Assessing Materiality in Franchise Disclosure Documents: A Canada-U.S. Analysis

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Franchise law practitioners in the United States and Canada (and elsewhere) must be intimately familiar with the concept of materiality. The core principle behind Canadian and U.S. franchise disclosure laws is the requirement to disclose information that a prospective franchisee considers material to the proposed franchise relationship. Franchisors and their legal counsel therefore must be able to determine effectively and assess material information in order to ensure proper and accurate disclosure to prospective franchisees. Failing to provide material information to prospective franchisees exposes franchisors and their principals to both civil and, in some jurisdictions, criminal penalties from applicable authorities, and often protracted and expensive claims for rescission and other legal action from their franchisees.

This article focuses on the concept of materiality and materiality assessments with respect to franchise disclosure requirements in the United States and Canada through a review of the regulatory framework as well as certain court decisions that elaborate upon the obligation to disclose material information relevant to a franchise offering. It also addresses the practical issues of making disclosures, including questions of disclosing potentially confidential information and the frequency and timing and other practical considerations when making materiality assessments. Many of the materiality principles examined here apply equally in other franchise disclosure jurisdictions around the world.

THE IMPORTANCE OF MATERIALITY

In both Canada and the United States, franchise legislation mandates the kind of information that must be disclosed to prospective franchisees in a disclosure document. Franchisors, however, may have some latitude when determining whether information is material and therefore must be disclosed. For example, a franchisor has discretion to determine whether a particular litigation action, not otherwise statutorily required to be disclosed, is material in scope. Additionally, in the provinces of Ontario, Prince Edward Island (PEI), New Brunswick (NB), and Manitoba, franchisors have a general requirement to disclose "all material information" to prospective franchisees, in addition to the enumerated list of disclosures specifically required to be disclosed by regulation. Materiality is the standard by which information is measured to determine whether it must be included within a disclosure document.

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Of course, guidelines or standards for what is considered material and what is not considered material can be, at least to a certain extent, established by law or rule without context. For example, rules can delineate a threshold percentage at which the departure of a certain number of the franchisees in a franchise system rises to the level of a "material event." But guidelines and laws are not capable of addressing material information in every situation and from the perspective of every franchise investor.

Generally speaking, a statement is material if a reasonable investor considers it important in deciding how to act.[1] The materiality of a statement or omission in a disclosure document therefore depends on the context in which it is made or omitted. Material information in a franchise disclosure document can vary depending on the industry, the size and configuration of the franchisor, and the experience and profile of the franchisee. The materiality of information also depends upon the context of the people who are disclosing and receiving the information. Information that a franchisor believes not to be material may, in fact, be material to a prospective franchisee. For this reason, it is the perspective of the recipient (in the franchise context, the prospective franchisee) that matters most when making a materiality determination.[2]

National origin as well as cultural and linguistic differences may also have an impact on the materiality of information in a franchise disclosure document. Prospective franchisees in another country or perhaps even within different parts of that country could view information differently than prospective franchisees in the franchisor's own country. Although this discrepancy is possible even in two (at least predominantly) culturally similar countries like Canada and the United States, the general principles of materiality in franchise disclosure documents are largely uniform between these two countries. Nevertheless, there are some significant differences in the way that material information is assessed and disclosed in Canada and the United States. Where applicable, this article addresses these differences.

CANADA

STATUTORY FRAMEWORK

Currently, only the provinces of Ontario, Alberta, PEI, and NB have franchise legislation and regulations in effect.[3]

Though at first glance the various franchise disclosure statutes in Canada appear to be very similar to each other in substance and in form, there are significant variations among these statutes that impact materiality assessments. For example, the definition of *material fact* is broader in the *Ontario Act* than, as noted below, in the other franchise disclosure statutes in Canada. Furthermore, the disclosure obligation generally in the franchise disclosure statutes of each of the provinces of Ontario, PEI, NB, and Manitoba require franchisors to disclose "all material facts" along with all material facts as prescribed, whereas the *Alberta Act* simply requires disclosure of certain information prescribed by its regulations.[4]

Franchise disclosure jurisdictions in Canada obligate franchisors to provide disclosure to prospective franchisees in the form of a disclosure document that is provided to the franchisee not less than fourteen days before the earlier of (1) execution of a franchise agreement or any other agreement relating to the franchise with the franchisor or franchisor's associate, and (2) payment of any monies to the franchisor or franchisor's associate.[5]

DEFINITION OF *MATERIAL FACT*

To correctly identify the information that must be included in a disclosure document in Canada, one should first carefully consider the particular requirements of the applicable provincial franchise disclosure legislation. Each franchise disclosure statute provides a list of information and a number of prescribed statements that a franchisor is required to include in its disclosure document. Although the definition of *material fact* included in each provincial statute is similar across each of the Canadian franchise disclosure jurisdictions, one subtle difference among them may result in very significantly different disclosure requirements.[6]

As noted above, each of the provinces of Ontario, NB, PEI, and Manitoba does not limit disclosure only to those items specifically enumerated by regulation. That is, the statutes for these provinces require a franchisor to disclose not only all of the material facts that are explicitly identified by regulation but also all other material facts given its catchall disclosure requirement, which obliges franchisors to disclose in their disclosure documents all material facts, including material facts as prescribed.

This catch-all disclosure obligation requires franchisors issuing disclosure documents in the provinces of Ontario, NB, PEI, and Manitoba to consider the disclosure of not only the prescribed disclosures set out by regulation but also any other material fact pertaining to the "business, operations, capital or control of the franchisor or 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."[7] As a result, franchisors issuing disclosure documents in these provinces will be required to conduct a much broader and more comprehensive audit of their franchise systems to ensure that all material facts are in fact disclosed.[8] There is no such comparable disclosure requirement in Alberta or the United States. This open-ended disclosure obligation makes a franchisor's materiality assessment exercise a very difficult and onerous one, particularly for franchisors that regularly issue disclosure documents. Particularizing disclosure documents for each and every franchise sale situation is a time-consuming and costly endeavor. Nonetheless, the consequences for failing to do so more than justify dedicating the resources necessary to ensure full compliance.

DEFINITION OF *MATERIAL CHANGE*

Each of the franchise disclosure statutes in Canada also requires disclosure of any "material changes" that occur between the date of the initial disclosure to the prospective franchisee and the date upon which the franchisee signs any franchise agreements or pays any monies to the franchisor or its associates.[9] In the event of such a change, a franchisor is required to provide its prospective franchisee with a material change statement. This is presumably required to ensure that the disclosure document is current on the date upon which an agreement is entered into between a franchisee and the franchisor or its associates and any monies are paid to the franchisor or its associates. To determine whether a particular change requires the issuance of a material change statement, one must consider the applicable statutory definition of the term *material change*. The *Ontario Act*, for example, defines *material change* in part as a "change in the business, operations, capital or control of the franchisor or franchisor's associate, a change in the franchise system or a prescribed change, which would reasonably be expected to have a significant adverse effect on the value or price of the franchise to be granted."[10]

The definitions of *material change* in the *New Brunswick Franchises Act* (*NB Act*),[11] the *Prince Edward Island Franchises Act* (*PEI Act*),[12] and the *Manitoba Franchises Act* (*Manitoba Act*)[13] include a change in the "franchise" in addition to a change in the business, operations, capital, or control of the franchisor or franchisor's associate and a change in the franchise system and thus are significantly broader than the applicable definitions set out by the *Alberta Franchises Act* (*Alberta Act*)[14] and the *Ontario Act*.[15] Franchisors offering franchises in the provinces of PEI and NB (and Manitoba once its franchise disclosure legislation is in full force and effect) are therefore required to disclose material changes that relate specifically to the franchise being offered.

Finally, franchisors need to further consider the definitions of *material fact* and *material change* with respect to how any information concerning the franchise system 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."[16] What is deemed reasonable and having a significant effect on either the value or price of the franchise or the prospective franchisee's decision to acquire the franchise is a question that franchisors must constantly address when preparing and updating disclosure documents in Canada.

SUBSTANTIAL COMPLIANCE

It is important to note that each of the Canadian franchise disclosure statutes renders void any attempt by franchisees or franchisors to contractually waive any rights that they may have under the franchise legislation. Some Canadian franchise disclosure jurisdictions have made attempts to soften the implications of a less-than-perfect disclosure document. Section 2(4) of the *Franchises Regulation* (*Alberta Regulations*),[17] for example, provides that a "disclosure document is properly given for the purposes of section 13 of the *Alberta Act* if the document is substantially complete."[18] In other words, if a disclosure document is somewhat deficient yet substantially complete, a franchisee may be barred from exercising its right of rescission under section 13 of the *Alberta Act*. Not surprisingly, however, the *Alberta Regulations* do not provide any guidance as to what would constitute a substantially complete disclosure document. The Alberta Court of Appeal in *Hi Hotel Ltd. Partnership v. Holiday Hospitality Franchising Inc.*[19] ruled that no substantial compliance defense was available where the franchisor failed to include a signed certificate of disclosure. The court held that the presence of an unsigned certificate of disclosure rendered the disclosure document so deficient that the substantial compliance defense could not possibly be relied upon.

CONSEQUENCES FOR NONCOMPLIANCE

Franchisors in Canada must adhere strictly to the statutory and common law disclosure obligations as failure to do so may result in significant adverse consequences to franchisors and those associated with their franchise systems. If a court were to rule that a franchisor entirely failed to provide a disclosure document or provided a materially deficient disclosure document to a prospective franchisee, the franchisee may not only be given a statutory right of rescission, it may also have a cause of action for misrepresentation against the franchisor; its agents, brokers, and associates; and every person who signed the certificate of disclosure.

Each of the Canadian franchise disclosure statutes provides remedies for franchisees in two distinct situations:

1. One in which no disclosure document was issued to a prospective franchisee, which would provide such a franchisee a two-year window following the execution of the franchise agreement to exercise the statutory rescission remedy.d
2. Another in which a disclosure document was delivered late or the contents of the document did not meet the requirements of the franchise disclosure statute, which would provide a prospective franchisee a sixty-day right of rescission.[20]

Canadian courts have had to confront the difficult task of determining whether a disclosure document riddled with deficiencies should trigger a two-year or a sixty-day right of rescission. Given the wide discrepancy between these two remedies, it is important to consider how the Canadian courts have addressed this issue to date.

In one Ontario Superior Court of Justice decision,[21] the court considered a situation in which a U.S. Uniform Franchise Offering Circular (UFOC) was given to a prospective franchisee without the franchisor first conforming the UFOC to Canadian disclosure requirements and without any accompanying disclosures to address the unique aspects of the Canadian franchise offering. In particular, the UFOC was missing material facts and did not strictly adhere to the Ontario statutory disclosure obligations. The court ruled that the subject UFOC did not amount to a disclosure document at all and that the franchisee therefore had a full two years to rescind the franchise agreement.[22]

The Ontario Superior Court of Justice in *Sovereignty Investment Holdings Inc. v. 9127-6907 Quebec Inc.* ruled that many immaterial deficiencies could not on a cumulative basis invalidate a disclosure document.[23] However, in this case, there were four material deficiencies, any one of which on its own would have been sufficient to invalidate the disclosure document. Namely, financial statements were not included in the disclosure document; no statement specifying the assumptions for the earnings projections was provided, and no information as to where any assumptions could be substantiated was provided; it was not delivered at the same time as one document contrary to section 5(3) of the *Ontario Act*; and there was no certificate of disclosure provided to the prospective franchisee.[24] The court attempted to distinguish between section 6(1) (the sixty-day rescission remedy) and section 6(2) of the *Ontario Act* (the two-year rescission remedy) and reasoned as follows:

> Section 6(1) is directed to the situation in which the franchisee was unable to make a fully informed decision as a result of inadequate time for consideration of such decision or inadequate disclosure of the material facts. Section 6(2) is directed to the situation in which the franchisee is unable to make an informed decision at all because of fundamental deficiencies in the disclosure provided to it.[25]

In this case, the court held that section 6(2) was applicable, thereby allowing the aggrieved franchisee to rescind the franchise agreement within the two-year period following the date on which it entered into the franchise agreement.[26]

UNITED STATES

STATUTORY FRAMEWORK

In the United States, both the federal government and certain states promulgate franchise legislation. Prior to 2007, federal franchise regulations under the Federal Trade Commission's franchise disclosure rule (FTC Rule)[27] had defined the term *material* as

> any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or which has any significant financial impact on a franchisee or prospective franchisee.[28]

When the FTC Rule was amended in 2007, the FTC decided that it was no longer necessary to include a definition of *material* within the Rule because "an understanding of materiality under the final amended Rule can best be gained by looking to long-established Commission jurisprudence . . . [of which] materiality is a cornerstone concept of that jurisprudence."[29] Because violations of the FTC Rule constitute violations of section 5 of the FTC Act,[30] the FTC believes that the jurisprudence that has developed around the interpretation of section 5 provides adequate guidance on what the term *material* means in the franchise disclosure context.[31] Materiality is, according to the FTC, determined by the reasonable consumer standard or, in franchise matters, by the reasonable prospective franchisee standard.[32]

Whether materiality is judged under the old FTC Rule definition or the amended FTC Rule's reference to section 5 jurisprudence, the FTC considers material information in a franchise disclosure document to be information that is likely to affect a prospective franchisee's investment decision with respect to purchasing a franchise. But what information, precisely, is likely to affect a prospective franchisee's decision-making process, and from whose perspective must this information be judged? The FTC addresses part of this question in the *Amended Franchise Rule FAQs*, where FAQ 21 asks whether a franchisor may require a prospective franchisee to identify the information in the disclosure document that it would regard as material.[33] The FTC's response to this question is that "a prospective franchisee is entitled to regard as material each and every statement in [(or that is required to be in)] a franchise disclosure document."[34]

The FTC therefore considers every required disclosure in a disclosure document to be material under the FTC Rule. There may, in addition, be information not otherwise required to be disclosed under the FTC Rule that could nevertheless be considered material to a prospective franchisee.[35] On this point, however, the language of the FTC Rule actually prohibits franchisors from including information in their disclosure documents other than information that is required or permitted by the FTC Rule or by state law not preempted by the FTC Rule.[36] According to the FTC, this prohibition is necessary to ensure that franchisors do not fill a disclosure document with unnecessary information or features that will distract prospective franchisees or discourage them from reading the document.[37] The FTC recognizes that it may be desirable to include additional material information in a disclosure document to ensure that required disclosures are accurate; thus, the FTC Rule does not preclude franchisors from providing other information to prospects orally, visually, or in separate literature as long as that information does not contradict the information in the disclosure document.[38] Franchisors also are permitted under the FTC Rule to add footnotes and other clarifications that may fall outside of specifically required information in order to ensure that disclosures are complete and not misleading.[39]

Much, if not most, of the disclosure required under the FTC Rule is made using an objective standard and does not require a materiality analysis. Examples include the existence of an affiliate that offers franchises, an officer or director of the franchisor, a fee that the franchisor charges to franchisees, or a principal trademark used in connection with the franchised system. If the fact or information is both required and present, there is no need to make a materiality determination. But, as we will discuss below, there are other required disclosures under the FTC Rule that are more subjective in nature and that, depending on the circumstances, may or may not be required to be disclosed.[40]

MATERIALITY UNDER UFOC GUIDELINES AND FDD GUIDELINES

The North American Securities Administrators Association (NASAA) developed the UFOC Guidelines in 1986 (modified in 1993).[41] In 2008, NASAA adopted the 2008 Franchise Registration and Disclosure Guidelines (FDD Guidelines) in response to the amended FTC Rule, and the disclosure requirements under the FDD Guidelines are very similar to those under the FTC Rule (which was less the case under the UFOC Guidelines). The FDD Guidelines largely amend and restate the UFOC Guidelines and retain many of the same standards as the UFOC Guidelines. The FDD Guidelines, however, notably drop the UFOC Guidelines' discussion of materiality in the context of litigation disclosures.[42]

The historical standards for materiality adopted under the UFOC Guidelines and established through cases decided under the UFOC Guidelines nevertheless remain applicable and instructive as to what is and is not material in a U.S. franchise disclosure document.[43]

United States v. Building Inspector of America, Inc. is an example of a case considering the materiality of certain litigation disclosures under the old UFOC Guidelines.[44] There, a franchisor was required to disclose an action in its UFOC but did not do so for a certain period of time. In defending the fact that the action was not included in some of its UFOCs, the franchisor claimed that it was not required to do so because the action was not material within the meaning of the UFOC Guidelines as it involved an amount ($15,000) that was less than 15 percent of the company's assets.[45] Although the court acknowledged that one of the definitions of materiality (in the UFOC Guidelines at that time) used the 15 percent test, it held that such test was not dispositive in this case.[46] Instead, the court noted that the action was material because another franchisee had claimed that the franchisor had violated the FTC Rule, which could bring into doubt the integrity and competence of the franchisor regardless of the actual amount of damages claimed.[47]

Although replaced by the newer FDD Guidelines, the materiality discussions in the UFOC Guidelines, notably the materiality threshold noted above for disclosure of certain actions, remain relevant to a franchisor's litigation materiality analysis. Materiality determinations made under the FDD Guidelines, whether for litigation disclosures or otherwise, should not differ from those made under the FTC Rule.

STATE LAW AND REGULATORY VARIATIONS

Like the amended FTC Rule and the UFOC/FDD Guidelines, most U.S. state franchise registration and disclosure laws do not define what is material in the context of a franchise disclosure document.[48] State franchise registration and disclosure laws generally prohibit a franchisor from offering or selling a franchise by making an untrue statement of a material fact, or omitting to state a material fact necessary to make a statement not misleading.[49] These state disclosure requirements are also commonly known as the "antifraud" provisions of their respective state franchise laws. This requirement applies not only to the content of a disclosure document but also to the content of a franchise registration application submitted along with the disclosure document.

The language of state antifraud provisions can help determine the materiality of information to be included in, or information that has been omitted from, a disclosure document. Under state antifraud language, and in general, franchisors must not make an untrue statement of a material fact or omit a material fact in a disclosure document.[50] But these statements or omissions also in general relate to information that is required to be disclosed, or relate to the circumstances in which the statements (or omissions) are made (e.g., state disclosure laws and regulations). Of course, there could be information material to a prospective franchisee's decision that is not otherwise required to be disclosed (or contemplated) under the FTC Rule or state law. In other words, is information material if it falls outside the scope of required disclosures? This question relates to the FTC Rule's prohibition against including information in a disclosure document other than that which is required by the Rule (or by state law, not preempted by the Rule).

A recent case considering this issue in the context of a financial performance representation is *Colorado Coffee Bean, LLC v. Peaberry Coffee, Inc*.[51] In that case, plaintiffs claimed that the franchisor committed fraud in connection with an earnings claim[52] by not disclosing certain additional information (e.g., cost and other information) indicating that the company-owned outlets were unprofitable.[53] Although the court ultimately ruled against plaintiffs on this issue on other (exculpatory) grounds, the court nevertheless found that the franchisor's failure to disclose profitability of the outlets was an omission of material information for plaintiffs.[54]

Colorado Coffee Bean also addressed whether a franchisor has an obligation to disclose financial information in addition to the information contained in its own financial statements. Plaintiffs' claim in this respect was that the franchisor fraudulently failed to disclose that its parent company (which operated the company-owned outlets) had suffered significant financial losses.[55] Although the trial court again ruled in favor of the franchisor for the same exculpatory reasons,[56] it also found that the franchisor actively and purposefully concealed material financial information from plaintiffs.[57]

In *Colorado Coffee Bean*, the parent company was not acting as a guarantor; thus, under the FTC Rule, the franchisor was not required to include the parent's financial statements in its disclosure document. The franchisor argued that the FTC Rule's prohibition on nonrequired information meant that the FTC Rule actually prohibited the franchisor from including its parent company's financial statements.[58] The court rejected this argument, noting that the relevant provision of the FTC Rule[59] deals only with "financial statements" and that the FTC Rule "does not preclude franchisors . . . from giving other non-deceptive information orally, visually, or in separate literature so long as such information is not contradictory to the information in the disclosure statement."[60] In this way, "franchisors are always free to disseminate additional truthful material information to a prospective franchisee."[61]

State laws also require franchisors to update and amend their franchise registrations if there is a material change in the information previously filed and registered with the state.[62] Many states further define what constitutes a material change requiring the amendment of the disclosure document[63] and also define what constitutes a material change or a material event.[64] These definitions vary by state, but events under various state laws that constitute a material change requiring an amendment under applicable regulations may include, among others, (1) termination of more than 10 percent of the system's franchisees during a three-month period, (2) reorganization or change in control of the franchisor, (3) changes in franchise fees charged to the franchisee, (4) changes in the goods or services that the franchisee may offer, and (5) any new products or services requiring an additional investment.[65] If there is a material change to the information previously disclosed in a disclosure document and registered with a state, state law will require franchisors to file an amendment to the state registration updating the disclosure document with any new material information.

A franchisor that violates these laws by making material misstatements or omissions in its disclosure document will generally be liable to the persons who, while relying on the information provided, purchased a franchise.[66] Some states, however, do not require a franchisee to have relied on this information in order for it to be a violation of state law. Some states also recognize an exception for franchisors that can prove that a franchisee knew the facts concerning the untruth or omission or that the franchisor (in exercising reasonable care) did not know and could not have known of the untruth or omission. Remedies under state law for failures to make proper disclosures include criminal liability, state-imposed penalties, civil liability for damages (in some cases up to treble damages), and rescission.[67] The severity and consequences of a franchisor's liability will depend on the circumstances of the misstatement or omission and the state(s) that are relevant to the alleged violations.

States also have a hand in making materiality judgments for or on behalf of franchisors. Most often, these judgments are rendered in the form of comments from state examiners in franchise registration states who believe that certain information must be included in a disclosure document. Some of this information may be of the objective standard under the FTC Rule or FDD Guidelines. But other information that state examiners require franchisors to include can be more subjective in nature.

For example, a state may mandate an additional "risk factor," which is a disclosure that is so important that it must be highlighted on the cover page of the disclosure document. Risk factor disclosures (whether franchisor-initiated or state-mandated) often relate to a nascent franchise program or the franchisor's or its parent company's financial condition. The FTC Rule does not require the disclosure of risk factors, but the FDD Guidelines do require disclosure of risk factors regarding venue and choice of law, and leave open the possibility that states can require franchisors to disclose additional risk factors. Some franchisors may determine on their own that certain information warrants disclosure as a risk factor. This is a subjective determination for which the franchisor must weigh the materiality of the issue as well as the presence and sufficiency of any other disclosures in the franchise disclosure document that address this information.

Perhaps more often it is the state regulators who, in reviewing a disclosure document, determine that certain information should be disclosed as a risk factor. Once a state requires a particular risk factor, the franchisor must then determine if that particular risk factor is material enough to be disclosed in other states. The NASAA Commentary to the FDD Guidelines addresses this issue.[68] It states that a franchisor must determine on its own whether one state's risk factor requirement is material in other states. The FDD Guidelines state that

> [a] risk factor imposed by one state may well be material to prospective franchisees in other states and may be included in the franchisor's state cover page in other states. State franchise laws have no extraterritorial effect, however, and the requirements of one state should not automatically be imposed on a franchisor's offers in another state.[69]

MATERIALITY ASSESSMENT: HOW OFTEN AND WHEN?

CANADA

Canadian franchise disclosure statutes impose an evergreen disclosure requirement upon franchisors: disclosure documents must be materially up-to-date at the time of each and every disclosure. A disclosure document must contain all material facts as prescribed, and the determination of what constitutes materiality is to be made immediately before each and every disclosure.[70] In addition, and as a general rule, a franchisor has an ongoing obligation to update its form of disclosure document on a regular basis if there are material changes in the information since the date of the earlier disclosure document.[71]

As for the need and frequency of issuing material change statements, this depends upon whether there has been a material adverse change at any time between the period of the initial or most recent disclosure and the execution of the franchise agreement (or any other agreement relating to the franchise) or the receipt of any funds by the franchisor or any of its associates with respect to the franchise. If a material change has occurred at any time during this period, then a franchisor is required to provide the prospective franchisee with a material change statement "as soon as practicable after the change has occurred" but before the earlier of any agreement is signed or any monies are received.[72]

Canadian franchise disclosure statutes predominantly do not provide any guidance as to the substance, content, or form of a material change statement.[73] A prospective franchisee should, however, be afforded the benefit of receiving and reviewing a material change statement with its legal counsel at least a couple of days before signing any agreement or making any payment. It has also become accepted practice to draft a material change statement containing a certificate of material changes that is certified by the officers and/or directors of the franchisor.[74] This is because each of the franchise disclosure statutes (except for the *Alberta Act*) implies that such a certificate is necessary.[75]

Franchise counsel must consider the following counterintuitive disclosure requirement in the face of a material change. Specifically, counsel must consider whether a franchisor must provide a prospective franchisee with a material change statement or an entirely updated disclosure document. A material change statement requirement only arises when there is a change in the franchise system or a prescribed change that would reasonably be expected to have a significant adverse effect; and in such circumstances, a material change statement may be provided immediately before the execution of any agreement or the payment of any monies, and there would be no delay in the disclosure process. Yet, if there is simply a material change that is not significantly adverse and that occurs before a franchisor enters into an agreement or receives any monies, then the franchisor is required to provide a new full disclosure document (reflecting the change) and wait an additional fourteen days before executing any agreement or receiving any monies. It is unclear whether Canadian legislators had this result in mind when imposing these uneven statutory waiting periods.

In certain circumstances, a completely new disclosure document is required for any new material changes that occur to the disclosure document, the franchise agreement, other agreements, or the franchising relationship before the consummation of the franchise grant (i.e., the execution of the franchise agreement or other agreements and the receipt of any funds in this regard). Changes to a franchise agreement or to certain disclosures that are warranted due to improper or inaccurate disclosures or omissions in a disclosure document may need to be provided either in a new disclosure document (thereby resetting the fourteen-day waiting period) if such information is specifically required to be disclosed by regulation, or in a material change statement if such information is deemed significantly adverse.

The issue of materiality may arise in Canada in certain other postdisclosure settings as well as on certain occasions when a franchisor is required to provide a disclosure document to an existing franchisee. This postsale disclosure requirement arises when an existing franchisee is required to enter into a supplemental agreement with the franchisor during the term of the franchise agreement. In Canada, franchisors are obligated to disclose to "prospective franchisees." Upon first analysis, given the term *prospective franchisee*, the disclosure obligation appears to be triggered only when dealing with a prospect that has yet to enter into a franchise agreement and in a situation where no disclosure obligation would arise with respect to an existing franchisee. Yet, the definitions of *prospective franchisee* and *franchise agreement* are rather broad:[76] they widely include any person who is invited by a franchisor or its associate, agent, or broker to execute an agreement or who has indicated an interest to enter into any agreement that relates to a franchise between a franchisor or its associate and a franchisee. The definitions of *prospective franchisee* and *franchise agreement*, therefore, are sufficiently expansive to impose a disclosure obligation on a franchisor even with respect to existing franchisees. Thus, consistent with the foregoing disclosure obligation to existing franchisees, it is important to consider the unique disclosure issues and obligations that arise in Canada specifically with respect to the transfer, renewal, and resale of franchises that have already been granted.[77]

UNITED STATES

Timing issues are very important when making franchise disclosures in the United States. Franchisors are required to update a franchise disclosure document with new material information at varying times under federal and state law. Once a franchise disclosure document is initially prepared, a franchisor's obligation to update the document with material information is not over. In addition to annually updating a disclosure document no more than 120 days following the close of each fiscal year, the FTC Rule requires franchisors to update disclosures with new material information at various intervals: (1) franchisors must update within a reasonable time after the close of each fiscal quarter to reflect any material changes; and (2) when a franchisor furnishes an Item 19 financial performance representation (earnings claim) disclosure, it must notify prospective franchisees of any material changes of which they are (or should be) aware.[78] Franchisors selling franchises in the United States are therefore required under the FTC Rule to consider on an ongoing basis whether it is necessary to update and amend a disclosure document to include new material information, as well as when those changes should be made. The quarterly updates can be prepared in a separate addendum to the disclosure document, and prospective franchisees must receive both the disclosure document and quarterly revisions at the time that the disclosure document is provided.

Under applicable state law, a franchisor's requirement to update a disclosure document due to material changes reverts to the requirements of the franchise registration states in which the franchisor is registered. As noted above, state laws generally require franchisors to update and amend their franchise registrations if there is a material change in the information previously filed and registered with the state. As for when state amendments to disclosure must take place following a material event, state requirements vary from quarterly (like the FTC Rule) to immediately.[79]

The practical application of franchise disclosure timing issues means that information that would certainly be required to be disclosed, for example, at the time that a franchise disclosure document is first prepared or updated each year at the time of an annual renewal, may not be material enough to warrant an amendment to the franchise disclosure document after the disclosure document is issued but before annual renewal. The addition of certain officers of the franchisor (e.g., a "vice president of marketing" in the case of ten other franchisor vice presidents) or the termination of a small percentage (e.g., 1 percent or 2 percent) of franchisees under the system are examples of information that would certainly be disclosed at the time a franchise disclosure document is issued or annually updated but would not necessarily be material changes requiring an amendment to the disclosure after it has been issued.

Another timing issue is the point during a franchise sale transaction at which a franchisor's disclosure obligations are complete. In the United States, federal and state disclosure requirements are presale obligations. This means that a franchisor's obligation to disclose current information to a prospective franchisee continues up until the time the franchise sale is made.[80] But at what time is a franchise sale considered to be made? *Bonfield v. AAMCO Transmissions, Inc.* considered this question—specifically, whether a franchisor's disclosure obligation ends at the time that the franchise agreement is signed or at some later date.[81] The court in *Bonfield* recognized that in some franchise sales, the franchisor's disclosure obligations may continue for a period of time following signing the franchise agreement until the time that the franchisor is no longer unilaterally free to reject the franchisee.[82]

PRACTICAL GUIDANCE

A franchisor must rely on various professionals to assist with preparing and amending disclosures under applicable franchise laws. These professionals, both internal and external, may also provide guidance on some of the more subjective materiality determinations in franchise disclosures, perhaps reflecting on past experience, case law, and other precedent when offering such assistance. Internal advisers may have the requisite knowledge to weigh the gravity of certain information compared to the totality of the company's circumstances. External advisers may have the experience and perspective to compare a particular franchisor's materiality decisions with other similar situations.

A franchisor's peer companies and, more significantly, its own franchisees can also be valuable resources for insight on making difficult materiality determinations, assuming a trusting and constructive relationship with these parties. Because the ultimate determination of materiality hinges on the perspective of prospective franchisees, a franchisor would do well to cultivate the opinions of its own franchisees. Moreover, if the materiality of information or an omission were ever to be questioned, it may be helpful for the franchisor to demonstrate consultation with franchisees on the issue prior to making the materiality determination.

Franchisors may want to appoint an individual (typically a senior manager) to coordinate materiality assessments and determinations and to be responsible for preparing and maintaining a current and accurate disclosure document. In addition, in Canada, such a designee might, but not necessarily, be the individual tasked with signing the disclosure document's certificate of disclosure.[83]

When making materiality determinations, franchisors should, among other things:

1. Consider the probability that the specified event will occur and predict the outcome of this event.[84]
2. Examine the anticipated magnitude of the event. In other words, the determination of materiality involves qualitative as well as quantitative considerations. For example, one piece of significant litigation can have farther-reaching consequences for a franchisor than numerous minor lawsuits. In addition, in some cases, otherwise nonmaterial information can become material if it results in a material event.[85]
3. Consider the impact that the disclosure document and, in particular, some of the negative or even positive disclosures may have on sales and existing relationships with third parties. Some disclosures may negatively impact sales and ongoing relationships. Although such considerations should not cause a franchisor to withhold any information in light of the requirement to comply with applicable laws and regulations, franchisors should consider the most appropriate ways to make such disclosures and to address in advance the timing and consequences of disseminating that information.

If a subsequent disclosure to a prospective franchisee contradicts an earlier one, a franchisor may wish to rectify the deficient disclosure by providing the prospect with a new and accurate disclosure document. Doing so, however, provides existing franchisees with certain statutory rights and, as such, should be done under the guidance of legal counsel.

A franchisor may become aware of events and information that, due to their uncertainty and confidential nature, do not rise to the level of a material fact or event that must be disclosed. For example, certain events may not be ripe for disclosure at the time that a franchisor becomes aware of them, especially if the event (for example, threatened material litigation) is more rumor than fact at the time. Other events, such as preliminary discussions relevant to the sale of the franchisor (before a decision is made or an agreement reached), a potential purchase of a competitor, and other significant financial transactions that the franchisor may contemplate may by their preliminary or tentative nature also not be ready for disclosure in the franchisor's disclosure document.

This is not to say that confidential information cannot or should not be disclosed. The confidentiality of information does not abrogate a disclosure requirement. But with respect to rumored and confidential information, franchisors must consider whether the information is ripe for disclosure in a disclosure document, and therefore material. A franchisor may be susceptible to accusations that it has omitted material information from its disclosure document if it continues to offer franchises yet fails to disclose certain rumored or confidential information.[86] For this reason, and in cases where franchisors are unwilling or unable to update their disclosure documents, they may have no choice but to halt franchise sales efforts pending the outcome of the event or the ability to disclose information about the event.[87]

Publicly traded franchisors face some additional considerations when determining whether information is material and whether or not it must be disclosed in a franchise disclosure document. Publicly traded companies are required to make periodic disclosures under applicable securities laws. In the United States, these disclosures include annual (10K), quarterly (10Q), and periodic (Reg FD) disclosure information. A publicly traded franchisor must therefore carefully coordinate its franchise and securities disclosures. If information is included in securities disclosure materials, a franchisor must also consider whether this information must appear in its franchise disclosure document and vice versa.

CONCLUSION

Information in a franchise disclosure document is material if a reasonable prospective franchisee considers it important in deciding whether to purchase the franchise. In the United States and in most of Canada (and elsewhere), franchisors face the core question of whether information to be disclosed is material. Most of the information included in franchise disclosure documents in the United States and Canada is objectively prescribed by statute or rule; but some disclosures are more subjective in nature, and franchisors have latitude to determine whether information is material (and therefore must be disclosed). Materiality is determined from the perspective of a prospective franchisee, and the materiality of information in a disclosure document depends on the context in which it is disclosed or omitted. The timing and form of disclosures can also impact materiality determinations. To avoid potential liability for failing to disclose material information, franchisors must take great care to consult the proper resources, professionals, and individuals to ensure disclosure of all required material information.

ENDNOTES

1. TSC Indus., Inc. v. Northway, 426 U.S. 438, 448–49 (1976); Basic, Inc. v. Levinson, 485 U.S. 224 (1988); *see also* Morris v. Int'l Yogurt, 729 P.2d 33, 38 (Wash. 1986) (finding that "a 'material fact' is 'a fact to which a reasonable man would attach importance to in determining his choice of action in the transaction in question'").

2. In Canada, however, the prospective franchisee's perspective is tempered by a reasonability test as the term *material fact* is defined as one "that would reasonably be expected to have a significant effect on the value or price of the franchise . . . or on the decision to acquire the franchise." *See, e.g.*, *Ontario Act*, s. 1(1).

3. Although Manitoba has passed a franchise disclosure statute, it is not yet in effect because the province has not yet passed regulations that address the specifics of the disclosure obligations. It is expected that Manitoba will pass its regulations sometime in 2011.

4. *Ontario Act*, s. 5(4)(a); *PEI Act*, s. 5(4)(a); *NB Act*, s. 5(5); *Manitoba Act*, s. 5(5)(a); *Alberta Act,* s. 3(a). For franchisors that are members of the Canadian Franchise Association (CFA), the CFA code of ethics imposes a mandatory disclosure requirement upon franchisors, even in provinces that do not have franchise disclosure statutes currently in force. Franchisors and their counsel should pay special attention to how such so-called voluntary disclosures generally, and materiality assessments in particular, are made in those provinces that are not presently governed by franchise disclosure legislation.

5. *Ontario Act*, s. 5(1); *Alberta Act*, s. 4(2); *PEI Act*, s. 5(1); *NB Act*, s. 5(1); *Manitoba Act*, s. 5. Certain relationships are completely exempt from the application of the Canadian franchise disclosure statutes; and certain exemptions from the disclosure requirements are available, including in some cases the payment of a fully refundable deposit and agreements that maintain confidentiality or designate territory or location.

6. *See Ontario Act*, s. 1(1) (defining *material fact* as including "any information about the business, operations, capital or control of the franchisor or 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"). In their franchise legislation, the provinces of Alberta, NB, PEI, and Manitoba all use the word *means* as opposed to the word *includes* in its definition of *material fact*.

7. See the definition of *material fact* at *Ontario Act*, s. 1(1).

8. Another important difference noted is that each of the definitions of *material fact* found in the *PEI Act*, *Manitoba Act*, and *NB Act* specifically includes a requirement to disclose information pertaining to "the franchise" (*PEI Act*, s. 1(1)(l); *Manitoba Act*, s. 1(1); *NB Act*, s.1(1)). This is in contrast to the *Ontario Act* and the *Alberta Act*, whose *material fact* definitions only relate to information pertaining to the business, operations, capital, or control of the franchisor generally and with respect to the "franchise system" (*Ontario Act*, s. 1(1); *Alberta Act*, s. 1(1)(o)). The explicit addition of the term *franchise* to the definition would therefore seem to impose upon the franchisor an obligation to disclose material facts pertaining to each individual location or franchise under consideration. Such information would, however, arguably be required to be disclosed by the *Ontario Act and* the *Alberta Act* in any event, given the second part of the definition of *material fact* in the Ontario and Alberta statutes.

9. However, as noted later, if the change is not expected to have a "significant adverse effect on the value or price of the franchise to be granted" but is otherwise a "material fact," then a franchisor may be obligated to provide a wholly new disclosure document and wait an additional fourteen days before the earlier of receiving any monies or having the prospective franchisees sign any agreement with the franchisor.

10. *Ontario Act.* Each of the other Canadian franchise disclosure statutes has a definition of *material change* similar to that of Ontario except that they do not specifically refer to a "prescribed change."

11. S.N.B. 2007, c. F-23.5.

12. R.S.P.E.I. 1988, c. F-14.1.

13. C.C.S.M. 2010, F-156.

14. R.S.A. 2000, c. F-23.

15. *NB Act*, s. 1(1); *PEI Act*, s. 1(1)(k); *Manitoba Act*, s. 1(1); *Alberta Act*, s. 1(1)(n); *Ontario Act*.

16. *Ontario Act*, s.1(1).

17. Alta. Reg. 240/1995.

18. *See also Franchises Act Regulations*, P.E.I. Reg. EC2006-232, s. 3(3).

19. Hi Hotel Ltd. P'ship v. Holiday Hospitality Franchising Inc. (2008), 2008 ABCA 276, at para. 100.

20. In Ontario, for example, see *Ontario Act*, s. 6(1)(2).

21. 1518628 Ont. Inc. v. Tutor Time Learning Centres LLC (2006), 150 A.C.W.S. (3d) 93, at paras. 10, 71–72.

22. *Id.* at para. 73.

23. Sovereignty Investment Holdings Inc. v. 9127-6907 Quebec Inc. (2008), 303 D.L.R. (4th) 515, at para. 21.

24. *Id.* at para. 15, 20.

25. *Id.* at para. 25.

26. *Id.* at para. 24. It is also important to note the Ontario Superior Court of Justice 2008 case of *6862829 Canada Ltd. v. Dollar It Ltd.*, which involved a disclosure document that did not include any of the following integral disclosures: the requisite financial statements, a signed certificate of disclosure, notice of pending lawsuits, or a copy of the offer to lease. Furthermore, the person declared as authorized to receive service of process in Canada was incorrect. 6862829 Can. Ltd. v. Dollar It Ltd. (2008), CarswellOnt 6948, at para. 27. These deficiencies deemed the disclosure document so materially deficient that the court ruled that no disclosure had essentially been provided. *Dollar It*, at para. 66. This case was overturned in part on appeal to the Ontario Court of Appeal; however, the substance of the appeal did not address the disclosure requirements. *See* 6862829 Can. Ltd. v. Dollar It Ltd. (2010), CarswellOnt 298, 2010 ONCA 34, at para. 1.

27. 16 C.F.R. § 436.

28. 16 C.F.R. § 436.2(n). Note that the previous FTC Rule specifically discussed the materiality of information in several different contexts for the preparation of a disclosure document, including litigation disclosures (16 C.F.R. § 436.1(a)(4) (where only material individual civil actions need be disclosed, "including any group of civil actions that, irrespective of the materiality of any single such action, in the aggregate is material")); disclosure of facts regarding bankruptcy, financing, business restrictions, customers, territories, and protected areas; and earnings claims.

29. FTC Rule Statement of Basis and Purpose, at III(A)(4) (2007), *reprinted in* CCH Bus. Franchise Guide ¶ 6060, at 9086.

30. 15 U.S.C. §§ 41–58.

31. FTC Rule Statement of Basis and Purpose, *supra* note 29 (noting that in the context of § 5 of the FTC Act, the FTC "regards a representation, omission, or practice to be deceptive if: (1) it is likely to mislead consumers acting reasonably under the circumstances; and (2) it is material; that is, likely to affect consumers' conduct or decisions with respect to the product at issue"); *see* Bildstein v. MasterCard Int'l, Inc., 329 F. Supp. 2d 410, 414 (S.D.N.Y. 2004).

32. FTC Rule Statement of Basis and Purpose, *supra* note 29.

33. Amended Franchise Rule FAQ 21, *reprinted in* CCH Bus. Franchise Guide ¶ 6090, at 9133-11, -12.

34. *Id.* The FTC notes that "[f]orcing a prospective franchisee to designate certain select statements as 'material' would invite the conclusion that statements not selected are not material, and a court reasonably could construe a franchisee's failure to select one or more particular statements as the prospective franchisee's waiver of reliance on those particular statements."

35. Certain information may not be contemplated by relevant franchise laws but may yet be material to a particular business or industry such that not disclosing that information to a prospective franchisee would be misleading. For example, franchise laws do not require a franchisor to disclose a franchisee's anticipated costs of purchasing products or commodities relevant to the franchise business. But if the franchisor is aware of an embargo, shortage, or other event that would impact the cost of a commodity that is highly integral to the franchise (e.g., cheese for a pizza franchise) in an extraordinary manner (e.g., not just a cyclical or typical price increase but perhaps a tripling of price), such information could certainly be material to a prospective franchisee's decision to purchase the franchise.

36. 16 C.F.R. § 436.6(d); *see also* 16 C.F.R. § 436.1(d), under which the FTC Rule defines each of the terms *disclose*, *state*, *describe*, and *list* as meaning to present "all material facts accurately, clearly, concisely, and legibly in plain English." In the Statement of Basis and Purpose, the FTC quoted a commenter as saying that this definition could be interpreted to mean that a franchisor must disclose "every material fact regarding the offered franchise, rather than disclosing all material facts pertaining specifically to the disclosures required pursuant to the Rule." FTC Rule Statement of Basis and Purpose, *supra* note 29. But the FTC notes that it does not intend such a reading of this definition and that a nearly identical version of this definition has not caused problems under the UFOC Guidelines. *Id.*

37. FTC Rule Statement of Basis and Purpose, *supra* note 29. The FTC "'note[s] that nothing in the rule prohibits a franchisor from furnishing prospective franchisees with nondeceptive and noncontradictory information outside of its disclosure document.'" Colo. Coffee Bean, LLC v. Peaberry Coffee, Inc., 2010 Colo. App. LEXIS 210, at *33 (Feb. 18, 2010)(quoting 72 Fed. Reg. at 15516 n.733; 15531 n.886.

38. *Id.*

39. *Id.*

40. An example of such materiality determinations can be found in the "business experience" disclosures of Item 2 of a franchise disclosure document, which, in addition to officers and directors of the franchisor (an objective disclosure standard), require a franchisor to disclose information about individuals with "management responsibility" relating to the sale or operation of franchises (a more subjective determination). Individuals employed by a franchisor with varying tasks relating to franchise sales or franchisee supervision may or may not meet this disclosure standard, and it is up to a franchisor to determine whether an individual with such management responsibilities (and who is not an officer or director of the franchisor) must be included in the disclosure document.

41. Bus. Franchise Guide (CCH) ¶ 5700.

42. The FDD Guidelines do not include the UFOC Guidelines' definition of *materiality* in the context of certain material civil litigation actions. In Item 3, the UFOC Guidelines explain that "an action, complaint or judgment is material if there is a substantial likelihood that: (a) a reasonable prospective franchisee would consider it important in the making of a decision relating to the named franchised business; or (b) it would have or has had any significant financial impact on the franchisor." UFOC Guidelines, Item III, General Instructions 3(a), (b). The UFOC Guidelines further explain that "an action, complaint or judgment shall be presumed to have a significant financial impact if the claim for damages or judgment, exclusive of interest and costs, equals fifteen percent or more of the current assets of the franchisor and its subsidiaries on a consolidated basis. Further, if any proceeding presents or presented in a large degree the same issues as other proceedings pending or known to be contemplated, the amount involved in such other proceedings shall be included in computing such percentage." *Id.*

43. *See, e.g.*, Bores v. Domino's Pizza LLC, 489 F. Supp. 2d 940 (D. Minn. 2007); United States v. Bldg. Inspector of Am., Inc., 894 F. Supp. 507 (D. Mass. 1995).

44. *Bldg. Inspector of Am.*, 894 F. Supp. 507. In that case, the U.S. government brought an action against a corporation and its shareholders alleging, among other things, that they violated the FTC Rule by failing to disclose certain information about prior litigation.

45. *Id.* at 517.

46. *Id.* The court stated that "it is pure sophistry on TBIA's part to argue that a reasonable prospective franchisee would not consider it important that another franchisee was claiming that TBIA had violated the FTC Franchise Rule. . . . Such a claim would bring into doubt the integrity and competence of the franchisors regardless of the actual amount of damages claimed."

47. *Id.* Instead, the court believed that the more important determination of materiality under the UFOC Guidelines was whether a reasonable prospective franchisee would consider the information important in the making of a decision relating to purchasing the franchise.

48. *But see* Ill. Admin. Code tit. 14, § 200.110 (noting that a statement or omission of fact "is material within the meaning of the act if there is a substantial likelihood that a reasonable prospective franchisee would consider it significant in making a decision to purchase or not purchase the franchise"); Cal. Corp. Code § 31109.1(d) (stating that for purposes of negotiated change exemption to the California Franchise Investment Law, "'material' means that a reasonable franchisee would view the terms as important in negotiating the franchise.").

49. *See, e.g.*, Cal. Corp. Code § 31202; 815 Ill. Comp. Stat. 705/11; Md. Code Ann., Bus. Reg. § 14-229(a); Minn. Stat. § 80C.13(2).

50. *Id.*

51. 2010 Colo. App. LEXIS 210 (Feb. 18, 2010).

52. At the time of *Colorado Coffee Bean* (i.e., before the 2007 amendment to the FTC Rule), financial performance representations were referred to as "earnings claims."

53. *Colo. Coffee Bean*, 2010 Colo. App. LEXIS 210, at *5–6. The earnings claims at issue in *Colorado Coffee Bean* included only historical gross sales information for the franchisor's company-owned outlets.

54. *Id*. at *13–14. The Colorado Court of Appeals upheld the trial court's determination that although the franchisor concealed material information from plaintiffs by not disclosing the fact that the company-owned outlets were unprofitable, plaintiffs were not entitled to rely on the earnings claim information, or lack thereof, due to certain exculpatory disclosure document language and plaintiffs' own acknowledgments.

55. *Id*. at *5–6.

56. *Id*. at *8. The trial court held that the franchisee's own acknowledgements precluded reasonable reliance on nondisclosure of the parent company's financial information.

57. *Id*. at *27–28. The state appellate court overturned the trial court's ruling regarding reliance on the parent company's financials and found that "the parent company's losses raise a question of undisclosed facts that may be material to prospective franchisees." The court stated that this information should have been disclosed because "ongoing parent company losses could foreshadow its insolvency, which could destroy the value of a franchise regardless of its location or management."

58. *Id*. at *30.

59. 16 C.F.R. § 436.1(a)(21) (2003).

60. *Colo. Coffee Bean*, 2010 Colo. App. LEXIS 210, at 30–31. In this manner, the court stated that the FTC Rule would not have precluded the franchisor from making a disclosure, especially if the disclosure was provided in a document separate from the disclosure document including language such as "the franchisor is the wholly owned subsidiary of . . . which has not shown a profit during its . . . years . . . of operation."

61. 72 Fed. Reg. 15,516 n.733; 15,531 n.886.

62. *See, e.g.*, 815 Ill. Comp. Stat. 705/11; Md. Code Ann., Bus. Reg. § 14-220(A).

63. *See, e.g.*, Md. Code Regs. 02.02.08.01; Minn. R. 2860.2400; N.Y. Comp. Codes R. & Regs. § 200.5.

64. *Supra* note 63.

65. *Id*.

66. *See e.g.*, Cal. Corp. Code § 31300 et seq.; Haw. Rev. Stat. § 482E-9; Va. Code Ann. § 13.1-570 et seq.

67. *Supra* note 66.

68. Commentary to 2008 Franchise Registration and Disclosure Guidelines, Question 0.3.

69. *Id*.

70. The need to continuously update the disclosure document, although costly and time-consuming, is lessened to some degree for Canadian franchisors given that there are no registration requirements in Canada.

71. Of course, this obligation only arises if a franchisor is actively selling franchises and issuing disclosure documents. A franchisor need not update and maintain its disclosure document if it is not selling franchises.

72. *See, e.g.*, *Ontario Act*, s. 5(5). Each of the Alberta, PEI, NB, and Manitoba Acts has similar legislation.

73. *See* s. 9 of the *NB Regulations*, which explicitly refers to the form of a material change statement, appended to the regulations as Form 2.

74. Preferably, the certificate of material changes should be signed by those officers and directors who signed the original certificate of disclosure.

75. The *Ontario Act*, s. 7(1)(e), inter alia, provides franchisees that have suffered a loss due to misrepresentations contained in the material change statement or as a result of the franchisor's failure to comply in any way with section 5 of the *Ontario Act* "a right of action for damages against, every person who signed the disclosure document or statement of material change." *See also PEI Act*, s. 7(1); *NB Act*, s. 7(1); *Manitoba Act*, s. 7(1).

76. *Ontario Act*, s. 1(1); *PEI Act*, s. 1(1)(p); *NB Act*, s. 1(1); *Manitoba Act*, s. 1(1). Interestingly, the *Alberta Act* does not provide a definition of the term *prospective franchisee*. In the case of an Alberta franchisor, therefore, a court may conclude that no such disclosure obligation would arise when imposing a new agreement upon an existing franchisee.

77. Note the presence of the limited renewal disclosure exemption with respect to renewals. See, for example, the *Ontario Act*, s. 5(7)(f), which, inter alia, provides that no disclosure requirement exists with respect to the renewal or extension of a franchise agreement where "there has been no interruption in the operation of the business operated by the franchisee under the franchise agreement and there has been no material change since the franchise agreement or latest renewal or extension of the franchise agreement was entered into."

78. 16 C.F.R. § 436.7(a), (b), (d).

79. For example, Illinois follows the FTC Rule's quarterly amendment requirement (815 Ill. Comp. Stat. 705/11); Minnesota requires amendments to take place no more than thirty days after a material event (Minn. Stat. § 80C.07); Hawaii requires an amendment to take place at least seven days before the sale of a franchise (Haw. Rev. Stat. § 482E-3(c)); and California (Cal. Corp. Code § 31123), Maryland (Md. Code Ann., Bus. Reg. § 14-220), and several other states require an amendment to be filed immediately.

80. *See* Bonfield v. AAMCO Transmissions, Inc., 717 F. Supp. 589, 591–92 (N.D. Ill. 1989), which notes that the Illinois Franchise Disclosure Act does not impose upon franchisors a continuing obligation to disclose to franchisees all material changes in franchise policy occurring after the date that a franchise agreement is executed.

81. *Id.* at 591.

82. *Id.* at 592.

83. Given the potential liability associated with signing a certificate of disclosure in Canada, it is critical to appoint as the designated signatories to the certificate of disclosure the officers and/or directors of the franchisor who are most knowledgeable about the franchisor's system and operation. Franchisors should consider the possible exposure of directors and officers to liability under applicable disclosure document statutes, specifically, the liabilities that may accrue to Canadian officers and directors who sign the certificates of disclosure or certificates of material changes. Such officers and directors should consider obtaining appropriate insurance and indemnities from the franchisor companies in advance of providing any disclosure documents.

84. Where the probability of an event (for example, a large

financial loss) is low, a franchisor can argue that no disclosure (or amendment) is warranted. But if a material event is likely to occur, or if the impact of an event would be to alter the value of the franchise or have an effect on a prospective franchisee's decision to purchase the franchise, then a franchisor should seriously consider making the appropriate disclosure.

85. For example, in the United States, the addition during the course of a year of four franchisees to a franchisor's system of 250 franchisees is likely not a material event for which the franchisor would be obligated to amend its franchise disclosure document to include this information. But would that same conclusion be reached if a prospective franchisee in a particular state (perhaps a smaller state, such as Delaware) receives a franchise disclosure document in October and the document, which was issued earlier in that year in March, indicates that there are no franchisees in that state when, in fact, the franchisor sold four franchises in that state in the months since the issuance of the franchise disclosure document? If the prospective franchisee would have considered that information important in deciding whether to purchase (or not purchase) the franchise—and especially if any of the four undisclosed franchises will, unbeknown to the prospective franchisee at the time of sale, be in competition with that franchisee or if the disclosure of such would reveal information of a material nature to the prospective franchisee—the franchisor's failure to disclose information concerning the four franchisees may be an omission of material information.

86. A franchisor engaged in discussions to possibly sell or merge its franchise system is an example. In this case, it is certainly possible, if not probable, that a franchisee could assert that the franchisor's omission of the transaction was material and that it would have reasonably been expected to have a significant effect on the value or price of the franchise to be granted or on the franchisee's decision to purchase the franchise.

87. If the sale of franchises, however, is unduly influenced either positively or negatively by certain rumors or if a rumor is partly correct, a franchisor may be required to promptly address the rumor in whole or in part in its disclosure document, subject to any duty of confidentiality that it may have in this regard.

