



# Lessons Learned

*A continuing column drawing lessons for franchise systems from franchise litigation and other sources.*

By: David E. Holmes, a founding partner of Holmes & Lofstrom, LLP.

## Canada

### **U.S. UFOC Fails to Satisfy Canadian Requirements; U.S. Franchisor Obligated to Disclose Unit-Level Financial Data in Assignment Scenario; Release Saves the Day**

Wise Franchisors learn from other Franchisors, whether from their mistakes or the things they do right, including those operating outside the U.S.

A recent Ontario, Canada, case ([1518628 Ontario, Inc. v. Tutor Time Learning](#)) serves to provide us with some of those lessons, both for Franchisors operating in Canada and in the U.S., as well as posting a warning about the possible application of Ontario's franchise law in ways not normally anticipated by U.S. companies.

This dispute arose out of an assignment of a Tutor Time franchise from an existing Franchisee to a new Franchisee, and to which the Franchisor consented.

To summarize the facts, the existing Franchisee, which was experiencing operational and financial challenges, contacted Tutor Time when the existing Franchisee had identified a buyer, and requested Tutor Time's consent to the sale. In the course of processing the sale, Tutor Time notified the buyer that it had not yet completed preparation of the disclosure document required under Ontario law, but provided the buyer with Tutor Time's U.S. UFOC "for informational purposes only." At no time did the buyer receive an Ontario-specific disclosure. (Why Tutor Time did not supply an Ontario-specific disclosure, prior to consenting to the sale, given that it was apparently aware that

☐ Northern California Office

4251 S. Higuera St., Suite 401 · San Luis Obispo, CA 93401  
Phone: 805.547.0697 · Fax: 805.547.0716



☐ Southern California Office

6621 E. Pacific Coast Hwy., Suite 250 · Long Beach, CA 90803  
Phone: 562.596.0116 · Fax: 562.596.0416

## Lessons Learned

Ontario had a franchise disclosure requirement in place, was not detailed in the judge's decision[MC1].)

[While the wording of the decision suggests that the buyer signed the then-current franchise agreement at the time of transfer, counsel handling the case states, in separate correspondence, that they did not in fact do so; no new franchise agreement was ever signed. Counsel plans to write to the judge to affirm this point in the reported decision, since the decision currently implies a fact situation different from reality.]

Subsequently, the new Franchisee had difficulties operating the unit and ultimately sold the business (without the franchise) to a new purchaser, and then filed this lawsuit against Tutor Time, claiming that there had been a violation of Ontario's franchise law, which generally requires pre-sale disclosure using a Ontario-specific document.

In a lengthy, detailed opinion, the trial court judge concluded that Tutor Time had an obligation to provide a disclosure document to the buyer, since Tutor Time had, among other things, required the husband of the sole shareholder of the buyer to guaranty the obligations of the buyer (other factors were present, but were not emphasized to the same degree by the court), an obligation which did not previously exist. While a U.S. court, or U.S. franchise counsel, might not have placed as much emphasis on this factor as others, the result is not entirely surprising, since an argument can be made that under the Ontario franchise law that since the husband was undertaking financial obligations with respect to the franchise, he should receive an appropriate disclosure.

Next, the court held that providing the U.S. UFOC did not satisfy the requirements of Ontario's franchise law. Again, while this portion of the decision might be debatable, it probably is not too surprising to experienced international franchise counsel since, in general, the requirements of each country's franchise disclosure laws differ.

The next portion of the decision, however, is surprising to most experienced international franchise counsel, particularly to those in the U.S. The facts in evidence apparently indicated that the seller's financial statements, as provided to the buyer, did not include certain past due obligations to Tutor Time. In addition, Tutor Time's field service person responsible for inspections, etc. of the

## Lessons Learned

unit was aware of certain regulatory problems, accounting irregularities and issues relating to overall management relating to the unit.

As would be typical in the U.S., Tutor Time did not share any of these issues with the buyer, at least prior to the sale. The court concluded that, under the Ontario franchise law, the Franchisor had a duty to disclose “all material facts” and that included the issues and problems relating to the unit and known to Tutor Time. In the court’s opinion, Tutor Time violated that duty by failing to make disclosure of those “material facts” to the buyer.

This result would be unusual in most U.S. jurisdictions, and few U.S. Franchisors conceive of it as being their obligation to share with potential buyers issues of which the Franchisor is aware with respect to the seller, his operations, finances, or otherwise. In fact, absent an appropriate provision in the seller’s Franchise Agreement, disclosure of such issues without the seller’s consent may expose the Franchisor to a lawsuit by the seller, especially if it results in the prospective buyer walking away from the deal. In this case, the Judge states that, if asked, the seller would probably have consented to such disclosure, a fact assumed by the Judge with no apparent evidentiary support and one at odds with the experience of most Franchisors in similar circumstances.

However, in the final portion of the opinion, Tutor Time escaped liability as a result of the buyer having, months after the sale, signed a release in favor of Tutor Time. Whether one puts this down to luck, or the wisdom of getting releases, is for the reader to decide.

### Lessons Learned:

1. Whenever a Franchisor does more than merely consent to an assignment, it should carefully review, with counsel familiar with the laws of the country concerned the need to provide a disclosure document meeting all applicable local requirements, and to all parties on the buyer’s side of the transaction.
- 1A. When drafting a franchise agreement, the Franchisor should (after advice from legal counsel) insert a requirement that each spouse of a principal of the transferee may be required to sign, among other things, a personal guaranty. In this case, this step would have supplied the “right” in the Franchisor (rather than simply the “power”) to make such a demand in this

## Lessons Learned

- case as a condition of consent to the transfer, and the exemption to disclosure might possibly have been upheld.
2. If ever in doubt, disclose, using a disclosure document meeting all applicable local requirements. The costs (in delay and dollars) are far less than those of even winning a lawsuit, let alone losing it.
  3. Do nothing in a foreign jurisdiction without getting advice of local counsel, experienced in franchising.
  4. Don't assume that a U.S. UFOC satisfies the requirements of other countries. In very few, if any, cases will it do so, at least without modification, and sometimes substantial modification.
  5. In every possible instance, get a release from the Franchisee; it has the virtue of being able to cure a multitude of sins, even those committed in ignorance.

*David Holmes has practiced domestic and international franchise law for more than 30 years. David earned his undergraduate and law degrees from the University of Southern California. He specializes in franchise law, including structuring franchise systems, drafting registration documents, legal compliance, litigation management and negotiations. He also serves as an expert witness on franchising matters in both federal and state courts and has taught graduate level business law courses at California State University, Long Beach. He contributes to the publications and committees of the International Franchise Association, American Bar Association and California State Bar.*