Kidnap, Ransom and Extortion Insurance: Will the Policy Pay Out?

In re Sabine Oil & Gas Corp.: Bankruptcy and the Rejection of Pipeline Contracts

Accidental Franchises: You May Be in a Franchise Relationship Without Even Realizing It
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While practical in theory, KRE insurance involves a puzzling area of law when terrorist groups are involved. Making ransom payments to terrorist groups violates international agreements as well as the laws of many jurisdictions, since it can be considered a form of terrorist funding. The laws that govern KRE insurance vary by jurisdiction, as certain countries explicitly make it illegal for insurance companies to directly or indirectly make ransom payments, while other countries rely on broad sweeping rules against terrorist funding to prohibit ransom payments.

Policy makers have to weigh the fact that issuing ransom payments motivates terrorist organizations to commit further kidnappings, against the reality that making a ransom payment may be the only way to save a captive’s life. Despite laws prohibiting the making of ransom payments, in practice, many countries are willing to turn a blind eye to those who make ransom payments, creating a substantial grey area in the law. This grey area becomes even more obscured when KRE insurance is involved because insurance payments for ransom can be viewed as reimbursements to the insured as opposed to direct payments to the terrorists.

United States
The United States Code prohibits funding terrorist organizations, which includes the payment of ransom monies to terrorist organizations. However, the outlook in the United States on ransom payments being made to terrorist groups has softened. In June 2015, President Obama announced that private parties may negotiate with and pay ransoms to terrorist groups without fear of criminal prosecution, which has been the informal practice for years. In fact, nobody has ever been prosecuted for paying a ransom in the United States. Based on this softening of position, KRE insurance providers may be more comfortable making or reimbursing ransom payments even if the funds are ultimately directed to terrorist groups. Nevertheless, in the event of prosecution, the penalty for funding terrorism is severe: imprisonment of up to 20 years (or life, if the death of any person results), and a fine of up to USD$250,000.00 in the case of an individual and USD$500,000.00 in the case of a corporate defendant.
KRE insurance policies can likely pay ransoms for those seeking economic gain without terrorist motives. When terrorist groups are involved; corporations and insurance providers may find themselves unable to lawfully help the captive regain freedom through ransom payments given legislation prohibiting such payments.

**United Kingdom**

Meanwhile, the United Kingdom (‘UK’) has taken a firmer approach. The *Counter-Terrorism and Security Act* (the “Act”) solidifies the UK’s unfavourable view of KRE insurance policies. The Act explicitly states that insurers cannot issue refunds of ransom payments made by the insured in response to terrorist demands, removing any confusion about the legality of reimbursements. Accordingly, KRE insurance policies in the UK are limited in terms of what types of support they can offer in a hostage crisis if the captors are designated as terrorists. KRE insurance can still offer services such as a negotiator, lost wages or salary, and medical expenses, but will be unable to reimburse any ransom payments. The offence of funding terrorism (which includes ransom payments) carries the consequences of either (or both) a prison term to a maximum of 14 years and an unspecified fine. While a corporate entity cannot be imprisoned, the Act makes clear that a consenting executive could be subject to imprisonment.

**Canada**

Canada has settled into a somewhat ambiguous position on ransom payments. The Criminal Code of Canada1 prohibits anyone from knowingly providing funds that will benefit a terrorist group, or that will be used, in whole or in part, for the purpose of any terrorist activity. Additionally, the United Nations Regulations5 prohibit any person in Canada or Canadian outside of Canada from knowingly providing funds that are to be used by anyone associated with identified terrorist groups, including the Taliban, Al-Qaeda, and 36 other organizations.

Despite these laws, Canada has a history of overlooking private citizens who pay ransoms to save loved ones. For example, Amanda Lindhout was held captive and tortured by a radicalized criminal group in Somalia whose actions could fit within the Criminal Code’s definition of “terrorist activity.” Lindhout’s mother paid a ransom for her release in 2009, despite warnings from Canadian officials, and was never charged under the offence of funding terrorism. More recently, Robert Hall was held captive by the extremist criminal group Abu Sayyaf in the Philippines. While Canadian officials worked diligently for his release without negotiating or making a ransom payment, his family and friends apparently raised $1.4-million for the ransom. This payment was rejected by the terrorist group and Robert Hall was executed.

Unlike the UK, Canada does not have legislation which explicitly prohibits KRE insurance ransom payments either directly or indirectly through reimbursement. Canada does, however, have the authority to criminalize the behaviour by relying on the Criminal Code or the United Nations Regulations mentioned above. Despite legal authority to prosecute, the Canadian government’s willingness to prosecute insurers and companies for such payments is unknown, given its history of failing to prosecute private individuals and the fact that such prosecution of insurers deviates from such laws’ original legislative intent. Provisions on terrorism were written with the safety of all Canadians in mind, and did not necessarily take multinational corporations or faraway victims into consideration.2

In the event of prosecution, a Canadian corporation can advance some limited defences to a charge of funding terrorism through a ransom payment. Depending on the facts, a duress defence could apply — a corporation cannot reasonably ignore threats of serious harm or death to an employee to whom they owe a duty of care. Another defence that may be available is that the payment was made without the knowledge that funds were going to a terrorist group. The success of this defence would require diligent research by a corporation as to the ultimate recipient of the payment and a reasonable belief that no terrorist would benefit. If there is no applicable or no successful defence to the charge of financing terrorism, the consequence is a maximum sentence of 10 years. In Canada, the offence of financing terrorism does not carry a specific fine; rather, the Criminal Code allows for discretion when sentencing a corporation for criminal offences, authorizing the court to fine a corporation as it sees fit.3

**Concluding Thoughts**

KRE insurance policies can likely pay ransoms for those seeking economic gain without terrorist motives. When terrorist groups are involved; corporations and insurance providers may find themselves unable to lawfully help the captive regain freedom through ransom payments given legislation prohibiting such payments. In these situations where ransom payments are illegal due to connections with terrorist groups, KRE insurance providers are often still able to provide other support services to assist with the crisis, such as a negotiation services and legal and rehabilitation costs. Accordingly, corporations with international operations may, despite the limitations, still find these policies valuable.

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1 In 2013, G8 leaders agreed to “unequivocally reject the payment of ransoms to terrorists” in accordance with the UN Security Council Resolution 1904 (2009).
2 18 USC § 2339B.
3 18 USC § 3571.
4 Counter-Terrorism and Security Act 2015 (UK), c 6, s 42.
5 Criminal Code, RSC 1985 c C-46, s 83.01 and 83.03.
8 Criminal Code, RSC 1985 c C-46, s 718.21.

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A recent decision made by the U.S. Bankruptcy Court (“the Court”) has the potential for widespread ramifications in the North American midstream sector. On March 8, 2016, the Court controversially ruled that Sabine Oil & Gas Corp. (“Sabine”), a Houston-based oil and gas exploration and production company, was permitted to withdraw from its long-term pipeline agreements with two midstream companies. While the decision comes from the influential U.S. Bankruptcy Court in Manhattan, the Court clarified that Texas law was not clear enough for her decision to be binding, which was instead meant to offer a “non-binding” analysis.

Background
Sabine filed for Chapter 11 protection on July 15, 2015, in order to facilitate the restructuring of its nearly $3 billion debt. Shortly thereafter, in September of 2015, Sabine filed a motion to reject two gathering and handling agreements with each of Nordheim Eagle Ford Gathering, LLC (“Nordheim”) and HPIP Gonzales Holdings LLC (“HPIP”).

The two agreements with Nordheim specifically provided that the agreement itself is a “covenant running with the [land]” within the designated area. Similarly, each of the two agreements with HPIP provided that Sabine’s undertaking to deliver the products to HPIP is a covenant “running with the lands and leaseholds interests” identified in the agreement.

The Motion
The Court heard oral arguments on February 2, 2016, where it considered whether Sabine had exercised reasonable business judgment in its rejection of the agreements, and whether the covenants did in fact run with the land as expressly indicated in all four agreements.

Sabine’s lawyers argued that potentially $115 million could be saved by repudiating the contracts with Nordheim and HPIP, referring to the agreements as “unnecessarily burdensome.”

The midstream companies naturally rejected Sabine’s argument, largely on the basis that the contracts in question gave them certain rights to the land. While
…the Court made no final determination as to whether the covenants in question ran with the land, or as to any other substantive legal dispute save for allowing rejection of the contracts.

bankruptcy law usually permits the bankrupt to sever some agreements, Nordheim and HPIP argued that their agreements with Sabine were unique. HPIP claimed that its contract included certain covenants “attaching to and running with the lands”, which continued to be binding on Sabine and any successor. Similarly, Nordheim objected on the grounds that Sabine’s right to transport gas on particular lands was transferred to Nordheim. Sabine’s relied on the language of its contracts to counter-argue, claiming that ownership rights were never transferred, and if they were, only rights pertaining to minerals—not land—were transferred.

The Law and the Decision
Pursuant to Section 365(a) of the U.S. Bankruptcy Code, a debtor is permitted to reject executory contracts or unexpired leases with the approval of the court.1 Bankruptcy courts have allowed such rejection, so long as it constitutes an exercise of “sound business judgment.” Typically, U.S. courts have been quite liberal in determining whether a debtor should be entitled to reject a contract, absent any indication of bad faith, whim or caprice.2 The test requires the court to look at whether the debtor’s decision to reject the contract in question is beneficial to the estate.3 Sabine argued that its rejection of the agreements was reasonable because it was not “financially viable” for it to deliver on the obligations under the contracts. Furthermore, absent rejection, Sabine would be required to make contractual deficiency payments, which would impose a substantial drain on the estate’s resources. Sabine argued that if it were permitted to reject the existing contracts, it would enter into new gathering agreements with other midstream companies on more favourable terms. The Court agreed with the foregoing and ultimately concluded that Sabine had in fact satisfied the standard for rejection of the contracts. It ruled that Sabine’s decision to reject the agreements was a “reasonable exercise of [Sabine’s] business judgment”.4

While the Court concluded it was able to rule on Sabine’s act of rejecting the contracts, it clarified that it could not “decide substantive legal issues, including whether the covenants at issue run with the land, in the context of a motion to reject, unless such motion is scheduled simultaneously with an adversary proceeding… to determine the merits of the substantive legal disputes…”.5

Nonetheless, the Court provided a “non-binding” analysis of whether the covenants ran with the land, noting this was a question of Texas state law. Under Texas law, a covenant runs with land when:

• it touches and concerns the land;

• it relates to a thing in existence or specifically binds the parties and their assigns;

• it is intended by the original parties to run with the land; and

• the successor to the burden has notice.6

The Court ruled that the first requirement was not satisfied, as the covenants did not appear to “touch and concern” the land. It was insufficient for the covenant to merely affect the value of the land. Rather, the covenant must affect the owner’s interest in the property or its use. In the case of gathering and handling agreements, the minerals, once extracted from the ground, cease to be real property and become personal property. Accordingly, the covenants in this case failed the test, and were determined not to run with the land, allowing Sabine to reject the agreements like any other contract under Section 365(a).

In concluding, the Court made no final determination as to whether the covenants in question ran with the land, or as to any other substantive legal dispute save for allowing rejection of the contracts. Commentators have noted that this conclusion likely leaves the case open to further litigation between the parties for definitive direction.

Application in Canada
Prior to the 2009 amendments to the Companies’ Creditors Arrangement Act1 (the “CCAA”), the ability of a debtor to disclaim a contract was entirely within the discretion of the court. Section 32(1) of the CCAA now allows a debtor company, on notice to the other parties to the agreement and to the monitor, to disclaim or resiliate any agreement to which it was a party at the commencement of the CCAA proceeding. The bankruptcy monitor must approve the disclaiming, failing which, the debtor must obtain a court order for the disclaiming or resiliation. In deciding whether to make the order, the court must consider whether the monitor approved the proposed disclaimer or resiliation; whether it would enhance the prospects of a viable compromise or arrangement; and whether the disclaiming or resiliation would likely cause significant financial hardship to a party to the agreement.7

Certain categories of agreements are exempt from the foregoing provisions. In particular, all of the following are exempt from section 32(1)—that is, they cannot be disclaimed: (i) eligible financial contracts, (ii) collective agreements, (iii) financing agreements if the company is the borrower, and (iv) leases of real property or of an immovable if the company is the lessor. While intellectual property agreements where the company is the grantor of rights can be disclaimed, the grantee’s right to use the intellectual property is not affected by the disclaimer.8

Notably absent from this list is any category under which midstream contracts might fit.9 Accordingly, such contracts are vulnerable to the risk of disclaimer and resiliation in the same way they are in the U.S.
The “test” that courts have adopted is the demonstration by the debtor company that the termination was fair and reasonable in all of the circumstances. Accordingly, the analysis is case-specific and will depend on each debtor’s set of facts. Courts have, however, considered authorizing termination where a company would become substantially more profitable by terminating an agreement and entering into a new one on more favourable terms permitted by the market. As such, the possibility of a Canadian court arriving at a result similar to Sabine is not only possible, but likely. While obviously entitled to stray from U.S. jurisprudence, it would not be surprising for a Canadian court to borrow principles from Sabine given the similarities in law. Regardless, the CCAA is designed to be debtor-friendly, and as such, a Canadian court could very well arrive at the same result as Sabine without specifically borrowing from it. Canadian midstream companies should be cognizant of the risk to midstream producers and the midstream sector troublesomeness for pipeline operators and the midstream sector. Midstream companies may see the incentive to renegotiate or amend existing contracts with producers to ensure their continuation. Midstream companies should be advised to review their agreements with upstream counterparts to assess whether any rejection risks exist, and accordingly, whether renegotiation should be considered.

While not binding, the Court’s decision has already made waves in the industry. The decision provides some welcome guidance for courts considering similar cases. However, it is certainly less than precedential, and courts will continue to consider the issue on a case- and contract-specific basis. Although we have yet to see a similar case decided or initiated in Canada, other U.S. producers have already filed motions similar to Sabine’s. Quicksilver Resources Inc. (“Quicksilver”) filed an application in the Delaware Bankruptcy Court to reject a contract with Crestwood Equity Partners. However, on April 6, 2016, the parties announced they had reached a new 10-year deal, in connection with which Quicksilver withdrew its motion.

Similar to Sabine, another producer, Magnum Hunter Resources Corp. (“Magnum”), sought to reject four agreements with Texas Gas Transmission Inc. (“Texas Gas”), calling them an “undue burden” on its operations. It was announced on March 10, 2016 that Magnum reached an agreement in Delaware bankruptcy court with Texas Gas, resolving the latter’s objections to the termination of certain pipeline contracts. The agreement, which is expected to receive approval of the U.S. Bankruptcy Court, provides that Magnum subsidiary Triad Hunter will terminate the four agreements with Texas Gas relating to the use of pipelines to transport gas. A separate credit agreement, pursuant to which Magnum agreed to provide a number of letters of credit to Texas Gas totalling $65 million, will be converted into an unsecured claim worth $15 million in Magnum’s Chapter 11 proceedings.

Impact and Further Developments

The ability to disclaim or repudiate a contract serves a useful purpose to upstream debtor corporations, in that it may draw from unprofitable or prejudicial contractual obligations. However, the Sabine decision sets a troublesome precedent for pipeline operators and the midstream sector generally, in both the United States and Canada. As counterparts to those contracts, the decision is likely to create uncertainty and instability for midstream companies, otherwise beloved to investors for secure and steady streams of revenue.

Given the current state of the market, the ability to repudiate or disclaim pipeline agreements may become a persuasive factor in a producer’s decision whether or not to pursue Chapter 11 filing or restructuring under the CCAA. Producers who previously avoided the insolvency route may go so far as to file for bankruptcy protection simply to be liberated from unfavourable pipeline contracts. By the same token, midstream companies may see the incentive to renegotiate or amend existing contracts with producers to ensure their continuation. Midstream companies should be advised to review their agreements with upstream counterparts to assess whether any rejection risks exist, and accordingly, whether renegotiation should be considered.

Footnotes

1 In re Sabine Oil & Gas Corp., 15-11835, U.S. Bankruptcy Court, Southern District of New York (Manhattan) (Sabine)
2 Sabine at p. 8-9
3 Sabine at p. 10
4 Ibid.
5 11 U.S.C. §365(a)
8 Sabine at p. 10
9 Sabine at p. 10
10 Inwood North Homeowners’ Ass’n, Inc. v. Harris, 736 S.W.2d 632, 635 (Tex. 1987).
11 RSC 1985, c. C-36 [CCAA]
12 CCAA, s. 32(4)
13 CCAA, s. 32(6)
14 CCAA, s. 32(9)
15 Note: There is no bright-line test for whether an agreement constitutes an “eligible financial contract”; however, the Ontario Court of Appeal has held that a contract which has as its primary thrust the physical supply and transmission of oil and gas is not an “eligible financial contract” for the purposes of the CCAA (Re Androscoggin Energy LLC, [2006] OJ No. 592, 75 OR (3d) 552).
16 Re Doman Industries Ltd., 2003 BCCA 344.
A “franchise” is defined in the Alberta Franchises Act¹, (the “Franchises Act”) and is essentially a right to engage in a business where several specific factors exist. In general terms, these factors include a business where goods or services are sold or distributed under a business plan prescribed by the franchisor, that is associated with a type of trademark of the franchisor and that involves a continuing financial obligation to and significant continuing operational controls by the franchisor.

In a 2016 Ontario case, Chavdarova v. The Staffing Exchange² (“Chavdarova”), the Court ruled that if the relationship between the parties meets the conditions set out in the definition of the word “franchise” in the Arthur Wishart Act (Franchise Disclosure)³, (the “Wishart Act”) then “the relationship between the parties is that of franchisor and franchisee, no matter what terminology the parties have used to describe the relationship.” The Wishart Act is Ontario’s franchise legislation and was modelled on and closely resembles the Franchises Act. Moreover, the definitions of “franchise” in the Wishart Act and the Franchises Act are substantially similar.

Although “franchises” are typically thought of as fast-food chains the definition of a “franchise” is sufficiently broad to draw commercial arrangements not intended as franchises under the purview of the Franchises Act.⁴ Even common business arrangements such as licensing agreements, distribution agreements and agency agreements may be considered a franchise relationship at law notwithstanding the characterization or description of such arrangements otherwise. This was the result in Chavdarova.

Examining Chavdarova
Chavdarova resulted from a failed business relationship between The Staffing Exchange Inc. (“TSE”), a business recruitment company and Lyudmila Chavdarova (“Chavdarova”), an individual who had entered into a licence agreement with TSE to access TSE’s Multiple Career Listing Services.

Chavdarova claimed that the relationship was one of franchisor and franchisee in order to avail herself of the rights and remedies offered to a franchisee under the Wishart Act and TSE claimed that the relationship was that of licensor and licensee as it wanted.

Accidental Franchises:
You May Be in a Franchise Relationship Without Even Realizing It

By Adrian Etchell and Ashton Butler, Summer Research Student

Introduction
There are situations where commercial arrangements, not intended by the parties to be a franchisor/franchisee relationship, have nonetheless been held by the courts to be such a relationship.
to avoid any obligations under the *Wisbort Act*. Ultimately, the Court found a franchise relationship to exist because the elements of a franchise relationship set out in the *Wisbort Act* were met notwithstanding the terminology TSE and Chavdarova used to describe their relationship.

First, the requirement for a payment to the “franchisor” by the “franchisee” was met by Chavdarova in two ways: (a) pursuant to payment made by Chavdarova to TSE for her to become a TSE Career Broker which the Court characterized as a payment required by her to enter into a relationship with TSE and not simply a training fee; and (b) due to billing services provided by TSE which remitted Chavdarova’s portion to her on an agreed upon schedule.

Secondly, the Court found that Chavdarova’s business operated in substantial association with TSE’s trademarks. The license agreement between the parties described TSE’s business as a:

…unique and proprietary system relating to the establishment, development and operation of services relating to the provisions to the consumer of recruitment and placement consulting services, which must be operated in accordance with uniform equipment, systems, methods, procedures and designs, and under [TSE’s] proprietary marks.”

The entire relationship was thus found to be premised on the identification of the Chavdarova’s operations with TSE’s intellectual property.

Finally, the Court ruled that TSE exercised significant control over Chavdarova’s methods of operation. In signing the licence agreement, Chavdarova had to acknowledge “the necessity of operating [her] business in strict conformity with [TSE’s] standards and specifications.” Moreover, TSE provided billing and invoicing services, collection services, office support, accounting support and other services.

**Implications for an “Accidental” Franchisor and Franchisee**

If a business arrangement is determined to be a franchise relationship, the parties thereto become subject to the obligations and may avail themselves of the rights under the *Franchises Act*.

**Implications for the “franchisor”**

If not exempted pursuant to the *Franchises Act Exemption Regulation*, a franchisor must disclose certain information to a franchisee prior to the franchisee commencing operations. Section 4 of the *Franchises Act* sets out the franchisee’s disclosure requirements. Notably, a disclosure document must be received by a prospective franchisee at least 14 days before either the signing of any agreement relating to the franchise, or the payment of any consideration by the prospective franchisee relating to the franchise. 6

The disclosure document itself must comply with the *Franchises Regulations*, (the “Regulations”) and simplifying, must contain a copy of the proposed franchise agreement and financial statements of the franchisor, details of current or pending litigation involving the franchisor, disclosure of previous or pending criminal charges involving and ongoing civil claims against the franchisor, disclosure of any restrictions on the goods or services the franchisee may sell, and information about closures of franchise outlets and any exclusive territory granted to the franchise.

If a franchisor or “deemed” franchisor does not meet the disclosure requirements, the franchisee or “deemed” franchisee may be able to rescind or cancel their agreement with the franchisor within 60 days of entering into it.7 If, on the other hand, a franchisor does not provide disclosure at all, a franchisee may rescind the franchise agreement within two years of the date that the franchisee is granted a franchise. 8 Troublingly for franchisors, Alberta Courts appear willing to rule that “no disclosure” has occurred in the event a franchisee is supplied with a deficient disclosure document.

Contract rescission means the franchisee is returned to the financial position it was in before it entered the franchise relationship with the franchisor. This means the franchisor has to refund any money it received from the franchisee and compensate the franchisee for any losses the franchisee incurred while acquiring, establishing and operating the franchised business. Additionally, a franchisee may have a right of action for damages if it suffered a loss because of a misrepresentation contained in a disclosure document. Chavdarova was entitled to the amount of money paid by her to TSE which included money paid for supplies and equipment. She was also entitled to damages for misrepresentation.

**Implications for the “franchisee”**

The *Franchises Act* is generally weighted in favour of a franchisee. If a would-be franchisee successfully claims that he/she is in fact in a franchise relationship, the franchisee may be able to avail itself of the statutory remedy of rescission and a statutory cause of action for damages resulting for franchisor misrepresentation, both granted under the *Franchises Act*. Therefore, if a party to a license agreement, distributorship, or sales agency agreement decides the bargain he/she has struck with a “franchisor” is not profitable, or simply wants out of his/her agreement, he/she may claim the existence of a franchise relationship and the fact that the disclosure obligations of the “franchisor” under the *Franchises Act* have not been met.

**Conclusion**

Ultimately, if an arrangement meets the definition of a franchise set out in the *Franchises Act*, a court may find a franchise relationship to exist, notwithstanding a business arrangement being characterized and described otherwise by the parties themselves. A waiver or release by a franchisee of its rights or waiver of the franchisor’s obligations and requirements under the *Franchises Act* has no impact. Accordingly, both “accidental” franchisees and franchisors should seek advice as to whether a business arrangement (proposed or existing) could be considered a franchise relationship.

**Footnotes**

1 RSA 2000, c F-29
2 2016 ONSC 1822
3 2000 SO 2000, c3
4 Canadian Franchise Law, supra note 1 at s 13(b);
Canadian Franchise Law, supra note 1 at 113.
5 * Canadian Franchise Law, supra note 1 at 112 – 113.
6 * Franchises Act, supra note 1 at s 4(2).
7 Alka Reg 242/1995
8 Canadian Franchise Law, supra note 1 at 39.
9 2016 ONSC 1822
10 Franchises Act, supra note 1 at s 4(2).
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