Franchise law tenet:

Disclosure! Disclosure! Disclosure!

LawPRO is seeing an increase in claims against lawyers by franchisees and franchisors. These claims tend to involve significant damages which often approach or exceed the available limits under the primary LawPRO policy.

Franchises are governed by the *Arthur Wishart Act (Franchise Disclosure), 2000* (the "Act") which was enacted by the Ontario government to provide protection to franchisees in relation to their dealings with franchisors, and to address the imbalance of power that exists between the parties.

Franchisees often share similar characteristics: They are not sophisticated business people or are not experienced with franchises; they are running a "mom-and-pop-style" family business; they are usually financially (and more importantly, emotionally) invested in the business; and they have scraped together their life savings to open the franchise. These characteristics frequently result in "sympathetic" claimants.

While the franchisee's key consideration may be "location, location, location," lawyers acting for both sides of a franchise transaction should be much more wary of ensuring that their clients are aware of the disclosure obligations which the Act (and the courts) have placed on franchisors.

The Act seeks to protect franchisees before they invest by requiring franchisors to provide full disclosure in a formal disclosure document. This document must be provided to the potential franchisee not less than 14 days before the candidate signs a binding franchise agreement or pays any amount of money to the franchisor.

Disclosure obligations of franchisors

The information that is to be disclosed is set out in the regulations to the Act and is extensive. Among other things, the Act requires the franchisor to:

- tell prospective franchisees personal information about the franchise owners;
- give detailed financial disclosure about both the franchisor's operations and the budget for the franchisee, etc.;
- explain operating policies of the franchisor; and
- reveal past history of the franchisor and other franchisees.

The franchisor must also provide the prospective franchisee prompt notice of any material change to any of the above.

Failure on the part of the franchisor to comply with disclosure obligations provides the franchisee with an extraordinary remedy – it allows a franchisee to rescind the contract within two years and to obtain the return of its investment in franchise fees, inventory and equipment costs. The franchisee is also entitled to obtain compensation for any losses incurred for setting up and operating the franchise business.

To take advantage of the right to rescission within two years of purchase, timing and notice are key components under the Act. One potential area of exposure for lawyers involves the timing of a Notice of Rescission under the Act. Another is the failure to refer to the Act when seeking to rescind the franchise agreement. Should the rescission remedy not be available to a franchisee as a result of one of these errors, the lawyer becomes a natural target for a claim.

Many of the larger cases at LawPRO have involved allegations that a lawyer failed to advise the franchisor or franchisee regarding proper disclosure. Regrettably, lawyers' files rarely document the fact that the statutory provisions of the Act and the consequences of non-compliance were explained to the client. As a result, liability is often a foregone conclusion or turns on a credibility contest, which commonly favours the client.

When the client is the franchisor

Franchisees are not the only potential claimants. Lawyers can also face significant liability to franchisors for failing to advise franchisors of their obligations relating to disclosure under the Act and the consequences that flow from inadequate disclosure. In one case, a lawyer who failed to advise his franchisor client to provide the franchisee with up-to-date, audited financial statements was found to have breached his duty of care to his client to ensure that adequate disclosure had been provided to the franchisee.

Lawyers must also ensure that disclosure documents are dated and signed by two officers or directors of the franchisor. The failure to provide a signed Certificate of Disclosure often triggers the franchisee's right to rescind. Furthermore, if the disclosure documents contain a misrepresentation, the signatories are exposed to personal liability, jointly and severally, for the full amount of the loss, provided that the loss results from the misrepresentation.

The current trend in the courts seems to be to protect franchisees by fashioning a remedy for them one way or another. Lawyers practising in this area need to be extremely cautious and should be careful to protect themselves by documenting advice to their clients in writing.

It should go without saying that dabbling in franchise transactions is risky and should be avoided at all costs. However, even those lawyers regularly practising in this area would be well advised to prepare a detailed letter or memorandum which provides information to their clients about a franchisee's right to receive full, complete and proper disclosure and the timing of their rights and remedies under the Act. Similarly, lawyers acting for a franchisor are well advised to prepare a detailed summary of what must be disclosed to a potential franchisee, the risk the franchisor faces if the disclosure documents are determined to be inadequate, as well as the personal risk that the signatories to the disclosure document face if the disclosure document contains misrepresentations that may be grounds for a claim for rescission and damages.

It would also be wise for lawyers to confirm, in writing, that they are not providing financial advice and that all financial statements should be reviewed by an accountant.

With regard to disclosure, the list of what must be included in disclosure documents is lengthy and beyond the scope of this article. As well, the definition of what constitutes a "material fact" is somewhat of a moving target and has been broadly expanded by the case law, creating further challenges for lawyers advising franchisees and franchisors. For example, in one case, the Court of Appeal found that the failure to provide the franchisee with a copy of the head lease or sublease amounted to material non-disclosure.

Defending claims against lawyers in the current climate is an uphill battle: Franchisees are often treated by the courts almost as a "protected class" as judges seem to strive to make findings in their favour in disputes with franchisors over disclosure. Indeed, to some this has created an impression of near absolute liability in favour of franchisees when it relates to disclosure.

As well, the uncertainty regarding what a court may find "material" creates significant risk for lawyers acting for both franchisors and franchisees. Ensuring, at the very least, that clients are aware of this uncertainty in the law, in writing, may serve to avoid or avert a potential negligence claim in the future.

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Buyer beware:

Title insurers' policy sublimits create new risks for lawyers

The increasing popularity of title insurance in Ontario over the past 15 years has created some new risks for lawyers. LawPRO has seen claims against lawyers for not recommending title insurance to clients and for obtaining title insurance without fully informed consent.

As Ontario title insurers get a better understanding of their exposure under their existing title insurance policies, some are changing the terms of those policies. Those changes present significant potential risks to lawyers.

A title insurer may, for example, add to its policy a sublimit on the amount of coverage for a specific issue and/or a specific geographical area. For example, an insurer may put a sublimit of $25,000 for issues related to conservation authority compliance in a specific geographical area.

Assuming that a lawyer does not want to assume the risk for losses over such a sublimit, he or she needs to address two questions:

- Is there an alternative policy available that does not have such a sublimit (although obtaining it for the client may mean additional due diligence)? and/or
- Would the client be better off if the lawyer did the appropriate searches that would enable him or her to give an opinion on the relevant issue?

Either way, the lawyer should always advise the client about the sublimit and what the lawyer is (or is not) doing about it.

The Residential Real Estate Transactions Practice Guidelines, released by the Law Society in January 2007 (see page 23), address the risks related to the use of title insurance in a transaction. A lawyer should aim to have the client's informed consent to the use of title insurance to assure title. If the policy does not entirely satisfy the client's risk in a given area, and the lawyer is not addressing the risk through the traditional method of making searches and opining on the results, the lawyer should obtain the client's agreement that neither the policy nor the lawyer are able to offer protection on the subject issue.