption.⁶³ As of January 2021, the FDA had approved only one CBD-based drug product: Epidiolex.⁶⁴ Any other CBD products claiming a medical use, including the product's ability to cure or provide relief for ailments, are considered non-FDA approved drugs and may not be lawfully sold.⁶⁵ Any dietary supplements containing CBD are also illegal under federal law.⁶⁶

The FDA considers any product that claims it can “cure or treat” an illness to be a drug under Section 201(g)(1)(B) of the CSA.⁶⁷ Specifically, a drug includes any “substance intended for use in the diagnosis, cure, mitigation, treatment, or prevention of a disease.”⁶⁸ The FDA is highly concerned about mislabeling and other claims made by CBD manufacturers as they relate to health concerns, ailments, and cures, including any claim that may cause a consumer to forego seeking traditional medical advice in favor of a CBD product.⁶⁹ For example, the FDA has considered the following claims in the advertising or marketing of CBD products unlawful:

- “It can help with digestive issues. . . . It may also help with tummy troubles, including ulcers.”⁷⁰
- “Instant relief for patients that are symptomatic of inflammatory auto-immune diseases.”⁷¹

63. *FDA Regulation of Cannabis and Cannabis-Derived Products, Including Cannabidiol (CBD)*, FDA (Jan. 22, 2021), <https://www.fda.gov/news-events/public-health-focus/fda-regulation-cannabis-and-cannabis-derived-products-including-cannabidiol-cbd#approved>.

64. *Id.*

65. 21 U.S.C. § 331(l); *FDA Regulation of Dietary Supplement & Conventional Food Products Containing Cannabis and Cannabis-Derived Compounds*, FDA (last visited Oct. 8, 2020), <https://www.fda.gov/media/131878/download>.

66. 21 U.S.C. § 321(ff)(3)(B) (containing definition of “dietary supplement,” which the FDA has determined excludes CBD).

67. David Evans, *FDA Enforcement Against Marijuana Manufacturers*, 1 *DRUG TESTING L. TECH. & PRAC.* § 1:115 (Mar. 2020).

68. *Drugs@FDA Glossary of Terms*, FDA, <https://www.fda.gov/drugs/drug-approvals-and-databases/drugsfda-glossary-terms> (last visited Oct. 8, 2020).

69. Hannah Catt, *Going Hemp Wild: Understanding the Challenges and Opportunities for FDA Regulation of CBD in Food Products*, 15 *J. FOOD L. & POL'Y* 74, 81 (2019); Amanda Milgrom, *Navigating the Web of CBD Regulations: How to Assist Clients*, 48 *COLO. LAW.* 24, 27 (2019).

70. *Warning Letter: Bee Delightful*, FDA (Dec. 22, 2020), <https://www.fda.gov/inspections-compliance-enforcement-and-criminal-investigations/warning-letters/bee-delightful-610689-12222020>.

71. *Warning Letter: BIOTA Biosciences LLC*, FDA (Apr. 9, 2020), <https://www.fda.gov/inspections-compliance-enforcement-and-criminal-investigations/warning-letters/biota-bioscience-s-llc-605164-04092020>.

- “Cannabis contains several cannabinoids that have anti-inflammatory properties. Specifically, CBD is the most likely possibility for treating COVID-19 related lung inflammation.”⁷²

Similarly, under the federal Food, Drug, and Cosmetic Act (FDCA), it is illegal to deliver or introduce into interstate commerce any food (including animal feed), health products, dietary supplements, or consumables to which CBD has been added because CBD is an active ingredient in FDA-approved drugs.⁷³

Though unlawful, the FDA has not taken aggressive enforcement actions against unlawful CBD sales, instead sending warning letters to CBD manufacturers that it believes have made “egregious” health claims or other unsubstantiated claims.⁷⁴ These warning letters inform the recipient of the violation and provide instructions on how to cure the violation (e.g., repackaging the CBD product).⁷⁵ The FDA sent twenty-two such warning letters in 2019.⁷⁶ It sent twenty-one letters in 2020, which classified each problematic CBD product as an “new drug” under 21 U.S.C. § 321(g)(1) and a “misbranded drug.”⁷⁷ One such unapproved CBD product was an injectable, which could pose serious health risks due to direct placement into the bloodstream.⁷⁸ In 2020, the FDA directed over half of the warning letters sent at unsubstantiated claims for CBD use to fight, prevent, or treat COVID-19.⁷⁹

The FDA actively monitors and responds to unsubstantiated health and other claims related to CBD products. Franchisors can avoid running afoul

72. *Warning Letter: For Our Vets LLC dba Patriot Supreme*, FDA (Oct. 16, 2020), <https://www.fda.gov/inspections-compliance-enforcement-and-criminal-investigations/warning-letters/our-vets-llc-dba-patriot-supreme-611043-10162020>.

73. Establishment of a Domestic Hemp Production Program, 86 Fed. Reg. 5596 (Jan. 19, 2021) (to be codified at 7 C.F.R. § 990).

74. Milgrom, *supra* note 69, at 26.

75. Other enforcement actions available to the FDA include seizure of the unlawful product, injunction, or even criminal prosecution. *Types of Enforcement Actions*, FDA (Nov. 6, 2017), <https://www.fda.gov/animal-veterinary/resources-you/types-fda-enforcement-actions>; Milgrom, *supra* note 69. Warning letters can have significant effects on a company. For example, in 2019, after CBD company Curaleaf received a warning letter for making “unsubstantiated health claims,” Curaleaf’s stock fell over seven percent. Further, CVS, which carried Curaleaf, announced it would remove Curaleaf products from its shelves. Zack Guzman, *The Largest US Marijuana Company Sees Shares Drop 7% Following FDA Warning*, YAHOO!FINANCE (July 23, 2019), <https://www.yahoo.com/now/curaleaf-shares-drop-7-following-fda-warning-letter222612763.html>.

76. *Warning Letters and Test Results for Cannabidiol-Related Products*, FDA (Aug. 5 2021), <https://www.fda.gov/news-events/public-health-focus/warning-letters-and-test-results-cannabidiol-related-products>.

77. See, e.g., *Warning Letter: New Leaf Pharmaceuticals, LLC*, FDA (Dec. 22, 2020), <https://www.fda.gov/inspections-compliance-enforcement-and-criminal-investigations/warning-letters/new-leaf-pharmaceuticals-llc-609744-12222020>.

78. *Warning Letter: BIOTA Biosciences LLC*, FDA (Apr. 9, 2020), <https://www.fda.gov/inspections-compliance-enforcement-and-criminal-investigations/warning-letters/biota-biosciences-llc-605164-04092020>.

79. Of the twenty-one warning letters issued in 2020, thirteen were related to “mitigat[ing], prevent[ing], treat[ing], diagnos[ing], or cur[ing] COVID-19.” E.g., *Warning Letter: Project 1600 Inc.*, FDA (June 18, 2020), <https://www.fda.gov/inspections-compliance-enforcement-and-criminal-investigations/warning-letters/project-1600-inc-608349-06182020>.

of the FDA by (1) working with counsel who specialize in FDA labelling compliance and claims to ensure that any product representations made are compliant, and (2) closely monitoring its franchisee to ensure that they are not making improper representations by limiting marketing materials to only those approved by the franchisors and zealously enforcing compliance with the operations manual and the franchise agreement.

2. Federal Trade Commission Regulation

Although the FDA has primary regulatory authority over CBD foods, beverages, and dietary supplements, the Federal Trade Commission (FTC) has also exercised authority over CBD sellers who make misleading or unsupported claims about the medical efficacy of their products.⁸⁰ On December 17, 2020, the FTC announced its launch of “Operation CBDceit” to crack down on false and misleading claims by CBD sellers on its websites and social media.⁸¹ This operation consisted of enforcement actions against CBD sellers who made “scientifically unsupported claims” about their products’ ability to treat serious health conditions, including “cancer, heart disease, hypertension, Alzheimer’s disease and others.”⁸² The FTC ordered six companies and individuals associated with them to stop making health claims and, in some cases, to pay fines.⁸³ While these six companies are the first to be subject to enforcement actions, they likely will not be the last. Andrew Smith, the FTC’s Director of Consumer Protection, warned: “Don’t make spurious health claims . . . otherwise, don’t be surprised if you hear from the FTC.”⁸⁴

CBD franchisors must carefully review their marketing materials, including packaging, websites, and social media to for misleading health claims regarding their products. They should also carefully monitor the advertising and social media of their franchisees for similar problematic claims.

IV. Benefits of Franchising

When done correctly, franchising is mutually beneficial for both the CBD franchisor and franchisee. Franchising permits the franchisor to strike while the iron is hot—to expand rapidly without the significant capital and labor required for corporate expansion in a burgeoning industry.⁸⁵ Accelerated

80. See Statement of Commissioner Rohit Chopra, FTC (Dec. 17, 2020), https://www.ftc.gov/system/files/documents/public_statements/1584918/2023047cbdchoprastatement.pdf.

81. *FTC Announces Crackdown on Deceptively Marketed CBD Products*, FTC (Dec. 17, 2020), <https://www.ftc.gov/news-events/press-releases/2020/12/ftc-announces-crackdown-deceptively-marketed-cbd-products>.

82. *Id.*

83. *Id.*

84. *Id.*

85. Rochelle Spandorf, *Franchising and the Cannabis Industry*, MARIJUANA VENTURE (July 22, 2019), <https://www.marijuanaventure.com/franchising-and-the-cannabis-industry>.

interest in using CBD products has driven interest in the CBD business, and particularly in CBD franchise opportunities.⁸⁶

The prospective CBD franchisor also can through franchising maintain significant control of its brand and products and provide meaningful assistance in a manner that mere licensing does not permit.⁸⁷ The franchisor receives royalties, advertising or marketing fees, and other monies, which assist in brand maintenance, development, and growth. In return, the franchisee benefits from an established system and brand and may receive assistance from the franchisor in site selection, training, and purchasing power, increasing the chance of success as compared to a local unknown startup.

Further, as a franchisee, the inexperienced operator is not alone in facing the challenges associated with making a business plan and conducting market research in a new and emerging market.⁸⁸ Due to the complexity of federal and state laws and regulations surrounding the CBD industry, operators may benefit from joining a system in which a franchisor and its operators stay abreast of the evolving rules and regulations and establish system rules and guidelines to ensure compliance with the law.⁸⁹ Specifically, an inexperienced operator may become overwhelmed without a network of other franchisees or a franchisor's training or instruction as it relates to CBD products, marketing, manufacture, quality control, transportation, and the like.⁹⁰

CBD companies considering expansion, but wary of the regulations involved in franchising, may be tempted to avoid franchise regulations by entering "distributor" or "licensing agreements." Such companies should consider the adage "Before you risk beating the odds, consider the risk of

86. As of January 2021, CBD franchises America Shaman had 319 locations and Your CBD Store had over 550 locations. Jonathan Small, *CBD Franchises Are Booming. But How Long Can They Last?*, GREEN ENTREPRENEUR (Jan. 2021), <https://www.greenentrepreneur.com/article/363395>. Both franchises have been in business since 2018. *Id.* Over six CBD franchise systems were established in 2020. *Id.*

87. To be considered a franchise, the franchisor must "(1) promise to provide a trademark or other commercial symbol; (2) promise to exercise significant control or provide significant assistance in the operation of the business; and (3) require a minimum payment of at least \$500 during the first six months of operations." *Franchise Rule 16 C.F.R. Part 436 Compliance Guide*, FTC, <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf> (last visited Oct. 8, 2020) [hereinafter *Compliance Guide*]. If any one of these elements are missing, the business relationship may be considered a license. *Id.* Most commonly, to achieve the classification of a license, a licensor will remove the element of significant assistance or significant control, both of which are fundamental aspects of a franchise. *Id.*

88. Jared Hecht, *The Pros and Cons of Buying a Franchise*, FORBES (Feb. 27, 2019), <https://www.forbes.com/sites/jaredhecht/2019/02/27/the-pros-and-cons-of-buying-a-franchise/#53ed8d4a1198>.

89. Eddy Goldberg, *The Benefits of the Franchise Model*, FRANCHISING, https://www.franchising.com/guides/benefits_of_the_franchise_model.html (last visited Feb. 11, 2021); see also Mark Davis, *The Man Behind Kansas City's Fastest Growing CBD Chain Is Gaining Notoriety and Making Some Enemies*, HIGH PLANS PUBLIC RADIO (Sept. 3, 2019), <https://www.kcur.org/health/2019-09-03/the-man-behind-kansas-citys-fastest-growing-cbd-chain-is-gaining-notoriety-and-making-some-enemies>.

90. Anna Zernone Giorgi, *Taping into the Growing CBD and Hemp Markets with Franchise Ownership*, FRANCHISING OPPORTUNITIES (Jan. 28, 2021), <https://www.franchiseopportunities.com/blog/recent-franchise-news/tapping-into-the-growing-cbd-and-hemp-markets-with-franchise-ownership>.

the odds beating you.” Indeed, CBD is most popular in states with some of the strictest franchise regulations. California, Florida, New York, and Washington are the top four states for CBD sales, with 2019 sales of \$730 million, \$291 million, \$215 million, and \$160 million respectively.⁹¹ California, New York, and Washington are registration states.⁹² New York has been described as having “the toughest franchise and disclosure statute in the nation” due, in part, to having “the broadest” definition of a “franchise.”⁹³ Each state’s franchise statute imposes significant penalties for selling unregistered franchises and provides civil remedies for the purchasers of an unregistered franchise.⁹⁴ Additionally, if a CBD company used a distributor or license model and later wanted to take advantage of the benefits of a franchise model, it would face, at the least, a thorough inquiry by state franchise examiners into its prior business model. In the worst-case scenario, a CBD business could find itself facing investigations and a possible consent order. Therefore, CBD businesses considering entering California, New York, or Washington may find it beneficial to initially dedicate the time and resources necessary to franchise its business in order to avoid any state penalties or inquiries.

V. Challenges to Franchising

While a CBD franchise system may have enormous growth potential, it also faces unique challenges. A fast-casual sandwich franchisor or franchisee can safely assume that it will have regular access to key ingredients, banking and financial support, and legal menu items. However, a CBD franchisor or franchisee cannot make the same assumptions. The quality of CBD products and accuracy of their labeling vary greatly, and state and regulators aggressively police false or misleading claims about CBD products.⁹⁵ State and local laws governing CBD sales and consumption, and the enforcement of those laws, change constantly. Federal trademark applications must be narrowly tailored and used lawfully to obtain protection, which may prohibit some products from having federal trademark protection.⁹⁶ Financial institutions remain wary of CBD clients and courts have treated CBD-related contracts

91. Jan Conway, *Dollar Sales of CBD in the United States in 2019, by State*, STATISTA (Oct. 13, 2020), <https://www.statista.com/statistics/1065838/dollar-sales-of-us-cbd-market-by-state>.

92. CAL. CORP. CODE § 31300; N.Y. GEN. BUS. LAW § 680; WASH. REV. CODE § 19.100.10.

93. Richard Bayer & Kelly A. Krug, *New York*, FRANCHISE DESK BOOK 1164 (Bethany L. Appleby, W. Michael Garner, & Karen Boring Satterlee eds. 2019).

94. CAL. CORP. CODE §§ 31402–31411; CAL. CORP. CODE §§ 31300, 31400; N.Y. GEN. BUS. LAW §§ 689–692; WASH. REV. CODE §§ 19.100.190, 19.100.210, 19.100.248.

95. Brett Schuman, Jennifer Fisher, Brendan Radke & Gina Faldetta, *A Survey of State CBD & Hemp Regulation Since the 2018 Farm Bill*, CANNABIS INDUS. J. (Oct. 22, 2020), https://cannabisindus tryjournal.com/feature_article/a-survey-of-state-cbd-hemp-regulation-since-the-2018-farm-bill.

96. U.S. PATENT & TRADEMARK OFFICE, EXAMINATION GUIDE 1-19 EXAMINATION OF MARKS FOR CANNABIS AND CANNABIS-RELATED GOODS AND SERVICES AFTER ENACTMENT OF THE 2018 FARM BILL, at 1 (2019).

differently.⁹⁷ Franchisors and franchisees should consider the unique risks of a CBD franchise before offering a CBD franchise system or purchasing a CBD franchise.

A. Quality Control and Unsubstantiated Claims

While studies have shown CBD to be effective for treatment of certain forms of seizures and may reduce anxiety, most other consumer claims about the benefits of CBD usage remain largely unsubstantiated by medical evidence or scientific clinical trials and are instead generally based on anecdotal evidence.⁹⁸ Pal Pacher, an investigator with the National Institutes of Health and president of the International Cannabinoid Research Society, believes that “consumers are participating in one of the largest uncontrolled clinical trials in history, and no one really knows what it is they’re taking.”⁹⁹ In fact, while the green industry attempts to persuade the public to believe that CBD is a “wonder drug” that is “perfectly safe and legal,” little is known about its side effects and contraindications with various medications.¹⁰⁰

Similarly, a lack of product knowledge by consumers frequently intersects with mislabeling of CBD products. For example, in 2019, a truck driver failed a drug test after using CBD oil labeled THC-free.¹⁰¹ The product actually contained “trace amounts” of THC, and the producer knew it.¹⁰² In another instance, a New Jersey Department of Corrections officer tested positive for THC after taking an oral supplement for degenerative arthritis and herniated discs, recommended by his doctor who believed his patient would not test positive on a drug test based on the information he received from the manufacturer’s “head doctors.”¹⁰³ Unbeknownst to the officer, the medicine contained 0.3% THC, a fact only disclosed on the manufacturer’s website, which the officer had not visited.¹⁰⁴

Unfortunately, unknowingly purchasing CBD products containing more THC than disclosed, or inaccurate amounts of CBD, is not a rare occurrence. According to a letter published in the *Journal of the American Medical Association* about its purchase and testing of eighty-four retail CBD products, twenty-one percent contained THC and twenty-six percent had a lower

97. Martha C. White, *CBD Products Are Flying off the Shelves—So Why Are Banks So Reluctant to Offer Financing?*, NBC (Oct. 17, 2019), <https://www.nbcnews.com/business/business-news/cbd-products-are-flying-shelves-so-why-are-banks-so-n1068151>.

98. Gabby Landsverk, *CBD Is a Cannabis Compound Used to Treat Everything from Pain to Anxiety. Here’s How to Use It Safely*, INSIDER (Sept. 1, 2020), <https://www.insider.com/what-is-cbd-and-what-is-safe-dose-2020-8>.

99. Freedman, *supra* note 7.

100. 1 CANNABIDIOL—SAFETY, DRUG TESTING, HEALTH AND WORK PERFORMANCE, DRUG TESTING L. TECH. & PRAC. § 1:18.80 (2020).

101. *Horn v. Medical Marijuana, Inc.*, 383 F. Supp. 3d 114, 129–30 (W.D.N.Y. 2019).

102. *Id.*

103. *In re Shorter*, No. A-3150-18T3, 2020 WL 2119299, at *1–3 (N.J. Super. Ct. App. Div. May 4, 2020); *see also* *Hamric v. City of Murfreesboro*, No. 3:18-CV-01239, 2020 WL 5424104 (M.D. Tenn. Sept. 10, 2020) (discussing instance where employee used CBD oral capsules and tested positive for THC on a drug test).

104. *In re Shorter*, 2020 WL 2119299, at *1–3.

amount of CBD than labeled.¹⁰⁵ Testing conducted by Goodbody Botanicals revealed that forty-five percent of manufactories tested “did not match the specification as detailed on their labels,” and one of the products tested only contained olive oil.¹⁰⁶ NBC New York tested three brands of CBD oils and four brands of CBD gummies, and discovered that less than half of the samples had correct labeling as it related to CBD.¹⁰⁷ It also found one product that contained no CBD, another with more pesticides than allowable in California, and yet another with more than four times the amount of legally permissible lead.¹⁰⁸ Thus, while the Final Hemp Rule may alleviate certain THC concentration issues by requiring that USDA-certified labs registered with the DEA test CBD content for THC amounts over 0.3%, the quality and accuracy of CBD products remain unpredictable.¹⁰⁹

While it is certainly possible to build a strong brand presence by providing quality products and ensuring rigorous testing standards and sourcing restrictions, because of the wide variance in quality for CBD products, franchisors and franchisees need to closely monitor sourcing for all products. Each franchise agreement should impose strict penalties, including possible termination, for any franchisee who sells unauthorized products. Similarly, a franchisor should strongly consider requiring franchisees to only purchase CBD products from franchisor-approved sources. At the current time, there are not enough USDA-certified labs to conduct all of the required testing. Thus, a franchisor must ensure that it properly researches any testing facility that it considers utilizing. Further, franchisors should be aware that many claims about CBD’s effectiveness are based on anecdotal evidence rather than scientific proof. Franchisors should be aware that in the event studies show a lack of effectiveness of CBD, their business may suffer.

B. Unclear and Conflicting State Laws

In addition to federal regulations, franchisors must also comply with state regulations related to the possession, sale, use, and marketing of hemp-derived CBD products. The prospective franchisor must be prepared to deal with a Gordian knot of contradictory regulations, requiring careful review and regular monitoring of each state’s laws. One cannot assume that a state’s approach to marijuana correlates to its approach to CBD regulation. For example, Mississippi allows the sale of any CBD products, including consumables, but imposes a specific and standard ratio of CBD to THC in all

105. CANNABIDIOL, *supra* note 100 (stating that “42.85 percent of products were under-labeled, 26.19 percent were over-labeled and only 30.95 percent were accurately labeled.”).

106. Serena Oppenheim, *CBD Oil: Meet Some of the Top Brands*, FORBES (Dec. 27, 2019), <https://www.forbes.com/sites/serenaoppenheim/2019/12/27/cbd-oil-meet-some-of-the-top-brand-s/#5c67785e7000>.

107. Dominique Astorino, *How to Buy the Best Safe and Effective CBD Products*, SHAPE (Feb. 21, 2019), <https://www.shape.com/lifestyle/mind-and-body/how-buy-best-safe-cbd-products>.

108. *Id.*

109. See Gene Daniels, *CBD Oil Quality Control—How to Pick the Right CBD Oil*, LEARNING CBD (Feb. 13, 2021), <https://learningcbdoil.com/blog/cbd-oil-quality-control>.

CBD products, and requires that all CBD products sold in the state be tested at the University of Mississippi's lab.¹¹⁰ Conversely, Hawaii allows the sale of consumable and topical marijuana products, but requires strict compliance with the federal approach to CBD consumables, including restrictions on usage in food, beverages, and dietary supplements.¹¹¹ At Waikiki Beach, one can legally sell marijuana gummies, but not CBD gummies.¹¹² North Carolina announced it would send warning letters to CBD businesses forbidding the use of CBD in food and drinks, including alcoholic beverages, but at the same time permitting CBD oil in other products.¹¹³ Maine and New York restrict sales of CBD by restaurants and other retailers.¹¹⁴ In Nebraska, two CBD retailers were charged with drug trafficking. The Nebraska Supreme Court ultimately dismissed the charges, holding that prosecutors had failed to demonstrate that the biomass in question contained THC and was a "controlled substance" but refused to rule on the legality of CBD products in the state.¹¹⁵

Twenty states prohibit the sale of food or beverages with CBD added.¹¹⁶ In Michigan, veterinarians can discuss the therapeutic benefits of CBD products for animals, but it is still illegal to sell CBD animal and pet feed products.¹¹⁷

States also regulate the packaging and labeling of CBD products.¹¹⁸ Franchisors should assume that all CBD products must have labels listing batch numbers and ingredients and should also be aware that states such as Florida, Indiana, Texas, and Utah require that CBD products have a scannable code with links to more detailed information about the product.¹¹⁹

Given the constant state of flux in the regulatory environment for CBD products, franchisors should design their systems and agreements with flexibility in mind and closely monitor state regulations in states where they have or plan to sell franchise outlets. Franchisees should expect that federal, state, and local regulations related to specific CBD products will change during the term of the franchise relationship and know that the franchisor

110. Schuman, *supra* note 95.

111. *Id.*

112. *Id.*

113. Whitt Steineker & Dexter Hobbs, Jr., *CBD Market Must Wait for Regulations to Ease in NC*, BRADLEY (Mar. 4, 2019), <https://www.bradley.com/insights/publications/2019/03/cbd-market-must-wait-for-regulations-to-ease-in-nc>.

114. *Investing in a CBD Business: Five Regulatory Concerns*, MCGUIRE WOODS (June 17, 2019), <https://www.mcguirewoods.com/client-resources/Alerts/2019/6/investing-in-a-cbd-business-five-regulatory-concerns>.

115. Theresa Bennett, *Nebraska Lawsuit Against CBD Retailers Highlights Ongoing Confusion Among Industry*, HEMP GROWER (Oct. 1, 2020), <https://www.hempgrower.com/article/nebraska-supreme-court-case-cbd-djs-vapes>.

116. Schuman, *supra* note 95.

117. Theresa Bennett, *New Michigan Law Allows Veterinarians to Discuss Marijuana and CBD with Pet Owners*, HEMP GROWER (Jan. 8, 2021), <https://www.hempgrower.com/article/new-michigan-law-veterinarians-cbd-marijuana-for-pets/>.

118. Schuman, *supra* note 95.

119. *Id.*

may be unaware of and unprepared to address those changes. Both franchisees and franchisors should consider joining or requiring franchisees to join local CBD industry groups that provide information related to regulations and opportunities for CBD businesses to advocate to lawmakers. Franchisors typically require that all franchisees must know and comply with all relevant laws. Franchisors should consider what steps they are willing to take to keep franchisees abreast of the changing landscape and perhaps consider a more active hand than is usually taken in advising franchisees on how to comply with the law.

C. Transportation and Interstate Commerce Concerns

The transport of hemp and hemp products produced in accordance with the 2018 Farm Bill is expressly permitted in interstate commerce,¹²⁰ but at least one state has seized hemp transported within its borders.¹²¹ The possible seizure of hemp products in transportation between states poses problems to two large goals of franchising: consistency and supply.¹²²

In *Big Sky Scientific LLC v. Idaho State Police*, the State of Oregon confiscated a shipment of industrial hemp being transported from Oregon to Colorado, two states where hemp is legal, under the theory that hemp with THC is illegal in Idaho.¹²³ The owner of the hemp opposed the confiscation, arguing that hemp was “not a controlled substance under federal law” and that Idaho could not “interfere with the interstate transportation of industrial hemp because of protections under federal law for interstate commerce.”¹²⁴ The federal trial court disagreed, finding that the hemp could be confiscated and that the owner could be prosecuted for the transportation of hemp under state law.¹²⁵ However, in *United States v. Mallory*, the defendants grew hemp in West Virginia with seeds purchased from Kentucky.¹²⁶ The United States argued that, by transporting hemp seeds from Kentucky to West Virginia, the defendants violated the CSA and would again violate the CSA by transporting hemp product to Pennsylvania for processing.¹²⁷ The district court

120. Sheehan & Roy, *supra* note 3, at 17. A further requirement for CBD to be lawfully sold is that the USDA must approve the hemp producer’s state regulatory and licensing structure. If a state does not have a hemp program approved by the USDA, the USDA will “construct a regulatory program under which hemp cultivators in those states must apply for licenses and comply with a federally-run program.” *Id.*

121. *Big Sky Sci. LLC v. Idaho State Police*, No. 1:19-CV-00040-REB, 2019 WL 2613882 (D. Idaho Feb. 19, 2019), *rev’d on other grounds*, 776 F. App’x 415 (9th Cir. 2019).

122. Mike Drumm & Caroline Bundy Fichter, *Franchising Under the Radar in the USA and Canada: How to Ensure Your Client’s Franchise Dreams Don’t Go “Up in Smoke,”* ABA 42ND ANN. FORUM ON FRANCHISING W-19, at 29 (2019).

123. *Big Sky Sci.*, 2019 WL 2613882, at *1.

124. *Id.*

125. Sam Kamin, *Marijuana Law Reform in 2020 and Beyond: Where We Are and Where We’re Going*, 43 SEATTLE U. L. REV. 883, 898 (2020).

126. *United States v. Mallory*, 372 F. Supp. 3d 377, 379 (S.D. W. Va. 2019).

127. *Id.* at 379.

disagreed, finding that, so long as the defendants were operating under a state license program, they were not in violation of the CSA.¹²⁸

Currently, the shipment of CBD products is generally allowed through United States Postal Service (USPS) and the private courier services UPS so long as the shipper complies with “all applicable laws and regulations,” including state and federal law.¹²⁹ Shippers using the USPS are also specifically required to hold a state license permitting the shipper to produce industrial hemp.¹³⁰ If the shipper also sells marijuana or marijuana products, the shipper must be mindful about choosing the appropriate carrier.¹³¹ CBD shipment is prohibited through FedEx.¹³²

D. FDD Disclosures

As detailed below, a CBD franchisor must carefully draft an FDD that accurately and thoroughly describes the franchise investment opportunity. Because CBD businesses are part of an emerging industry and each state regulates CBD products differently, franchisees will be subject to vastly different regulations and restrictions depending on the state in which they are located, which must be detailed in Item 1.¹³³ These regulations and restrictions could affect the franchisee’s initial investment total, which is estimated in Item 7.¹³⁴ Further regulations and restrictions may affect the franchisee’s ability to sell certain products, and its sourcing and marketing decisions, operations, and licensing, may lead to challenges in providing an Item 19 disclosure.¹³⁵ Thus, each type of regulation could dramatically affect the franchisee’s bottom-line and decision to invest. The FTC created the Franchise Rule on the theory that “an informed investor can best determine whether a particular deal is in their best interest.”¹³⁶ When the “particular deal” is an investment in a CBD

128. *Id.* at 385–86. Notably, the court found that the “relevant section of 2014 Farm Bill begins with the phrase ‘[n]otwithstanding the Controlled Substances Act . . . or any other Federal law, industrial hemp can be grown and cultivated in a State under certain conditions . . . its use of the term ‘notwithstanding’ indicated Congress intended to override any conflicting provision of the CSA.” *Id.*

129. *Shipping Hemp Products*, UPS, <https://www.ups.com/us/en/help-center/packaging-and-supplies/special-care-shipments/hemp.page> (last visited Oct. 8, 2020); *453 Controlled Substances and Drugs*, USPS, https://pe.usps.com/text/pub52/pub52c4_019.htm (last visited Oct. 8, 2020). USPS allows shipment of CBD products, but the shipper must comply with “all applicable laws and regulations,” specifically including the requirement that CBD contain less than 0.3% THC and may require further documentation at the time of shipment or at a “later date.” *Id.* Such documentation includes “laboratory test results, licenses or compliance reports,” which must be producible for at least two years from the shipping date. *Id.*

130. *Publication 52 Revision: New Mailability Policy for Cannabis and Hemp-Related Products*, USPS, https://about.usps.com/postal-bulletin/2019/pb22521/html/updt_002.htm (last visited Feb. 27, 2021).

131. *Shipping Hemp Products*, *supra* note 129. UPS will not ship hemp products that is in violation of state law or “from any location that sells Marijuana or Marijuana products.” *Id.*

132. *Prohibited Items for Shipment*, FedEx, <https://www.fedex.com/en-dm/shipping/prohibit-ed-items.html> (last visited Feb. 27, 2021).

133. FTC Rule on Franchising, 16 C.F.R. § 436.5(a)(1).

134. *Id.* § 436.5(g).

135. *Id.* § 436.5(s).

136. Statement of Basis and Purpose, 72 Fed. Reg. 15445 (Mar. 30, 2007).

franchise, franchisors should consider the effect of state regulations on the franchisee's ability to operate a unit including their effect on sales or profitability, and disclose that information accurately.

1. Item 1

Franchisors are required to disclose laws and regulations specific to the franchised business in Item 1 of the FDD.¹³⁷ While general business laws need not be disclosed, those laws related specifically to the CBD franchise must be disclosed. The FTC determined that such disclosures are necessary because “regulations . . . affect the franchisee’s operating costs and ability to conduct business.”¹³⁸ Thus, in *FTC v. Car Checker of America*, a federal district court concluded that the franchisor likely violated the Franchise Rule when it failed to disclose that “many state laws barred [franchisees] from selling automotive service contracts or require such individuals to obtain an insurance license before they can sell automobile service contracts.”¹³⁹ Similarly, in *United States v. Lifecall Systems*, the parties entered into a consent decree where they agreed that the franchisor had violated the Franchise Rule by failing to disclose state registration requirements to prospective franchisees.¹⁴⁰

As discussed in Section IV(b), CBD law varies significantly by state and may change with relative frequency in any given state. CBD franchisors must ensure that they remain versed in state and federal CBD laws to avoid inaccurate disclosures. Inaccurate disclosure could result in an action by the FTC or state examiners.¹⁴¹ Further, many state franchise statutes and some state common laws generally permit a franchisee to bring an action against its franchisor for damages or rescission.¹⁴² In several states, franchisees may sue franchisors for omitting a material fact during the sales process. As it relates to CBD franchising, franchise attorneys may disagree as to how specific Item 1 disclosures need to be. For example, is it sufficient for a franchisor to limit its Item 1 disclosure to broadly state that the franchisee will be operating a business in a highly regulated industry? Or should Item 1 also state that many states, counties, and cities regulate the sale of CBD products and that franchisees should investigate regulations that may affect their franchised locations? Or should Item 1 explain specific state and federal regulations, which may include, but are not limited to, laws relating

137. See Compliance Guide, *supra* note 87 at 31 (stating “[t]he disclosure should simply state that a specific type of regulation exists and that prospective franchisees should investigate the matter further”).

138. 72 Fed. Reg. at 15474.

139. *FTC v. Car Checker of Am.*, Civ. A. No. 93-623, 1993 WL 56815, at *3 (D.N.J. Feb. 8, 1993).

140. *United States v. Lifecall Sys.*, No. 1:90-CV-03666, Doc. No. 3 (D.N.J. Sept. 14, 1990).

141. Martin Cordell & Beata Krakus, *We Broke the Law! Now What?*, IFA 50TH ANN. LEGAL SYMPOSIUM at 9–13 (May 7–9, 2017). Remedies available to state examiners include stop orders / cease and desist, injunctive relief, fines, investigative costs, rescission and restitution and criminal penalties. *Id.*

142. *Id.*

to CBD testing and laboratory requirements, state licensing, usage, labeling, and content requirements and specifications? If a franchisor chooses to detail state and federal regulations in its disclosure, it should closely track CBD regulations in states where they intend to sell franchises and confirm that applicable regulations are thoroughly and accurately disclosed before offering a franchise.¹⁴³

2. Item 7 Disclosures

In Item 7, franchisors must provide an estimated initial investment and list “each type of expense beginning with pre-operating expenses” and including “business licenses.”¹⁴⁴ Item 7 is not intended to “capture all the expenses made over the life of the franchise,” and franchisors can give a range of estimates.¹⁴⁵ If states require additional licenses to operate a CBD business, those costs should be listed in Item 7.

3. Item 19 Disclosures

Because CBD is subject to fluctuating local regulations, the financial performance of CBD franchises may vary widely depending on location. Item 19’s financial performance representation is an optional FDD disclosure item that attempts to inform a potential franchisee of the amount of money that it can make by franchising with that system.¹⁴⁶ Any Item 19 disclosure must provide accurate data upon which “a prudent businessperson” could rely when deciding whether he should invest in the franchise system.¹⁴⁷ Item 19 may reflect a subset of units, including a geographic subset.¹⁴⁸ If it reflects a subset of units, the franchisor must disclose characteristics of the subset and the number of outlets that had the described characteristics.¹⁴⁹

As discussed in Section (IV)(d)(i), any given CBD product may be permissible in one state, but not another. Such state laws barring certain CBD products could result in myriad different products throughout the system, thus resulting in inconsistencies among franchised locations. Due to the potential lack of consistency of products for sale, it may be hard to accurately provide a financial performance representation that is not misleading.¹⁵⁰ If franchising in multiple states, CBD franchisors may consider omitting Item 19 altogether, or providing a geographic subset by state or similar regulatory

143. See generally Drumm & Fichter, *supra* note 123.

144. 16 C.F.R. § 436.5(g)(1)(i).

145. *Id.*

146. Statement of Basis and Purpose, 43 Fed. Reg. 59685 (Dec. 21, 1978).

147. *NASAA Franchise Commentary Financial Performance Representations*, NASAA (May 8, 2017), <https://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf> [hereinafter *NASAA Commentary*].

148. 16 C.F.R. § 436.5(s)(3).

149. *Id.* § 436.5(s)(3)(ii)(a).

150. Julie Bennett, *Right Way, Wrong Way to Present Item 19*, *FRANCHISE TIMES* (Aug. 28, 2015), https://www.franchisetimes.com/article_archive/right-way-wrong-way-to-present-item-19/article_bae56717-d273-5463-ab7b-531740b1a715.html.

restrictions, which would allow franchisees to more accurately predict how a franchised CBD location could perform in that state.¹⁵¹

E. Trademarks

A trademark is a source identifier for the owner's goods, products, and/or services.¹⁵² Applying for and ultimately registering a trademark federally is especially valuable to CBD franchise systems, in part due to the industry's rapid expansion and competitive nature, in which a registered trademark serves as a source identifier and creates or enhances customer loyalty.¹⁵³ Further, registration of a federal trademark on the Principal Register provides a presumption of validity and ownership in any trademark dispute.¹⁵⁴

Besides needing to comply with federal regulations governing the growth of hemp, which requires a license from the USDA,¹⁵⁵ for a trademark to be valid and registered, the mark must be used in commerce.¹⁵⁶ For trademark registration purposes, such use in commerce must be lawful under federal law.¹⁵⁷ Therefore, hemp-derived products containing less than 0.3% THC are the only cannabis-derived products eligible for federal trademark registration and protection.¹⁵⁸ Consequently, applicants for CBD-related product trademarks must narrowly tailor the applications and must specify that such hemp-derived products contain less than 0.3% THC.¹⁵⁹ If "HEMP," "CBD," or "another variation of the terms cannabis or cannabidiol (e.g., 'CANNNA') is included in the trademark, the applicant will likely receive an official action on the legality of the product under federal law.¹⁶⁰ Applicants cannot apply for "beverages, dietary supplements, or pet treats," if formulated with CBD, as such products cannot lawfully enter commerce, and the United States Trademark and Patent Office (USPTO) follows FDA guidelines on this matter.¹⁶¹ For example, even though a Denver company's

151. NASAA Commentary, *supra* note 147. Item 19 permits franchisors to use a geographic subset so long as the subset is not misleading and the franchisor can describe why that subset was chosen.

152. Trademark Act of 1946 (Lanham Act), 15 U.S.C. § 1127.

153. Erik Pelton & Jeffrey Walsh, *Cannabis Trademarks 101*, VINCENTE SEDERBERG LLP (Nov. 13, 2020), <https://vicensederberg.com/insights/cannabis-trademarks-101>.

154. *What Is a Trademark?*, USPTO, <https://www.uspto.gov/about-trademarks#:~:text=When%20a%20plaintiff%20owns%20a,services%20listed%20in%20the%20registration.>

155. *Id.*

156. 15 U.S.C. § 1127.

157. EXAMINATION GUIDE 1-19: EXAMINATION OF MARKS FOR CANNABIS AND CANNABIS-RELATED GOODS AND SERVICES AFTER ENACTMENT OF THE 2018 FARM BILL, USPTO (2019), [hereinafter Examination Guide].

158. *See id.*

159. If an application does not specify that the CBD product contains less than 0.3% THC, an office action will likely be issued by the USPTO examiner. Lisa W. Rosaya & Lindsey E. Utrata, *What You Need to Know About CBD and Trademarks in the US*, BAKER MCKENZIE (Sept. 9, 2019), <https://www.bakermckenzie.com/en/insight/publications/2019/09/what-need-know-cbd-trademarks-us>.

160. *Id.*

161. Examination Guide, *supra* note 157; Nathalie Bougenies, *Can CBD Companies Secure Federal Trademark Protection*, ABOVE THE LAW (May 19, 2020), <https://abovethelaw.com/2020/05/can-cbd-companies-secure-federal-trademark-protection>.

product contained less than 0.3% THC, the USPTO refused the registration of the product because the hemp oil extract was sold as a dietary and nutritional supplement.¹⁶² But cosmetics containing CBD may be lawful and therefore registerable if “not adulterated, mislabeled, or intended to affect the structure or function of the body, or to diagnose, cure, mitigate, treat, or prevent disease (*i.e.*, intended as a drug).”¹⁶³

If a franchisor sells some cannabis goods that are legal under the CSA, and others that are not, the franchisor may apply for a federal trademark only for those products that do not violate federal law.¹⁶⁴ For those products that are not federally lawful, the franchisor may seek a state trademark, if permissible in accordance with state law, which could provide protection within that particular state. For example, if all other provisions are met, if a franchisor sells lip balm with less than 0.3% THC, and a bath bomb with more than 0.3% THC, the franchisor could federally register a trademark only for the lip balm.

Complex federal regulations specific to the cannabis industry makes brand protection for a CBD franchise more complicated than traditional, less-regulated franchises. When applying for a federal trademark, franchisors should ensure federal and state compliance with CBD regulations. Otherwise, a CBD franchisor’s trademarks may be federally unprotectable. Franchisors would be well served to work with a trademark attorney who has experience handling cannabis-related trademarks.

F. Banking Issues

Although hemp-derived CBD products are legal at the federal level,¹⁶⁵ many financial institutions have not recognized the distinction between legal CBD products and federally illegal THC products, and such institutions have been reluctant to offer loans or other banking services to CBD businesses.¹⁶⁶ Additionally, because the 2018 Farm Bill did not obligate state or tribal regulatory agencies to remove prohibitions or legal limitations on the sale of hemp or hemp-derivative products, their continued illegality has caused financial institutions to avoid the industry. Additionally, some CBD business owners have reported that banks still negatively associate CBD use with marijuana.¹⁶⁷ Lack of clarity regarding the parameters of providing legal banking services to CBD business and regarding whether banks would need

162. *In re Stanley Bros. Social Enters. LLC*, 2020 WL 3288093 (T.T.A.B. 2020).

163. FDA REGULATION OF CANNABIS AND CANNABIS-DERIVED PRODUCTS, INCLUDING CANNABIDIOL (CBD), USDA (2021); *see also* EXAMINATION GUIDE, *supra* note 157.

164. Bougenies, *supra* note 161.

165. Agricultural Improvement Act of 2018, Pub. L. No. 115-334, § 12619.

166. David Koch, Dawn Newton & Frank Robinson, *The Distribution of Legal Cannabis: Impact and Opportunities for Franchising*, IFA 52TH ANN. LEGAL SYMPOSIUM at 29 (May 5–7, 2019).

167. White, *supra* note 97.

to implement additional oversight or regulatory requirements have contributed to their reluctance to embrace the industry.¹⁶⁸

At the national level, a bipartisan group of congresspeople have pushed federal regulators to develop guidance for banks and other financial institutions serving CBD businesses. In a letter sent to Jerome Powell, the Chairman of the Board of Governors of the Federal Reserve, the authors, including Rodney Hood, the chairman of the National Credit Union Administration, Jelena Williams, the chairman of the Federal Deposit Insurance Corporation, and Colorado Senator Michael Bennet, urged federal regulators to “work both expeditiously and in a coordinated manner to issue guidance describing how financial institutions can offer financial products and services to hemp producers and processors.”¹⁶⁹

In August 2019, the National Credit Administration published its official guidance to credit unions regarding servicing hemp-based businesses.¹⁷⁰ Although it noted that “hemp provides new opportunities for communities,” the letter went on to encourage credit unions to “thoughtfully consider whether they are able to safely and properly serve lawfully operating hemp-related business” and strongly implied that hemp-related businesses are more likely to be involved in criminal activity.¹⁷¹ The guidance noted that servicing a hemp-related business could be more complex and risky than servicing other businesses and identified three factors credit unions should consider before accepting a hemp-based business.¹⁷² First, credit unions should be “alert to any indication that the account owner is involved in illicit activity,” maintain appropriate due diligence procedures for hemp-related accounts, and promptly file suspicious activity reports for any activities that appear to involve money laundering or other illegal or suspicious activities.¹⁷³ Second, the guidance encouraged credit unions to verify the customer’s compliance with state laws by using enhanced due diligence and reporting approaches.¹⁷⁴ Third, the guidance stressed that credit unions need to be familiar with state or federal law that restricts, regulates, or governs a CBD’s business activities.¹⁷⁵

In December 2019, the Board of Governors of the Federal Reserve System also issued a guidance letter to banks.¹⁷⁶ The Guidance Letter explained

168. James J. Black & Marc-Alain Galeazzi, *Cannabis Banking: Proceed with Caution*, BUS. L. TODAY (Feb. 6, 2020), https://www.americanbar.org/groups/business_law/publications/blt/2020/02/cannabis-banking.

169. Letter from Senator Michael Bennet to Financial Regulators (June 13, 2019), https://www.bennet.senate.gov/public/_cache/files/a/a/aab80ecd-b522-4905-a145-43d442739b6d/E4D04D85DAD8BA068C200064C88B697D.letter-to-financial-regulators.pdf.

170. NAT’L CREDIT UNION ADMIN., 19-RA-02 SERVING HEMP BUSINESSES (2019), <https://www.ncua.gov/regulation-supervision/letters-credit-unions-other-guidance/serving-hemp-businesses>.

171. *Id.*

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

176. SR 19-14: Statement on Providing Financial Services to Customers Engaged in Hemp-Related Businesses, Board of Governors of the Federal Reserve System (2019).

that “it is generally a bank’s business decision as to the types of permissible services to offer” and noted that the “2018 Farm Bill explicitly preserved the authority of the U.S. Food and Drug Administration to regulate hemp products under the FD&C Act.”¹⁷⁷ The FDA regulates health and wellness claims such as the claims commonly made by many CBD businesses regarding their products.¹⁷⁸ Accordingly, banks may be hesitant to offer services to CBD businesses because of the risk that such businesses violate FDA regulations.

Legislative activities have continued in this area. The U.S. House of Representatives passed the Secure and Fair Enforcement of Banking Act (SAFE Banking Act) on September 25, 2019.¹⁷⁹ The bill provides a safe harbor for financial institutions that work with cannabis business clients including CBD businesses. The bill had bipartisan support and passed in a 321-103 House vote.¹⁸⁰ After the Senate failed to take up the bill, the House of Representatives included some language from the SAFE Banking Act in the Health and Economic Recovery Omnibus Emergency Solutions (“HEROES”) Act.¹⁸¹ Senate Republicans declared the SAFE Act “dead on arrival,” and it has not received a vote.¹⁸²

In the absence of safe harbor legislation and clear guidance from regulatory agencies, CBD franchisors and franchisees will continue to struggle to secure funding and gain access to banking services.¹⁸³ While CBD franchisors may be able to access capital through venture capital and private equity firms,¹⁸⁴ franchisees may find it more difficult to access traditional funding sources. Although the Small Business Administration (SBA) has clarified that businesses that sell hemp or hemp-derived products under the 2018 Farm Bill are eligible for SBA loans and COVID-19 relief programs, such as the Paycheck Protection and Economic Injury Disaster Loans, CBD business may struggle to find banks willing to work with them.¹⁸⁵ A handful of banks market themselves as being hemp-friendly, and, as of publication, there are at least two financial service companies that assist CBD companies in locating

177. *Id.*

178. Federal Food, Drug, and Cosmetic Act, 21 U.S.C. 321(p).

179. SAFE Banking Act, H.R. 1595, 116th Cong. (2019).

180. *Id.*

181. HEROES Act, H.R. 6800, 116th Cong. (2020); *see also*, Eric Sandy, *U.S. House Passes SAFE Banking Act as Part of New Coronavirus Relief Bill: UPDATE*, CANNABIS BUS. TIMES (May 18, 2020), <https://www.cannabisbusinesstimes.com/article/us-house-adds-safe-banking-act-coronavirus-relief-bill>.

182. Sarah Hansen, *McConnell Vows the Next Stimulus Bill Will Be the Last One*, FORBES (May 29, 2020), <https://www.forbes.com/sites/sarahhansen/2020/05/29/mcconnell-vows-the-next-stimulus-bill-will-be-the-last-one/?sh=396862502e0b>.

183. *Id.*

184. Patrick Williams, *Intrinsic Capital Partners Raises \$102M for Cannabis and Hemp-Related Investment*, HEMP GROWER (Oct. 23, 2020), <https://www.hempgrower.com/article/intrinsic-capital-partners-raises-102m-cannabis-hemp-ancillary-businesses>.

185. Eric Sandy, *Hemp Growers Will Need to Educate Lenders When Seeking Small Business Loans*, HEMP GROWER (Apr. 7, 2020), <https://www.hempgrower.com/article/hemp-industry-small-business-loan-educate-lenders>.

hemp-friendly banks and obtaining compliant services.¹⁸⁶ Generally, a CBD franchisor or franchisee is more likely to be successful locating a bank if they are operating in a state with a well-developed hemp program and CBD guidance from state banking regulators.¹⁸⁷

Banking difficulties pose unique challenges for the CBD franchisor and franchisee. Franchisees need access to banks for lending, financial services, and merchant processing. An unbanked franchisee can create headaches for the franchisor because the franchisees will not be able to collect fees through automatic fund transfers, and franchisees operating a cash-only business may be tempted to under-report sales, employees, or taxes. In addition, operating as a cash-only business creates a significant security risk to the franchise itself and its employees and owners. CBD stores are frequently robbed, either for cash or CBD (because the thieves mistakenly believe the product contains significant amounts of THC).¹⁸⁸ A franchisor should consider designating a bank or financial services company as an approved or required supplier for banking services to ensure that franchisees will have uninterrupted access to banking services.

G. Access to Courts and Arbitration

Parties considering a CBD franchise should also be aware that CBD franchises may not have access to the court system for the resolution of disputes or bankruptcy. Generally, a court will not enforce a contract if doing so would require a party to engage in illegal conduct.¹⁸⁹ The extent to which an illegal contract is enforceable depends on whether the legal terms are severable from the remaining terms.¹⁹⁰ Courts have reached conflicting results when determining whether illegality applies to a contract for a CBD business.

In *Earth Science Tech, Inc. v. Impact UA, Inc.*, the plaintiff, a CBD distributor, signed a distribution agreement to resell the defendant's CBD oil.¹⁹¹ Earth Science cancelled the agreement and alleged that the defendant had not provided pure CBD oil as required by the agreement.¹⁹² The defendant denied the allegations and accused Earth Science of breaching the contract

186. Elena Schmidt, *Banking Options for US-Based Cannabis & Hemp Companies*, ACS LABORATORY (Aug. 28, 2020), <https://acslabcannabis.com/blog/education/banking-options-for-us-based-cannabis-hemp-companies/#so>.

187. *Id.*

188. *Thieves Hit 2 Chicago CBD shops Also Robbed Days Earlier; Take Thousands Worth of Product*, ABC 7 CHICAGO, (Mar. 5, 2022), <https://abc7chicago.com/weed-dispensary-pot-shop-robbery-chicago/11622572>; Karen Kucher, *Armed Robber Makes off with \$1.3 Million Worth of Hemp in Oceanside*, SAN DIEGO UNION TRIB. (Nov. 11, 2021), <https://www.sandiegouniontribune.com/news/public-safety/story/2021-11-11/armed-robber-makes-off-with-1-3-million-worth-of-hemp-in-oceanside>.

189. *Kaiser Steel Corp v. Mullins*, 455 U.S. 72 (1982).

190. *Montara Owners Ass'n v. La Noue Dev., LLC*, 353 P.3d 563, 568 (Or. 2015) (stating "when an agreement is partly legal and partly illegal, if the legal may be separated from the illegal, the legal part will be enforced").

191. *Earth Sci. Tech, Inc. v. Impact UA, Inc.*, 809 F. App'x 600 (11th Cir. Apr. 14, 2020).

192. *Id.* at 602.

by failing to pay for the shipments.¹⁹³ The parties submitted the case to arbitration, and the arbitrator entered a judgment in favor of defendants for \$3.9 million.¹⁹⁴ Earth Science moved to vacate the award, arguing that confirming the final award would be inconsistent with federal law because the agreement was signed before the 2018 Farm Bill.¹⁹⁵ Both the district court and the appellate court disagreed and confirmed the award.¹⁹⁶ Specifically, the appellate court noted that Earth Science claimed on its website that its products “were derived from ‘federally legal industrial hemp plant’ and that ‘CBD Rich Hemp Oil is legal everywhere in the USA.’”¹⁹⁷ The appellate court observed that presumably “Earth Science [would not] flagrantly conduct its operations and advertise them as legal if it believed that distribution was illegal.”¹⁹⁸ Second, the appellate court concluded that, even if the distribution agreement was illegal when it was signed, the 2018 Farm Bill legalized CBD and mooted the illegality argument.¹⁹⁹ The court noted that enforcing the distribution agreement in 2020 would not require a party to engage in illegal conduct.²⁰⁰

However, in *In re UC Colorado Corp.*, a Colorado bankruptcy court concluded that a company operating facilities that extracted and converted CBD extracts from hemp could not seek bankruptcy protection because it was “engaged in the marijuana industry.”²⁰¹ Within two days of the corporation filing for bankruptcy protection, the court issued a *sua sponte* order to show cause why the cases should not be dismissed due to the debtor’s involvement in the cannabis industry.²⁰² Several months later, the court appointed an examiner to determine whether the debtor was engaged in an illegal business. The examiner concluded that the debtor had been involved in “illegal cannabis business in the past” by providing consulting services to recreational and medical marijuana business in states that had legalized marijuana and in Canada and that such services constituted a small fraction of the debtor’s current operations.²⁰³ The examiner also concluded that the debtor was currently engaged in an illegal enterprise because its current assets were derived or comingled with assets derived from illegal activities, the debtor had allowed third parties to sell illegal marijuana products branded with the debtor’s intellectual property, and the debtor’s securities filing indicated that

193. *Id.* at 603.

194. *Id.* at 604.

195. *Id.*

196. *Id.* at 608.

197. *Id.* at 609.

198. *Id.*

199. *Id.*

200. *Id.*

201. Order to Show Cause, *In re UC Colorado Corp.*, No. 1:20 BK-12689 (Bankr. D. Colo. Apr. 22, 2020), ECF No. 17.

202. *Id.*

203. Examiner’s Report at 24, *In re UC Colo. Corp.*, No. 1:20 BK-12689 (Bankr. D. Colo. Nov. 12, 2020), ECF No. 212.

increased marijuana enforcement could impact their business.²⁰⁴ Based on these findings, the examiner concluded that, “while the debtor is not actively conspiring with others to violate the CSA,” it was “aiding and abetting the cannabis industry in violation of the CSA” and was not entitled to bankruptcy protection.²⁰⁵ The creditors moved for dismissal based on the examiner’s report, on grounds that the debtor was mismanaging assets and there was no reasonable likelihood of reorganization. The court dismissed the bankruptcy on January 12, 2021, but did not state the grounds for dismissal.²⁰⁶

In addition to lawsuits related to contract enforcement and bankruptcy, a party considering a CBD business should consider the risk of consumer lawsuits based on false or misleading claims on CBD products. In 2020, consumers filed twenty class-action lawsuits in California, Florida, Illinois, and Massachusetts,²⁰⁷ alleging that they purchased CBD products based on false claims regarding the amount of CBD²⁰⁸ or THC in the product or the therapeutic benefits of the product.²⁰⁹ Several courts have stayed these cases on the basis of primary jurisdiction doctrine, which allows a court to stay a case “pending the resolution of an issue within the special competence of an administrative agency”²¹⁰ because “the initial decision making responsibility should be performed by the relevant agency rather than the courts.”²¹¹ Courts most commonly apply the doctrine in cases where “the claim required the resolution of . . . a particularly complicated issue that Congress has committed to a regulatory agency.”²¹² In one case, the court have found that the application of the doctrine is appropriate because (1) the 2018 Farm Bill “explicitly recognized the FDA’s authority to regulate” products containing hemp-derived CBD;²¹³ (2) the FDA is actively involved in developing regulations for ingestible CBD;²¹⁴ and (3) the exercise of regulatory authority over CBD labeling requires agency expertise and uniformity of standards.²¹⁵ While the stays of consumer litigation may offer CBD

204. *Id.*

205. *Id.*

206. *Id.*

207. David J. Apfel, *CBD You in Court: Consumer Class Actions Involving Hemp-Derived CBD Products*, CANNABIS INDUS. J. (Aug. 18, 2020), https://cannabisindustryjournal.com/feature_article/cbd-you-in-court-consumer-class-actions-involving-hemp-derived-cbd-products.

208. *See, e.g.*, Glass v. Global Widget, LLC, No. 2:19-cv-01906, 2020 WL 3174688 (E.D. Cal. June 15, 2020).

209. *See, e.g.*, Complaint, Benson v. Charlotte’s Web Holdings, 1:20 cv-0418 (N.D. Ill. Jan 17, 2020), ECF No. 1.

210. Clark v. Time Warner Cable, 523 F.3d 1110, 1114 (9th Cir. 2008).

211. GCB Comm’ns, Inc. v. U.S. S. Comm’s, Inc., 650 F.3d 1257, 1263–64 (9th Cir. 2011).

212. *Id.*

213. Snyder v. Green Roads of Florida, LLC, 430 F. Supp. 3d 1297, 1308 (S.D. Fla. Jan. 3, 2020).

214. Colette v. CV Scis., Inc., 2:19-cv-10227, 2020 WL 27339861, at *5 (C.D. Cal. May 22, 2020).

215. *Snyder*, 430 F. Supp. 3d at 1307–08.

franchisors and franchisees some comfort, some courts have speculated that the FDA rules and regulations on CBD may be applied retroactively.²¹⁶

VI. Conclusion

The CBD industry has enormous potential for franchisees and franchisors. However, because of the unique and rapidly changing regulatory landscape, franchisors may not simply utilize a generic franchise model to develop a CBD-based system. They must develop a franchise system with enough flexibility to adapt quickly to new regulations at the federal, state, and municipal level. A pizza franchisor may safely assume that pepperoni and cheese will be legal and available for the duration of a franchise agreement, but a CBD franchisor or franchisee does not have such stability. Regulators may conclude that key products or ingredients are illegal or impose onerous restrictions on how they can be marketed. Franchise agreements, therefore, must include not only the flexibility necessary to allow the parties to adapt to new laws and regulations but also the oversight to ensure that the parties are complying with them.

²¹⁶ Glass v. Global Widget, LLC, No. 2:19-cv-01906, 2020 WL 3174688, at *4 (E.D. Cal. June 15, 2020).

LADR Case Notes (September–November 2021) and FLJ Currents (Spring 2022)

Maisa Frank, David Harford & Sawan S. Patel

The following case summaries were originally distributed by the ABA Forum on Franchising’s Litigation and Dispute Resolution Division on ABA Connect between September and November 2021. The case summaries are republished here, with minor stylistic updates to match the *Journal’s* standard style practices, so that members of the Forum have a convenient and consistent way of locating past case notes. The case notes are distributed without personal attribution, so no personal attribution is given here.



Ms. Frank



Mr. Harford



Mr. Patel

SEPTEMBER 2021 LADR NOTE

Adventure Park Franchisee Ass’n (APFA), Inc. v. UATP Mgmt., LLC, 537 F. Supp. 3d 897 (N.D. Tex. 2021).

A recent decision from the U.S. District Court for the Northern District of Texas demonstrates just how difficult it is for franchisee associations to establish associational standing under the so-called “*Hunt*-test.” *Adventure Park Franchisee Ass’n (APFA), Inc. v. UATP Mgmt., LLC*, 537 F. Supp. 3d 897 (N.D. Tex. 2021). In *APFA*, the district court declined to find *Hunt* associational standing for franchisee associations seeking declaratory relief on behalf of their members’ claims of tortious conduct and breach of contract by the franchisor. On those grounds, the district court granted UATP’s motion to dismiss.

APFA alleged that UATP’s conduct, in the aggregate, (a) breached an implied covenant of good faith and fair dealing, (b) breached over fifty franchisees’ rights under UATP’s form Franchise Agreement (FA), (c) violated the Texas Deceptive Trade Practices

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Consumer Protection Act (TDTPCA) and the New Jersey Franchise Practices Act (NJFPA), and (d) engaged in common-law fraud. AFPA specifically alleged that, beginning in April 2019, UATP wrongfully withheld revenues from a new Membership Program until the franchisees agreed to change terms regarding the payment and distribution structure of said Membership Program. Some franchisees signed these new terms. Implemented concurrently with this new Membership Program was a new local marketing program. This program required mandatory use of a particular vendor in a manner that allegedly violated expenditure caps and markup prohibitions contained in the FA (i.e., making money from markups with vendors and suppliers).

Additionally, UATP imposed the use of mandatory vendors upon the franchisees respecting the purchase of socks, construction services, and insurance. APFA further alleged that UATP received rebates from the required socks and construction at the same time that it provided financing to franchisees who could not afford the marked-up prices—which were allegedly marked-up due to the rebates paid by the vendors to UATP. Similarly, APFA alleged that the alleged mandatory insurance broker overcharged and underdelivered. To be clear, UATP represented to the franchisees that they were free to shop elsewhere for better deals on insurance.

APFA, on behalf of over fifty of its franchisee-members, sued UATP. Even where the association itself is not injured, an association may have standing as the representative of its members sufficient to confer jurisdiction. *Ass'n of Am. Physicians & Surgeons, Inc. v. Tex. Med. Bd.*, 627 F.3d 547, 550 (5th Cir. 2010). In such a case, the association must show that “[1] its member[s] would otherwise have standing to sue in their own right; [2] the interests it seeks to protect are germane to the organization’s purpose; and [3] neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit.” *AFPA*, 2021 WL 1814695, at * 4 (quoting *Ass'n of Am. Physicians & Surgeons*, 627 F.3d at 550); see also *Hunt v. Wash. State Apple Advert. Comm'n*, 432 U.S. 333, 343 (1977) (articulating the test for associational standing). Here, only the first and third prongs were in dispute.

The first prong represents the constitutional standing requirement. *AFPA*, 2021 WL 1814695, at *4. A high risk of economic injury is defined to be injury that is sufficiently concrete, immediate, direct, traceable, and redressable by the court. *Id.* at *5 (citing *Davis v. Fed. Election Comm'n*, 554 U.S. 724, 734 (2008)). The court quickly dispensed with the first prong, finding sufficient APFA’s pleading that members “have suffered and continue to risk suffering an alleged economic injury in the form of increased fees and inflated vendor payments, allegedly outside the scope of the [FA] and not properly disclosed in the FDD.” *Id.* at *5. The court then turned to the focus of its opinion: which line of cases to follow in its application of the third prong of the *Hunt* test.

Courts diverge in applying the third prong of the *Hunt* associational standing test in cases where, as here, a franchisee association sues a franchisor

on behalf of its member-franchisees. *Id.* at *4. While the third prong states that the participation of individual members of an association must not be required, the court acknowledged that a claim may still be permissible if it “requires participation of *some* members.” *Id.* at *6 (emphasis original) (quoting *Hosp. Council of W. Pa. v. City of Pittsburgh*, 949 F.2d 83, 89 (3d Cir. 1991)). Still, the court noted that “declaratory or injunctive relief rarely require individual determinations.” *Id.* at *6 n.6. The court surmised that the third prong effectively turns on a prudential question: how much participation is too much participation in the context of declaratory or injunctive relief sought by franchise associations?

Acknowledging the difficulty of answering this question, the court surveyed other courts across the country and concluded that the following prudential concerns were enough to defeat the third prong: conflicting state law in multiple interested jurisdictions, see *Ass’n of Merger Dealers, LLC v. Tosco Corp.*, 167 F. Supp. 2d 65, 73–74 (D.D.C. 2001); claims of tortious conduct and breach of contract instead of discrete legal issues like challenges to statutes and regulations, see *DDEA of S. Fla., Inc. v. Dunkin’ Donuts, Inc.*, No. 00-CV-07455, 2002 WL 1187207, at *7 (S.D. Fla. May 22, 2002); a party to a contract not present to litigate that contract, see *Mich. Dairy Queen Operators’ Ass’n*, No. 08-CV-00036, 2008 WL 2566547, at *2–3 (W.D. Mich. June 9, 2008); the risk in divergences in individual franchisees’ franchise agreements, see *Dealer Store Owners Ass’n, Inc. v. Sears, Roebuck & Co.*, No. 05-CV-01256, 2006 WL 91335, at *5 (D. Minn. Jan. 12, 2006); declaratory relief only framing the controversy between the parties instead of resolving the controversy, see *Mich. Dairy Queen Operator’s Ass’n*, 2008 WL 2566547, at *2–3; and the inherently individualized nature of some underlying legal standards like “bad faith” and “unreasonableness,” see *Dunkin’ Donuts Franchised Rests. LLC v. Shrijee Inv., Inc.*, Nos. 08-12836, 08-14213, 2008 WL 5384077, at *11–12 (E.D. Mich. Dec. 23, 2008).

The court found only two courts that had concluded a franchisee association could proceed under a theory of associational standing. However, the court reasoned that those courts’ analysis “largely rested on the deference of the pleading stage, the narrowness of the declaratory relief based on purely legal remedies, the uniformity of the franchise agreements, and the expectation of later class certification.” *Id.* at *6; see *EA Indep. Franchisee Ass’n, LLC v. Edible Arrangements Int’l, Inc.*, No. 10-CV-01489, 2011 WL 2938077, at *1 (D. Conn. July 19, 2011); *EA Indep. Franchisee Ass’n, LLC v. Edible Arrangements Int’l, Inc.*, No. 10-CV-01489, 2012 WL 5878657, at *2 (D. Conn. Nov. 21, 2012); *Nat’l Franchisee Ass’n v. Burger King Corp.*, 715 F. Supp. 2d 1232, 1239 (S.D. Fla. 2010).

The court rejected APFA’s argument that the claims were not so individualized as to require participation by all the franchisees because each of APFA’s claims raised identical prudential concerns associated with declaratory relief without any of the “safeguards found by the two departing courts.” *Id.* at *7. The court ultimately echoed the sentiments of the Eastern District of

Michigan in *Sbrijee Investment* and concluded that APFA was “simply not in the best position to present the subtleties of the franchisees’ individualized contract and tort claims” under the guise of declaratory relief. *Id.* Thus, the court found that APFA failed to establish the third prong for associational standing and granted UATP Management’s motion to dismiss.

OCTOBER 2021 LADR NOTE

***Mujo v. Jani-King International, Inc.*, 13 F.4th 204 (2d Cir. 2021).**

A recent case from the Second Circuit demonstrates that the question of whether a franchisee can assert a claim for misclassification under several state laws in the United States remains a live issue.

Jani-King is a franchisor of commercial cleaning services. Jani-King receives payment directly from its customers for cleaning services provided by its franchisees, and then Jani-King pays its franchisees after deducting fees from the customer’s payments. The fees are agreed upon in each franchisee’s agreement. Jani-King negotiates the terms of the customer contract and offers the customer to one its franchisees.

Plaintiff-Appellants Simon Mujo and Indrit Muharremi, franchisees of Jani-King International, Inc., brought claims against Jani-King for improperly reducing their wages under Connecticut law and for unjust enrichment under Connecticut’s anti-kickback statute. Plaintiff-Appellants contended that their franchisees were misclassified as independent contractors, but are actually Jani-King’s employees. The Second Circuit affirmed the district court in dismissing Appellants’ claims of improper wage deductions and unjust enrichment because, even if the franchisees were considered employees, the franchisees had agreed in their franchise agreements to deductions in their gross revenue.

Under Connecticut law, service is deemed to be employment unless it is shown that (1) the individual has been and will continue to be free from the control and direction in connection with the performance of such service, (2) such service is performed either outside the usual course of the business for which the service is performed, and (3) the individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature involved in the service performed. This test is commonly known as the ABC test and is also applied in other jurisdictions.

If Plaintiff-Appellants were employees of Jani-King, then Jani-King would be subject to the Connecticut Minimum Wage Act and Connecticut’s anti-kickback statute. The Connecticut Minimum Wage Act states that an employer cannot withhold wages unless (1) the employer is required or empowered to do so by state or federal law; (2) the employer has written authorization from the employee for deductions on a form approved by the commissioner; (3) the deductions are authorized by the employee, in writing for certain health care expenses; (4) the deductions are for contributions attributable to automatic enrollment; or (5) the employer is required under

the law of another state to withhold income tax of that state. The Connecticut anti-kickback statute implicated in this matter prohibits employers from deducting any part of the wages with the representation that the fee is necessary to secure or continue employment.

Connecticut also defines a “franchise” under the Connecticut Franchise Act. The opinion cited to a decision from the Connecticut Appellate Court, *Jason Roberts, Inc. v. Administrator*, 127 Conn. App. 780 (2011), which held that an individual can be both an employee under the ABC test while simultaneously being classified as a franchisee.

Appellants contended that Jani-King violated the Connecticut Minimum Wage Act by deducting fees from their compensation, and those fees were not permitted under the Wage Act. The Wage Act did not define “wages.” However, the Connecticut Supreme Court previously found that the wages should be defined under the employment contract. In this case, the court found that the franchise agreement was also the employment agreement.

Based on this analysis, the court agreed with the district court in finding that the Appellants failed to state a claim under the Wage Act because the franchise agreement allowed the deductions. Even if the Appellants were employees, the franchisees’ wages constitute the franchisees’ profit after Jani-King makes its deductions under the franchise agreement. Therefore, the Wage Act did not apply to the portion of gross franchise revenue that the parties agreed is not part of the franchisees’ compensation.

The court further agreed with the district court in granting Jani-King summary judgment on Appellants’ unjust enrichment claim. Connecticut law expressly authorizes bona fide franchise agreements, in which the franchisee receives the benefit of the franchisor’s intellectual property and support services in exchange for franchise fees and recognizes that franchisees may simultaneously be classified as employees. These employee-franchisees may enter into compensation agreements that define the franchisees’ compensation as the portion of gross revenue attributable to the employee-franchisees’ work after the franchise fees are subtracted. The court found that the parties agreed to the structure of the payments and that the Appellants did not show that the franchise agreement was not a bona fide franchise agreement.

Appellants sought an order certifying three questions of law: (1) Where workers are misclassified as independent contractors under the ABC test, is it a violation of Connecticut law to require the workers to make payments that they could not have been required to make if they had been properly classified as employees? (2) Where misclassified workers are actually employees of a franchisor, do the “franchise fees” that they must pay in order to obtain janitorial work qualify as unlawful payments for a job under the Connecticut anti-kickback statute? (3) Is a contract purporting to authorize deductions from a worker’s pay binding and enforceable where the same contract purporting to authorize the deductions also misclassifies the worker as an independent contractor such that the worker may not realize the deductions

would be unlawful deductions from wages under the Connecticut Minimum Wage Act?

The court found that Appellants' proposed questions did not warrant certification. The court found authoritative Connecticut state court decisions supporting the conclusion that, even if the franchisees were employees, an employee and employer may enter into an employment contract where the employee's wages are defined as some sum of money less than the gross revenue received by the employer.

The dissent claimed that the court should have certified the issue because it believed there is still a question under Connecticut law as to the proper classification of Appellants as employees, franchisees, or a hybrid of the two. The dissent noted that the First Circuit in *Patel v. 7-Eleven, Inc.*, 8 F.4th 26 (1st Cir. 2021), recently certified to the Massachusetts Supreme Judicial Court whether the ABC test applies to the relationship between a franchisor and a franchisee. Because the consequence of the proper classification of Appellants directly impacted the ultimate outcome of the case, the dissenting judge considered it inappropriate to decide the merits without asking the Connecticut Supreme Court to weigh in. The dissent also criticized the majority's characterization of *Jason Roberts*, stating that the case actually suggests that, when a worker qualifies as an employee, Connecticut employment law applies, regardless of whether a franchise agreement was signed.

NOVEMBER 2021 LADR NOTE

***Roof Maxx Technologies v. Tabbert*, No. 2:20-cv-03156, 2021 WL 3617158 (S.D. Ohio Aug. 16, 2021).**

A distributor of spray-on roof shingle treatments sued its former exclusive dealer for breach of contract and a declaratory judgment enforcing the post-term noncompete. The filing came as a surprise to the exclusive dealer, Tabbert, because a few weeks earlier, Lisa Tabbert had sent Roof Maxx a notice of rescission based on alleged fraud and misrepresentation and the parties were in confidential settlement negotiations at the time.

Tabbert answered the complaint and filed a counterclaim and a third-party complaint against Roof Maxx and its owners, Michael and Todd Feazel. Tabbert alleged fraud, false advertising under the Lanham Act, violation of the Ohio Deceptive Practices Act, and sought declaratory judgment regarding the enforceability of the Exclusive Dealership Agreement. In her fraud claim, Tabbert alleged that Roof Maxx had enticed her to enter the agreement by falsely stating that the product was patented. In fact, the patent had lapsed several years prior, and Roof Maxx had been unable to reinstate it. In her breach of contract claim, Tabbert alleged that Roof Maxx had breached the duty of good faith and fair dealing by imposing a new payment plan, requiring franchisees to convert to a micro website and enroll in an autopayment plan when the franchise agreement did not address those issues. Roof Maxx filed a 12(b)(c) motion to dismiss.

With respect to Tabbert's fraud claims, Roof Maxx argued that Tabbert had not pleaded fraud with sufficient particularity pursuant to Ohio Civ. R. 9(b)—which is very similar to Federal Rule of Civil Procedure 9(b)—or shown justifiable reliance. The district court rejected both arguments. Ohio Civ. R. 9(b) requires parties pleading fraud to allege the time, place, and content of the alleged misrepresentation as well as the fraudulent scheme, the defendant's intent, and the injury. However, the district court noted that Ohio Civ. R. 9(b) "must be read in harmony with Ohio Civ. R. 8's simplicity of pleading" and stated that the threshold test for sufficiency under Ohio Civ. R. 9(b) should be whether the complaint provided the defendant with sufficient notice of the misrepresentation and allowed the defendant to answer the allegation in an informed manner.

The district court determined that Tabbert had met her burden. She had identified the time of the misrepresentations as the several weeks leading up to the date that the agreement was signed. She had identified the fraudulent scheme as Roof Maxx misleading individuals to believe that the materials were patented and exclusive and that Roof Maxx and its owners made this misrepresentation with the intent to "lock" her and other dealers into restrictive contracts with five-year non-compete clauses. Tabbert had alleged injury by stating the specific dollar amount of her initial investment as well as a general description of her lost profit and business opportunities. Most importantly, Tabbert had pleaded sufficient details as to place and content of the misrepresentations by identifying oral statements, marketing materials, and social media posts and, where possible, had attached documents containing the allegedly fraudulent statements as exhibits to the Counterclaim.

Roof Maxx also argued that Tabbert had not shown justifiable reliance because patents are a matter of public record and that Tabbert did not independently verify Roof Maxx's claim. The district court disagreed. It noted that reliance may be justified when a statement is not unreasonable on its face and if, under the circumstances, the plaintiff has no reason to doubt the veracity of the representation. Relevant circumstances may include the nature of the transaction, the circumstances of the representation, the relationship between the parties, and their respective levels of experience.

Here again, Tabbert's well-drafted complaint aided her case. The district court emphasized that Roof Maxx was a well-established national distributor of roofing products, while Tabbert had no experience in the roofing industry. Importantly, Tabbert highlighted the fact, and the district court agreed that it was significant that Roof Maxx's statements were made in printed marketing materials. Given Roof Maxx's experience and the formality of its representations, the district court determined that Tabbert had no reason to doubt their veracity.

Roof Maxx further argued that Tabbert should have checked the patent registry. This argument may be familiar to attorneys litigating disputes regarding a franchisor's failure to register. To support its argument, Roof Maxx cited several real estate cases in which the plaintiff failed to check

public records such as flood plain restrictions and could, therefore, not show justifiable reliance in their fraudulent concealment claims. The district court rejected this argument for two reasons. First, it determined that, unlike the real estate cases where the misrepresentation related to the thing being purchased, in this case, the misrepresentation was an inducement to enter a dealership agreement not the object of the agreement itself. The district court concluded that, in the absence of any facts suggesting that Tabbert should have known she was being deceived, she was not obligated to independently check the patent register before purchasing the dealership.

This case illustrates the importance of careful pleading. A wise franchise attorney should draft their fraud claims with Civil Rule of Federal Procedure 9(b) and a 12(b)(6) motion in mind. In this case, Tabbert's counsel clearly identified which facts they would rely on to overcome a 12(b)(6) motion and was careful to include those facts in the complaint. Counsel demonstrated the maximum "show, don't tell" and used exhibits containing the misstatements to support their fraud claims. Counsel cannot choose the facts of their case, but they can choose to use favorable facts that they are given to maximize their effect. The Roof Maxx case provides an excellent guide.

FLJ CURRENTS

ANTITRUST

***TRBR, Inc. v. AmeriCredit Financial Services, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,975, 2021 WL 4522306 (E.D. Mich. Oct. 4, 2021).**

The U.S. District Court for the Eastern District of Michigan dismissed claims brought by two dealerships against General Motors Financial (GMF) and General Motors (GM) under the Automobile Dealer's Day in Court Act, the Sherman Act, and various state law claims.

The plaintiffs, TRBR, Inc. and TRBR II, Inc. (collectively, TRBR) are two automobile dealerships. They brought several claims against AmeriCredit Financial Services, Inc., which provides financing to dealerships as GMF, and GM, the car manufacturer and distributor, alleging that GMF and GM worked together to undermine TRBR's dealerships. Specifically, TRBR alleged that issues began when it ordered thirty trucks from GM but delivery was delayed due to flooding. GMF demanded immediate payment for the trucks despite the delivery delay. TRBR was late on payment, and so GMF imposed an interest rate increase and stricter payment requirements. Then, according to TRBR, GM claimed that TRBR was in breach of its Dealer Agreement for misusing the family discount plan. As a result, GM imposed on TRBR new verification procedures related to the discount plan, which it claimed arose from racially discriminatory assumptions and had a disparate impact on its customers. Sales dropped precipitously, TRBR fell behind on payments, and GMF stopped financing new inventory. Eventually GMF terminated all future borrowing as permitted under its agreement with TRBR.

In earlier motion practice, the court dismissed several of TRBR's claims against GM, except for claims under the Automobile Dealer's Day in Court Act and the Sherman Act. After finding that it had jurisdiction to hear TRBR's claims against GMF, the court permitted GMF to file a renewed motion to dismiss plaintiffs' claims against it for failure to state a claim under Rule 12(b)(6).

The court granted GMF's motion to dismiss the Automobile Dealer's Day in Court Act claim, finding that the Act did not apply to GMF because it is not an automobile manufacturer. To fit within the statutory definition of automobile manufacturer, TRBR would have to specifically allege an agency relationship between GMF and GM. Because it failed to do so, the court dismissed the Automobile Dealer's Day in Court Act claim against GMF. The claim against GM survived because it was at least plausible that GM demanded that TRBR use a verification system that relied on racially discriminatory standards.

Turning to the Sherman Act claim, the court determined that the claim must be dismissed because GMF and GM are wholly owned corporate siblings with a shared parent. Thus, as a matter of law, they could not conspire to restrain trade in violation of the Act.

The court further dismissed several state law claims against GMF. It dismissed claims under the Michigan Motor Vehicle Franchise Act because the Act does not apply to the loan agreement or the relationship between the parties. It dismissed the breach of contract claim because TRBR failed to identify a specific contractual provision that GMF breached. It dismissed the good faith and fair dealing claim because Michigan law does not recognize such an independent claim. Finally, the court dismissed the tortious interference claim because TRBR did not identify any duty owed to it by GMF that is separate from the contract.

ARBITRATION

***Parrella v. The Orange Rabbit, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,974, 2021 WL 4462809 (S.D.N.Y. Sept. 29, 2021).**

Franchisee Nicholas Giacomelli and his company The Orange Rabbit filed an arbitration action against franchisor ILKB, LLC and three of its executives, including Michael Parrella. The plaintiffs alleged that the defendants fraudulently induced them to purchase three franchises and brought claims for fraud, negligent misrepresentation, breach of contract, and claims under state franchise statutes. The arbitrator found in Giacomelli and Orange Rabbit's favor and awarded them more than one million dollars in damages. Parrella and ILKB moved to vacate the award, while Giacomelli and Orange Rabbit moved to confirm the award. The Southern District of New York denied the motion to vacate and confirmed the award.

Parrella and ILKB moved to vacate the award on two grounds: first, that the arbitrator violated Section 10(a)(3) of the Federal Arbitration Act (FAA)

by refusing to adjourn the arbitral hearing, and second, that the arbitrator violated Section 10(a)(4) by exceeding his powers.

The plaintiffs contended that the arbitrator should have granted various requests to adjourn the arbitration hearing, which began on March 23, 2020, in light of the COVID-19 pandemic and to allow Parrella's newly retained attorney time to meet with Parrella and familiarize himself with the case. The arbitrator had granted several earlier applications to postpone the hearing but denied the later requests after making clear to the parties that the March 23, 2020, date was firmly set and would not be further extended. As to the pandemic, the arbitrator ruled the hearing could proceed in a fair manner via Zoom video conference. When specific issues arose, such as the inability of ILKB's counsel to access certain documents in their office due to a stay-at-home order, the arbitrator provided specific solutions that would allow the hearing to continue. The court also observed that Parrella had ample notice of the hearing and had a clear deadline to retain new counsel, but failed to do so until three days before the start of the hearing. As a result, the court found that the arbitrator's refusal to adjourn the hearing fell within the broad discretion of appointed arbitrators to grant or deny an adjournment.

Turning to the second issue, the court first considered whether it or the arbitrator had the authority to decide questions of arbitrability. The court determined that the franchise agreement clearly and unmistakably delegated questions of arbitrability to the arbitrator. Next, the court held that although Parrella was not a party to the franchise agreement, he demonstrated his intent to arbitrate and waived his right to object to arbitrability by actively defending himself in the arbitration and filing crossclaims against a co-defendant.

Because the arbitrator had the authority to determine questions of arbitrability, his decisions on that subject were entitled to extreme deference. Against this framework, the court considered four areas in which Parrella and ILKB claimed the arbitrator exceeded his powers and ruled against them on all counts. First, the arbitrator did not exceed his powers by finding that Parrella was subject to arbitration. In making that decision, the arbitrator made essentially the same findings as the court—that Parrella demonstrated his intent to arbitrate. Second, the arbitrator did not exceed the scope of his authority by determining that Giacopelli—a non-signatory to the agreement—was a proper party to the arbitration because his claims were related to the claims of Orange Rabbit. Third, the arbitrator did not exceed the scope of his authority by permitting two plaintiffs with the same claims to participate in one arbitration, despite language in the franchise agreement calling for individual arbitration, because the language could be read to refer to claims brought by multiple franchisees, rather than a single claim brought by a franchisee and his business. Fourth, the arbitrator did not exceed his authority in awarding attorneys' fees and costs because the franchise agreement plainly gave the arbitrator the right to do so. After finding that the arbitrator acted within his powers, the court confirmed the arbitral award.

***Takiedine v 7-Eleven*, Bus. Franchise Guide (CCH) ¶ 16,927, 2021 WL 3223070 (E.D. Penn. July 29, 2021).**

The U.S. District Court for the Eastern District of Pennsylvania granted a motion for reconsideration and reversed its prior decision to stay a 7-Eleven franchisee's claims pending arbitration so that the franchisee could pursue his claims in court.

The plaintiff, Azmi Takiedine, was a 7-Eleven franchisee for over forty years. He brought suit against 7-Eleven in 2017, alleging that it had tried to make his business unprofitable by, in part, failing to make "make a commercially reasonable effort to obtain the lowest cost for products and services" from vendors, including by identifying available "discounts, allowances and other opportunities for price adjustments" as was required under the plaintiff's franchise agreement with 7-Eleven.

7-Eleven's contractual obligation to make efforts to secure the lowest prices from vendors was subject to an arbitration clause in the plaintiff's franchise agreement. That clause provided that disputes were to be handled by a five-member "Franchise Selection Committee" composed of 7-Eleven franchisees. Under the arbitration clause, each year 7-Eleven would provide the Committee with a list of all vendor agreements that 7-Eleven entered into during the previous year. The Committee would review the agreements and identify which ones it would like a "Third Party Reviewer" to review. If the Third Party Reviewer concluded that 7-Eleven breached its obligation to try to obtain the lowest costs for products and services, it would notify the Committee and 7-Eleven. Then the Committee and 7-Eleven would be obligated to attempt to resolve the dispute informally within thirty days and then through non-binding mediation for an additional thirty days. The Committee could only initiate arbitration after completing all these steps. The arbitration provision also provided a one-year contractual limitations period and a limitation on remedies that prohibited either side from recovering damages in arbitration.

When the plaintiff originally sued, 7-Eleven move to compel arbitration. The district court granted the motion and ordered the entire case stayed, pending arbitration of the claims relating to 7-Eleven's alleged breach of the obligation to secure low-cost vendor agreements. Several years later, the plaintiff sought to "lift the stay," contending that 7-Eleven's requirement to arbitrate these claims was unconscionable. Although the district court found that the plaintiff's motion was really a motion for reconsideration filed two years too late, it found reconsideration appropriate because it was necessary to prevent "manifest injustice."

First, the Court addressed the delay in seeking reconsideration. Although the district court's local rules provided a fourteen-day time limit for reconsideration motions, the court held that it could excuse the delay when (1) it had a sound rationale for doing so, and (2) there was no prejudice to a party who has relied on the local rule to its detriment. The court found both of these requirements had been met because 7-Eleven did not argue that it

relied upon the fourteen-day time period to its detriment and because the district court had a sound reason to reconsider its prior order. The district court found that when it had initially stayed the litigation pending arbitration it had assumed that the claims would actually be resolved in arbitration. Instead, because of the nature of the procedure set forth in the arbitration clause, the plaintiff's individual claims were not sent to arbitration, and the plaintiff was not able to personally advance any of his claims in the intervening two years.

Second, the district court reconsidered the substance of the order staying the case pending arbitration to determine if the clause was unconscionable. As a threshold issue, the court addressed whether the Federal Arbitration Act (FAA) preempted Pennsylvania's law of unconscionability. It held that the FAA did not preempt Pennsylvania's unconscionability defense. It then proceeded to find the clause unconscionable and unenforceable. The court found the clause procedurally unconscionable because it had been presented on a "take it or leave it" basis. The district court found the clause substantively unconscionable because it left individual franchisees without a way to litigate their claims, whether in court or in arbitration. The arbitration provision did not expressly provide any method for individual franchisees to participate in disputes. Individual franchisees had no way to influence the Committee charged with arbitrating claims because they were not elected by franchisees and the Committee members were required to keep their work confidential so they could not even respond to informal complaints submitted by franchisees. The court also cited to evidence that the plaintiff had submitted from a former Committee member who testified that the Committee had never arbitrated a single dispute with 7-Eleven because the lack of damages meant that the Committee had little or no leverage to force 7-Eleven to change its vendor negotiating practices. The court also found the contractual limitations period unconscionable because claims accrued once a dispute arose between the Committee and 7-Eleven, but individual franchisees had no way to know when claims accrued due to the confidential nature of the proceedings between the Committee and 7-Eleven.

Finally, the court addressed whether to sever the unconscionable provisions from the requirement to arbitrate. It found that severance was not possible because it "cannot merely replace every reference to the 'Franchise Selection Committee' with 'Mr. Takiedine' without fundamentally rewriting the contract." The district court reversed its prior order compelling arbitration and permitted the plaintiff to proceed with his claims in court.

Escobar v. National Maintenance Contractors, Bus. Franchise Guide (CCH) ¶ 16,937, 2021 WL 3572652 (D. Or. Aug. 12, 2021).

The U.S. District Court for the District of Oregon granted a motion to compel arbitration of claims for breach of contract, tort, employment, and Racketeer Influenced and Corrupt Organization Act (RICO) filed against National Maintenance Contractors, LLC, a janitorial and maintenance

franchisor and its corporate affiliates, including individuals involved in the management of the franchisor.

The plaintiffs, a group of franchisees and their employees located throughout Washington and Oregon, filed suit against the defendants alleging that the defendants had engaged in “unlawful franchising practices” by misclassifying them as franchisees instead of as employees. The plaintiffs asserted breach of contract, tort, employment, and RICO claims against the defendants. Each of the plaintiffs who owned a franchise had signed a franchise agreement containing an arbitration clause providing for the resolution of all claims “on an individual basis” in Minneapolis, Minnesota.

The plaintiffs opposed the motion to compel arbitration on multiple grounds. They argued that none of them consented to the clause; that the defendants could not enforce the clause against the non-signatory plaintiffs (the employees of the franchisees); the non-signatory defendants could not enforce the agreement; the arbitration agreement was unconscionable; and the entire franchise agreement was unenforceable due to economic duress and illegality of its terms. While the court found that some aspects of the arbitration clause were unenforceable, it granted the motion after severing the unconscionable clauses.

The court first addressed the argument of the franchise owners that they did not consent to the agreement because they did “not have ‘sufficient proficiency to read technical and legal English’ when they signed the franchise agreement.” The court rejected this argument citing to Oregon and Washington law holding that a failure to read a contract is not a sufficient defense to its enforcement. The district court said that there was no evidence that the franchise owners had been deprived of the opportunity to investigate any provisions that they did not understand before deciding whether to sign the franchise agreement and there was no record to support claims for fraud or deceit by the defendants. It held that the defendants had no obligation to explain the agreement or translate it for the plaintiffs. The court also relied upon the fact that it was undisputed that each franchisee operated a franchised business and accepted payments under the franchise agreements, which demonstrated the plaintiffs’ “objective assent” to the terms of the agreements.

The district court next addressed the argument of the franchise employees that they could not be required to arbitrate because they did not personally enter into any of the agreements. The court held that these plaintiffs were equitably estopped from resisting the application of the arbitration clause because each one had knowingly exploited the benefits of the agreement and received benefits from its enforcement. They had done so by performing services and receiving compensation pursuant to the rights and duties provided in the agreements. The district court also noted that each of these individuals was either present when the franchisee signed the agreement or was a family member of the franchisee.

The court found that the non-signatory defendants could also enforce the arbitration clause. The court held that, because the plaintiffs alleged the

defendants were involved in a RICO conspiracy, the claims asserted against all defendants were intertwined and the defendants were entitled to have their defenses jointly tried in arbitration.

In addressing the plaintiffs' assertion that the clause was unconscionable, the court first had to determine whether this issue had been delegated to the arbitrator. The court found that it would need to address the plaintiffs' unconscionability defense because the arbitration agreement had no "clear and unmistakable" language delegating the issue of arbitrability to an arbitrator, especially given the relative sophistication of the parties.

Regarding unconscionability, the court found there was procedural unconscionability because of the relative sophistication of the parties but held that the agreement was not so unconscionable that it would render the arbitration clause void. The court found that the agreement contained an unconscionable forum selection clause requiring the plaintiffs, who are low-income individuals, to travel from Oregon and Washington to Minnesota to arbitrate their claims. The court also found that the provision limiting the parties' right to recover punitive damages substantively unconscionable. Nevertheless, the court upheld the remainder of the clause by severing these provisions.

Finally, the court rejected the plaintiffs' argument that it should refuse enforcement of the arbitration clause because the franchise agreements were void as against public policy. The court did not make an affirmative finding regarding whether the contracts were legal or complied with public policy. Instead, because these arguments targeted the validity of the entire contract, the court found that these challenges were subject to the arbitration clause and needed to be resolved by an arbitrator. The court then compelled each plaintiff to arbitrate their claims individually.

BREACH OF CONTRACT

***JTH Tax LLC v. Grabowski*, Bus. Franchise Guide (CCH) ¶ 16,953, 2021 WL 3857794 (N.D. Ill. Aug. 30, 2021).**

This case is discussed under the topic heading "Misappropriation of Trade Secrets."

***Takiedine v 7-Eleven*, Bus. Franchise Guide (CCH) ¶ 16,927, 2021 WL 3223070 (E.D. Penn. July 29, 2021).**

This case is discussed under the topic heading "Arbitration."

CHOICE OF LAW

***ACD Distribution LLC v. Wizards of the Coast LLC*, Bus. Franchise Guide (CCH) ¶ 16,952, 2021 WL 4027805 (9th Cir. 2021).**

ACD Distribution LLC (ACD), a Wisconsin distributor, appealed an order granting summary judgment on the pleadings by the U.S. District Court

for the Western District of Washington. Upon a de novo review, the Ninth Circuit affirmed.

ACD argued that Wisconsin's Fair Dealership Law (WFDL) prevented Wizards of the Coast LLC (Wizards) from canceling its distribution agreement with ACD "without good cause." However, the Ninth Circuit determined that the district court correctly concluded that it must apply Washington law, which lacked an analogous "good cause" requirement, based on the Washington choice of law provision in the parties' agreement (the provision stating that "[t]his Agreement will be governed by and interpreted in accordance with the laws of the State of Washington, without reference to conflict of laws"). Furthermore, the Ninth Circuit rejected ACD's argument that the contractual choice of law provision did not cover the dispute. The court concluded that ACD failed to preserve their argument and, therefore, waived it. Regardless, the Ninth Circuit concluded that the argument was meritless based on a reasonable reading of the agreement's governing law provision.

The Ninth Circuit applied Washington's choice of law rules and agreed with the district court that Washington law, and not Wisconsin law, applied. Under the relevant *Restatement (Second) of Conflict of Laws* §187(2), adopted by Washington, the law of the state chosen by the parties will be applied unless its application "would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties." The Ninth Circuit found that assuming the WFDL reflected a "fundamental policy" of Wisconsin, ACD had not shown that Wisconsin had a "materially greater interest" in the determination of when Wizards could terminate the agreement. ACD provided no basis to conclude that Wisconsin had a "materially greater interest" than Washington, given Washington's decision to not adopt a law similar to WFDL. The court also agreed with the district court, which recognized that ACD specifically agreed to a contract requiring venue in Washington and application of Washington law.

LABOR AND EMPLOYMENT

***Goro v. Flowers Foods, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,967, 2021 WL 4295294 (S.D. Cal. Sep. 20, 2021).**

The U.S. District Court for the Southern District of California granted a motion for partial summary judgment dismissing two affirmative defenses of the bakery company, Flower Foods and its subsidiaries, in which the defendants asserted that they could not be held liable under the plaintiffs' wage and hour claims because they were never the plaintiffs' employers.

Defendant Flower Foods, a publicly traded company, owns, markets, and sells many well-recognized bakery products such as Nature's Own, Dave's Killer Bread, and Wonder. As part of its business, it and its subsidiaries contract with distributors to sell these products throughout the United States.

The plaintiffs are distributors who had entered into distribution agreements with Flower Foods or one of its subsidiaries providing for the right to distribute Flower Food products in a defined geographic territory. Although the distribution agreements expressly provided the plaintiffs were independent contractors, the plaintiffs sued Flower Foods and the subsidiaries with which they directly contracted for various claims under California's wage and hour laws. The defendants asserted as their first affirmative defense that they could not be held liable because they are not the employers of the distributors. Their thirty-second affirmative defense asserted that the claims were preempted by federal law. One of the plaintiffs moved for summary judgment on both affirmative defenses arguing that California's "ABC" test controlled and that there was no dispute of fact that the defendants are the employers of the distributors.

The court granted summary judgment finding no dispute of fact that defendants could be held liable as the plaintiffs' employers. It rejected the defendants' argument that under California law the "ABC" test did not apply to the issue of whether defendants are the plaintiffs' employers, finding that the claims at issue were covered by one of California's wage orders and that this mandated application of the "ABC" test. The court also held that the "ABC" test was not preempted by federal law. The defendants had argued that both the Lanham Act and the FTC's franchise rule preempted the application of California's ABC test. The defendants asserted that because the FTC Franchise Rule requires a "franchisor . . . to exert a significant degree of control over the franchise's method of Operation" and the Lanham Act requires franchisors to "control use of their trademarks," these laws preempted the "ABC" test's requirement that independent contractors be "free from control" of the alleged employer. The court, starting with the presumption that Congress did not intend to preempt a law that is within a state's historical police powers, rejected the argument because defendants did not identify an express conflict between the "ABC" test and the FTC Franchise Rule or the Lanham Act.

The court also found that there was no dispute of fact that defendants were the plaintiffs' employers under the "ABC" test. Under the "ABC" test, a putative employer must establish three elements to demonstrate it is not an employer:

- (A) the putative employee is independent of the hiring organization in connection with the performance of the work, both under the contract for the performance of the work and in fact;
- (B) the putative employee performs work that is outside the hiring entity's business; and
- (C) the putative employee is routinely doing work in an independently established trade, occupation, or business that is the same as the work being requested and performed.

While the distribution agreements provided that each plaintiff was "an independent contractor" that "shall not be controlled by [the defendants] as to

the specific details or manner of DISTRIBUTOR’s business,” the court held that there was no dispute as to the plaintiffs’ status as employees because they were integral to the defendants’ business of selling baked goods. In making this determination, the court pointed to Flower Foods’ SEC filings reporting that eighty-five percent of Flower Foods sales for fiscal year 2017 were through distributors and identifying Flower Foods’ “distributor partners” as part of the “core business.” The court also granted summary judgment as to whether Flower Foods, which had no direct contract with the plaintiffs, could be held liable as an employer. In so holding, the court pointed out that the distribution contracts required the distributor plaintiffs to sell products to large chain accounts that Flower Foods had already contracted with and that the plaintiff distributors could be terminated for failing to sell products under these contracts. The court found that, as long as the distributor plaintiffs were providing a service to Flower Foods, even indirectly, the distributors were Flower Foods employees.

***Escobar v. National Maintenance Contractors*, Bus. Franchise Guide (CCH) ¶ 16,937, 2021 WL 3572652 (D. Or. Aug. 12, 2021).**

This case is discussed under the topic heading “Arbitration.”

***Patel v. 7-Eleven, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,944, 8 F.4th 26 (1st Cir. 2021).**

Convenience store franchisees filed a putative class action claiming that its franchisor, 7-Eleven, misclassified them as independent contractors rather than employees. The U.S. District Court for the District of Massachusetts denied the franchisees’ motion to certify and granted the franchisor summary judgment. The franchisees appealed, and the First Circuit held that it would certify to Massachusetts Supreme Judicial Court the question of whether the Massachusetts Independent Contractor Law’s (ICL) independent contractor test applied to a franchisor that was required to comply with the Federal Trade Commission’s (FTC) Franchise Rule.

The franchisees owned franchised 7-Eleven stores in Massachusetts. The franchisees were obligated to operate their stores around the clock, stock inventory by preferred vendors, use a 7-Eleven payroll system to pay store staff, and adhere to other guidelines pursuant to their franchise agreements. The franchise agreements classified the franchisees as independent contractors, noting that they did not receive a regular salary from the franchisor. Instead, each franchisee had to draw pay from their store’s gross profits, after paying various fees to the franchisor required by the franchise agreement. Nonetheless, the franchisees sued their franchisor, alleging that it misclassified them as independent contractors, rather than employees, in violation of the ICL, Massachusetts Wage Act, and Massachusetts Minimum Wage Law.

The ICL presumes “an individual performing any service” to be an employee and therefore protected by state wage and hour laws, unless that individual’s alleged employer can demonstrate that (1) the individual is free from control and direction in connection with the performance of the

service, both under his contract for the performance of service and in fact; and the service is performed outside the usual course of the business of the employer; and (2) the individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed. The FTC Franchise Rule defines a franchise, in part, as a commercial relationship where the parties agree that “[t]he franchisor will exert or has authority to exert a significant degree of control over the franchisee’s method of operation, or [the franchisor will] provide significant assistance in the franchisee’s method of operation.”

The franchisor argued that its franchisees were properly classified as independent contractors and that the ICL did not apply to its relationship with franchisees because the conflict between the ICL and the FTC Franchise Rule made it impossible for them to satisfy federal law and demonstrate that the ICL did not apply. The franchisees disagreed and asserted that the franchisor had the same burden as any other purported employer under the ICL, which it failed to meet.

The Massachusetts Supreme Judicial Court (SJC) had yet to analyze the potential conflict between the ICL and the FTC Franchise Rule. The court’s closest decision was from *Monell v. Boston Pads, LLC*, 31 N.E.3d 60 (2015), where the SJC considered the overlap between a Massachusetts real estate statute and the ICL and held that the ICL did not apply to the workers in that case because the real estate statute made it impossible for purported employers to also satisfy one or more of the ICL’s prongs. However, the First Circuit considered this case merely informative, as it determined that the most prudent approach would be for the SJC to weigh in on the issue.

The First Circuit certified the question to the SJC on whether the three-prong test for independent contractor status set forth in the ICL applies to the relationship between a franchisor and its franchisee, where the franchisor must also comply with the FTC Franchise Rule.

MISAPPROPRIATION OF TRADE SECRETS

***JTH Tax LLC v. Grabowski*, Bus. Franchise Guide (CCH) ¶ 16,953, 2021 WL 3857794 (N.D. Ill. Aug. 30, 2021).**

The U.S. District Court for the Northern District of Illinois granted summary judgment in favor of a tax preparation franchisor on a breach of contract claim filed by an area developer, and denied the area developer’s motion for summary judgment on several claims asserted by the franchisor.

JTH Tax, the franchisor of Liberty Tax Service franchises, entered into an area development agreement with defendant David M. Rocci, pursuant to which he was given the right to sell Liberty Tax franchises in a portion of Massachusetts. The agreement had a term of ten years. Under the agreement, Rocci agreed to identify and secure a minimum number of franchisees each year. Rocci failed to meet the minimum requirements in 2015, 2016, and 2017. As the agreement neared the end of its term, in May 2017 Rocci

sent written notice of his desire to renew the area development agreement as required by its terms. Rocci never received a response to his notice, and the agreement expired in January 2018. Rocci alleged that Liberty's failure to renew the agreement constituted a breach of contract.

Rocci and Liberty were also parties to several franchise agreements that governed the operation of three tax preparation offices in Illinois. Before December 2016, Rocci operated these offices. In November 2016, he and an entity called Rock Tax Team entered into a purchase and sale agreement with defendant Nicole Grabowski for the Illinois tax businesses. In January 2018, Grabowski abandoned the businesses, and Rocci stepped in to operate the business in Plainfield, Illinois. Liberty alleged that, during the 2018 tax season, Rocci filed tax returns outside of Liberty's system in violation of Rocci's two-year post-term noncompete. In January 2019, the Plainfield office reopened under the name Rock Tax Team, although Liberty alleged that Rocci continued to use Liberty's name, trademarks, and confidential material. There was also evidence that two former employees who worked for the Liberty franchises went on to work for Rock Tax Team. Based on these facts, Liberty asserted claims for misappropriation of trade secrets, common law unfair competition, and breach of the covenant not to compete.

Regarding Rocci's breach of contract claim, the court determined that a provision that allowed for renewal of the agreement "provided Area Developer is in compliance with the terms and conditions in this Agreement" meant that Liberty could refuse to renew the agreement based on Rocci's failure to meet the minimum development requirements. This was true even though a different provision said that Liberty's "sole remedy for failure to meet Minimum Requirements" was to delete franchise territories from the area developer agreement. The court interpreted the latter provision to provide the sole in-term remedy, leaving nonrenewal as a permissible remedy at the expiration of the agreement. Thus, it granted summary judgment in favor of Liberty on Rocci's breach of contract claim.

Turning to Liberty's claims, the court identified several types of confidential information that could constitute trade secrets, including methods of operation, services, techniques, customer lists, and marketing information. The court then determined that circumstantial evidence—including testimony from Liberty's corporate representative that he identified an additional tax filer number associated with Rocci on an IRS database, the fact that Rocci failed to return the customer list, and testimony from Grabowski about her belief that Rocci was using alternative software—could support the claim for misappropriation of trade secrets. The same evidence could support a claim for violation of the noncompete, according to the court. Finally, the court determined that a claim for common law unfair competition could exist outside of the Illinois Uniform Deceptive Trade Practices Act or a claim for tortious interference. As a result, the court denied Rocci's motion for summary judgment on each of these claims.

