

Make Sure the Financial Statements You Prepare for Franchisors Meet the Necessary Requirements

Since the introduction of the *Arthur Wishart Act (Franchise Disclosure), 2000* (Ontario) (the “Act”), franchisors looking to set up franchises in Ontario have had to learn to prepare their franchise disclosure document (“FDD”) with great care and detail. Otherwise, they run the risk of a potentially unhappy franchisee exercising one of its rights of rescission found under section 6 of the Act. A successful rescission claim effectively allows a franchisee to get out of the franchise agreement that they previously agreed to be bound by and recoup their investment.

Over the last 15 years many legal professionals who provide advice to franchisors have had to get up to speed with the provisions of the Act, related disclosure regulations and the case law that has arisen to establish general principals in respect of franchisor disclosure requirements. That way, they can better assist their clients with interpreting the Act and regulations. However, I suspect that very few accountants have gone to similar lengths to determine what issues may be linked to the financial statements their franchisor clients provide to potential franchisees. This newsletter will help accounting professionals better understand how they can ensure that the product of their relationship with a franchisor does not end up being the root cause of a franchisor’s demise.

Required Standards of Financial Disclosure

One of the most important factors for prospective franchisees to consider when making its decision to become a franchisee of a franchise system is the financial health and viability of the franchisor itself. The Act together with its regulations requires a Franchisor, unless it meets one of the financial disclosure exemptions set out in section 11 of the regulations, to provide:

(i) *an audited financial statement for the most recently completed fiscal year of the franchisor’s operations, prepared in accordance with generally accepted auditing standards that are at least equivalent to those set out in the Canadian Institute of Chartered Accountants Handbook;*
or

(ii) *a financial statement for the most recently completed fiscal year of the franchisor’s operation prepared in*

accordance with GAAP that is at least equivalent to the review and reporting standards applicable to review engagements set out in the Canadian Institute of Chartered Accountants Handbook.

Case law over the last decade has determined that “notice to reader” is not an acceptable standard for financial statements under the Act’s requirements. Courts have also confirmed that internally prepared statements, or simply showing or printing a prospective franchisee information from QuickBooks or other accounting software programs, is not acceptable.

Additionally, stale financial statements, even if prepared in accordance with the standards in (i) or (ii) above, will not meet the requirements under the Act. However, if 180 days has not yet passed since the end of the most recent fiscal year and the financial statements are not yet ready, section 3(2) of the regulations states that the FDD shall include financial statements from the previous year as long as they meet the audit or review engagement standard set out in (i) or (ii) above. For a new start-up franchisor that has operated for less than one fiscal year, or if 180 days has not passed since the end of the first fiscal year and the financial statements are not yet prepared, section 3(3) of the regulations states that the franchisor shall provide an opening balance sheet for the franchisor in the FDD.

Exemptions to Providing Financial Disclosure

If your franchisor client is a large, well-established franchisor that has numerous franchise locations, there may be an exemption under the Act and regulations that

allows the franchisor to be exempt from the financial statement disclosure requirements. Section 11(1) of the regulations sets out a number of criteria that a franchisor must meet to be exempt.

The first of the criteria deals with franchisors that have a net worth of at least \$5,000,000 (or \$1,000,000 if it is controlled by a corporation whose net worth is at least \$5,000,000). The second deals with the number of franchise locations that the franchisor (or the franchisor and the corporation that controls the franchisor) has had over the last five years, being at least 25 locations in Canada or at least 25 locations in one other jurisdiction other than Canada. The third requires that the franchisor (or the corporation that controls the franchisor) has been engaged in the line of business associated with the franchise continuously for no less than five years preceding the date of the FDD. The last requires that the franchisor has not had a judgement, order or award made in respect of fraud, unfair or deceptive practices or a law regulating franchises (including the Act and its regulations), such judgement, order or award being made against it in Canada or in another jurisdiction that it relies on in respect of meeting the second requirement.

It appears the justification for these exemptions from providing financial statements are based on the idea that franchisors who meet all 3 of the criteria should be financially sound and have substantial resources, making it less likely that they will go under or default on obligations to their numerous franchisees. Interestingly though, there are no exemptions from financial disclosure under the legislation and regulations in the United States that govern disclosure from franchisors to franchisees.

Timing Consideration relating to the Delivery of the Financial Statements

As briefly touched upon above, the Act requires that the completed financial statements for any fiscal year be ready for disclosure in an FDD no later than 180 days following the fiscal year end. If a franchisor's statements are not ready 180 days following the end of the fiscal period and the franchisor simply includes the previous year's

statements, those statements will be considered stale and not meet the requirements of the Act and regulations. This can result in a court finding that the financial disclosure for the franchisor is deficient and will likely lead to a franchisee being able to exercise one of its rights of rescission.

Additionally, the Act requires that the FDD be delivered to the prospective franchisee in one document no less than fourteen days before the franchisee signs any agreement or makes any payments in respect of the franchise. This means that a franchisor is not allowed to deliver an FDD that does not contain the financial statements with the idea that it will get the fourteen day time period to start running, only to deliver the financial statements a couple of days later when the accountant has them finalized. To avoid any of these issues, the franchisor and its accountant must work closely and keep each other informed as to when statements will be ready and when the franchisor is looking to deliver an FDD.

Earnings Projections

Although the Act does not require a franchisor to provide an earnings projection or an estimate of annual operating costs as part of the FDD, if the franchisor decides to provide these items to a prospective franchisee at any time (not just as part of the FDD), the franchisor must follow the requirements set out in items 2 and 3 of section 6 of the regulations. As the accountant of a franchisor, you will likely be asked to assist with putting together or reviewing such projections or estimates. If this is the case, you should be aware that the franchisor must provide: (i) a statement specifying the basis for the estimate of operating costs and the assumptions underlying the estimate; and/or (ii) the reasonable basis for each projection and the assumption underlying the projections. Additionally, the franchisor will need to provide a location where information is made available for inspection in respect of such estimates or projections.

Note that neither the Act nor the regulations stipulate that an earnings projection or estimate has to be provided in writing to be caught by the requirements. Therefore, oral

statements made by a franchisor, franchisor's associate or agent to a potential franchisee may trigger certain disclosure requirements. Be sure to ask your franchisor client about what its associates and agents are telling prospective franchisees in respect of earnings projections and estimates for costs during the sales process. You will need to make sure your client includes this information in the FDD and ensure that the necessary assumptions and information are also included and made available. If possible, it would be a good idea for you to work with your franchisor clients in developing the information that is being used by those that are trying to sell franchises to potential franchisees.

Courts have found that the basis for estimates and projections are highly relevant for a prospective franchisee trying to evaluate its investment decision. Not providing all of the requirements under the Act and regulations will likely lead to a finding that the FDD is deficient and the franchisee will be allowed to exercise one of its rescission rights.

The Remedy of Rescission

Sections 6(1) and 6(2) of the Act provide for two different rights of rescission: (i) the first being a right the franchisee may exercise within 60 days of receiving the FDD if the FDD was not delivered at least fourteen days before the franchisee signed an agreement or provided any payment in respect of the franchise, or if the contents of the FDD did not meet the requirements of section 5 of the Act, and (ii) the second being a right the franchisee may exercise no later than two years after entering into the franchise agreement if the franchisor never provided the FDD.

Case law has demonstrated that the courts have strictly adhered to the wording of the Act and regulations when determining whether financial statements delivered by a franchisor meet the requirements. Failing to deliver financial statements or failing to deliver financial statements that meet all the prescribed requirements has generally been found to be a fatal deficiency. Courts have concluded that such a flaw can disqualify the delivery of the FDD and allow a franchisee to apply for the remedy of

rescission within two years of entering into the franchise relationship instead of only within the 60 day timeframe of receiving the FDD.

Consequences of Rescission

If a franchisee is successful in exercising one of its rights of rescission under either section 6(1) or 6(2) of the Act, the franchisor (or franchisor's associate), within 60 days of the exercise of rescission, shall be required to: (a) refund any monies received from or on behalf of the franchisee (other than money for any of the items set out in (b) or (c) below); (b) purchase back from the franchisee any inventory that the franchisee purchased pursuant to the franchise agreement and is remaining at the effective date of rescission (at the same price as paid by the franchisee); (c) purchase back from the franchisee any supplies and equipment that the franchisee purchased pursuant to the franchise agreement (at the same price as paid by the franchisee); and (d) compensate the franchisee for any losses incurred by the franchisee in acquiring, setting up and operating the franchise (minus any amount already accounted for in (a), (b) or (c)).

The four obligations mentioned above (which are set out in more detail in section 6(6) of the Act), being to refund and repurchase inventory, supplies and equipment from the franchisee are not only obligations of the franchisor; these obligations also extend to the franchisor's associates. A franchisor's associate is defined to include, among others, someone who, directly or indirectly, controls the franchisor as well as someone that is directly involved in the grant of the franchise. This means that owners, directors and officers of a franchisor client may also be found to be personally liable for compensating the franchisee under section 6(6).

It is worth pointing out that a rescission right exercised by a franchisee based on a defect in the financial disclosure provided (or not provided) by the franchisor usually falls under the two year rescission right of section 6(2) and likely comes with a higher price tag for the franchisor and its associates to pay, given that there could be more expenses and more losses associated with operating a

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franchise for almost two years as opposed to 60 days. Courts have determined that the franchisee does not have to suffer any losses while operating the franchise for the franchisee to be able to exercise its rights of rescission. Additionally, neither the franchisor nor any of the franchisor's associates are entitled to any discount or offset in respect of profits made by a franchisee exercising such rights.

How to Add Value for the Franchisor Client

Accountants providing advice to franchisor clients can add additional value to their client relationships by ensuring their franchisor clients are aware of the required reporting standards for financial statements under the Act and regulations, understanding the timing issues that their franchisor clients face and working to meet the deadlines under the Act for completing the most recent fiscal year-

end financial statements. Accountants should also work closely with any franchisor clients when they are preparing operating cost estimates and earnings projections, ensuring the franchisor client is using reasonable assumptions and also documenting such assumptions properly in the FDD.

Accountants are not the only professionals that franchisors need to work closely with in preparing and keeping the FDD up-to-date. However, it has been well documented in case law that errors in providing financial disclosure to a prospective franchisee are generally fatal to the assertion of a franchisor that it has fulfilled its obligation to provide an FDD. Having a handle on the requirements related to financial disclosure in the Act and the regulations will help an accountant ensure that it is not his or her work product or advice that has potentially subjected the franchisor to an expensive claim for rescission by an unhappy franchisee.

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