The Legislative Assembly of Ontario
Standing Committee on Regulations and Private Bills
1st session, 37th Parliament
Toronto, Ontario, Canada

Public Hearing Testimony

FRANCHISE DISCLOSURE ACT, 1999
Consideration of Bill 33, An Act
to require fair dealing between parties to franchise agreements,
to ensure that franchisees have the right to associate and
to impose disclosure obligations on franchisors

Wednesday 8 March 2000
Location: Ottawa, Ontario

Expert Witness: **Dr. Gillian K. Hadfield**
Professor, Economics & Law
University of Toronto

The Vice-Chair: I'd like to start the meeting with Dr Gillian Hadfield. We have until 10:20 for your presentation, Dr Hadfield, and that includes any questions the committee may have. If you want to make the full time for your presentation, there will be no time for questions. If you give us a few minutes, we can have an opportunity to ask you a few questions. The floor is yours.

Dr Gillian Hadfield: Thank you very much. I'm going to try to keep it as brief as possible so we can have lots of time for questions. I have prepared some overhead slides, which Les Stewart is going to help me with, so that we can get through this.

I'm delighted for this opportunity to address the committee, and commend the committee for its attention to this issue. I started studying franchising 15 years ago, and often find it's a good way to bring a halt to a conversation to say that I'm interested in franchising, because it doesn't sound like something terribly exciting to study. But it's actually quite a complex, interesting and very important relationship in our economy.

I'm here today to talk to you as an economist. I am on the faculty of law at the University of Toronto. I'm currently on leave, on sabbatical at Stanford University, but my permanent position is with the University of Toronto. I have a law degree and a PhD in economics. I'll tell you a bit about my background in just a moment.

I am the current president of the Canadian Law and Economics Association and former director of the American Law and Economics Association. I am a Canadian. I did my bachelor of arts in economics at Queen's University, where I was awarded the medal in economics. As I said, I went to Stanford for my PhD and my law degree. My PhD was in economics. My thesis topic is predictably long and obscure, but I thought I'd mention it to you, so you can see how franchising connects to the broadest set of interests I have continued to work on to the present time. The title was "Long-term Relationships and Commitment and the Design of Long-term Relationships, Applications and Limitations of Contracting."

My interests generally are: What does it take to make a long-term economic relationship a valuable one, what is the role of contracting, and where are the points at which contracting needs additional support from legal rules? I have written a number of articles on franchising, some of which have "franchising" in the title and some of which do not, because I view franchising as an example of a more general set of issues related to overcoming problems of commitment and productivity in long-term relationships.

I teach contracts at the University of Toronto, and teach an advanced contracts class in which franchising is a dominant part. I have continued to work on related issues, as they arise, in design of legal institutions and consumer protection. Enough about me. Let's talk about franchising.

My plan for this presentation is to speak to you as an economist and to try to bring out what, in my work, I have identified as the important things to pay attention to about franchising. There are fairly simple things you can know about franchising that give a lot of guidance to thinking through the problem of what you do about franchising. Do you leave it alone completely, or is there any role for legislation?

Franchising, as you may already have discovered, is a term that has a lot of different meanings. The type of franchising most of us are interested in, and are focusing on here, could more specifically be called "business format franchising." That is a type of franchising where a franchisor is selling a small business package to somebody who wants to operate a small business. Franchisees are individuals who are buyers of that package. They can be characterized as people who respond to an advertising pitch. Franchisees, in fact, will go out and identify themselves as: "I'm interested in buying a franchise. What are my options? What are my possibilities?" They respond to the pitch: "Own your own business. Follow our rules and you'll succeed." It's very important to keep in mind that that's who franchisees are and that is the nature of how this relationship gets started. There's nothing wrong with that; that's what is being sold.

I want to emphasize that the industry is franchising and not hamburgers. Franchising is sometimes described as a method of distribution, but it's not. It does distribute products, but it's an industry in and of itself, where the product is the small business package for somebody who wants to operate their business. In order to be successful a franchisor has to figure out that if they haven't established internally the structures for serving franchisees and providing them with the kinds of support they need to be successful, they're not going to survive as franchisees. This hard lesson was learned, for example, by the founder of Domino's. When Domino's Pizza decided to go into franchising, they failed quite dramatically because they hadn't realized they were no longer selling pizzas but were now selling franchises. That's one of the things you look for in identifying a sophisticated franchisor. They have figured that out.

To give you a sense of this as an industry, I went on to the Web site www.franchising.com, which is a Web site to which anyone could go who is looking to buy a franchise or looking to advertise a franchise. It's billed as a worldwide directory of franchising. You can enter, "I'd like to know by country or I'd like to know by investment level what my options are," and it will spit those out. I just pulled out a fraction of the "H's" to give you some sense of this as a market for franchises and also to give you a sense of the wide range of areas in which franchising occurs.

Franchising is not just McDonald's and Domino's and Hampton Inns, but is also Hair Club for Men, Hakky Instant Shoe Repair, Hammerle--I don't even know what that is--H20 Plus, a lot of different areas. It's now a very large fraction of the retail market. People who are going into franchising look for something they might be interested in doing, but they are not coming to it and saying, "Look, I'm an experienced motel operator, and I'd like to operate one of your motels." They're looking for an investment opportunity, they're looking to be their own boss and they're looking for a good package.

If you look at this Web site, some of them have more specific information. For example, Häagen-Dazs, in their pitch to prospective franchisees, provides information about how long they have been franchising, ie, giving some indication of how sophisticated they are and whether they know what franchising involves in terms of supporting franchisees; what the investment levels are; how many units they have; how many company-owned units they have, which is important information for a franchisee to know both in terms of what ground-level information does the company have, but also, are they coming in and buying up the franchisees. Häagen-Dazs here is showing they've been this since 1974 and their number of company-owned units is two. That indicates there is probably not a situation where they're buying up their franchisees who are successful, which is something that happens in some systems.

The franchise relationship has a very distinctive structure, and if you can get a handle on this structure, it's an excellent key to figuring out how to think about what we do with franchising in terms of legislation. Franchising is characterized by a separation of ownership and control over the assets in the business.

Franchisees own the assets; the franchisors control them. That is something we see in lots of places in the economy. We see that in securities markets. We see that in corporations. Shareholders own the assets, own the company; managers and directors control those assets. That separation of ownership and control is something, in all of these settings, that is a source of great value. I may have the assets, own them, but not be the best person or organization to determine what to do with them. So you give your money to a stockbroker and ask them to invest it on your behalf, or the fund manager. Invest in a company and have the managers make the business decisions and the corporation purchase the assets of a franchise and have a franchisor determine what is the best way to deploy those assets. That is a source of value and that's why franchising is valuable.

That separation of ownership and control, however, also creates vulnerability. The fact that somebody else is controlling your assets means that you've got to be a little bit worried about whether they're going to be putting them to the best use for you, or whether they're going to be taking advantage of them.

The types of risks that you face up front when you separate out ownership and control--and we can see this in franchising as well--is a problem of misrepresentation, misrepresentation as to what the individual or organization that has control over the assets is going to do with them. Some of them are fairly standard things: fraud, misleading advertising or where you're paying for nothing. This is not something that is special to the franchise industry. This is something that arises throughout the economy in lots of different places. Telemarketing is another example where we can see that, and the fly-by-night stocks are another example, where you invest in a company that actually doesn't have the capitalization that it may represent. You can be defrauded by scam operations. I want to draw that comparison.

The previous slide was about risks at the outset of a franchise relationship. The risks I want to emphasize in franchising have to do with ongoing risks. Ongoing risks arise because of something that economists have labelled opportunism. Opportunism is formally the extracting of the value of the sunk investment that somebody has made in a relationship, taking advantage of the fact that someone is locked in to a certain extent. I'm going to give you an example of it in just a minute to make it quite clear, because this is the source of the vulnerability, the way in which the vulnerability in franchising arises.

It's hard sometimes for people to understand how it could be that franchisors would ever take advantage of franchisees, because it appears at first glance that they must have the same interests: everybody wants this business to succeed. To some extent that's true, but there are ways in which their interests diverge.

One of the most important ones is in terms of where their returns from the franchise are coming from. Franchisees at the end of the day are collecting the profits from the franchise. They've got their revenues, they take off all their costs, they take off their royalties to the franchisor, and what's left over are their profits. Franchisors collect their money from a franchise from an upfront franchise fee, if there is one, and generally from royalties. Royalties are collected on the basis of revenues before any costs are taken off. So if all those revenues are there, the franchisee is paying attention to the level of costs because he wants to know what's left over at the end of the day. But his costs are not of the same concern to the franchisor unless they're impinging on revenues or the ability to sell other franchises. So there's a way in which their interests can diverge. A franchisor can be interested in generating volume and not too concerned about costs; franchisees are concerned about what is left over at the end of the day.

Because of the separation of ownership and control, franchisors are making outlet decisions when they're deciding where to open up other outlets, whether to go ahead with the renovation of an outlet or a change in a marketing approach, whether or not to introduce new menu items or put on a promotional plan. All the decisions that the franchisor is making, which, remember, are the reasons that a franchise is valuable--it is not a bad thing that franchisors are making decisions about how to run this outlet. This is precisely why people want to be franchisees, because they want franchisors making those decisions and not themselves. But they're making those decisions with the franchisees' money. So the question is, to what extent are they taking into account, when they're making those decisions, that it's not their money at risk but the franchisees' money at risk?

This risk is not something special or unusual in terms of franchising. I go back to the analogy to the securities market or a corporation. We know that in our corporate law, if we have investors handing their money over to the managers of corporations, there's a risk of self-dealing; that is to say, the managers directing the assets of a company to ventures or suppliers that are owned or controlled by the managers and making profits from the fact that they're in the position of management. We know there's a risk of insider trading, taking advantage of the fact that they have the information before the investors, the owners, have it and trading on it. We know that we can't have a productive, vibrant economy with a productive, vibrant securities market or corporate structure without protections against self-dealing and insider trading, and that's what we do have in those areas. The things I'm talking about in franchising are just exactly the same.

I wanted to give you a specific example of what I mean by opportunism, just to make it a little bit more graphic for you. Suppose you had a $100,000 investment in a franchise, and within a year that franchise generated $200,000 in revenue. Remember, that's where the franchisor's royalties come from, off that $200,000. Just suppose the costs of operating the franchise outlet were $120,000 and that the franchisee paid himself a salary of $50,000, which I just want you to assume. I'm an economist; we're making a lot of assumptions here. That $50,000 is what that franchisee was making and could make if they gave up the franchise and went back into whatever their employment was before they became a franchisee.

Those numbers--$200,000 minus $120,000 minus $50,000--gosh, I think I added wrong. We have a return of $30,000. Sorry. This is actually good. You know people are paying attention.

To correct the record--I'm a theorist; I was never any good at the numbers--the return on the investment is $30,000. That's an even better return on the investment than I was anticipating here in this franchise. That looks pretty good, right? You put your $100,000 down, you make the same salary you made in the non-franchise setting and you're making a $30,000 return--I'm just assuming this is in one year--on that $100,000 investment. This is not a representation of what is going to happen to you if you open a franchise, by the way.

So there's that $30,000 sitting there. Suppose the franchisor comes in in the second year and says: "You know what, we've decided we need to overhaul the outlet. We've just discovered that the aisles are too narrow and we need a different marketing approach. We need to make certain kinds of changes." The franchisor can increase the cost of operating that outlet by as much as $30,000 a year before you're going to say, "You know what, I'm out of here, I'm done."

Here's what I mean. That could be through legitimate decisions about needing to change the outlet because that's what we need to do to maintain competitiveness. It could be that if we don't pay that $30,000, next year those revenues are not going to be $200,000; they're going to be $100,000 or lower. But it could also be that that money is sitting there and the franchisor has opportunities to extract that value: They could raise royalties, they could make investments they would not make themselves if those were their own assets at risk. So the point here is the notion of opportunism and the vulnerability of that $30,000 sitting there. The franchisee is going to stay in business even if that is gone. If that $30,000 is pulled out by the franchisor, the franchisee now faces these two choices: "I can stay in the business, I've made my $100,000 investment, but if that's a sunk cost, if that is gone, I can't recoup that. I get $50,000 a year in salary if I stay, I get $50,000 a year in salary if I leave. I've lost my $30,000 return on my $100,000 investment but there's nothing I can do about that." That's what makes a franchisee vulnerable.

You can look at that risk of opportunism and you can think a lot of things about it, like it's unfair and shouldn't be allowed, it's outrageous, whatever you want to think in terms of that risk. I'm going to focus on why we should be concerned about it, what is the public interest in doing something about the risk of opportunism, which I should say is a standard risk in many long-term relationships. The reason we have contract law is to deal with the problem of opportunism.

I want to talk a bit about what the efficiency considerations are with respect to doing something about opportunism and those risks. Franchising is what modern retailing looks like. From varying statistics, I think it's about 45% of the retail market in Canada and it has the potential to become even more so. The

reason that franchising is the way of the future, the way it has been for some time now as well, is because franchising takes the value you get from having a large-scale operation, the returns to scale of bulk buying, of collecting information, of being able to manage inventories, of large-scale advertising, it takes all of those benefits that are available to a large-scale operation and parcels them out to small-scale operations. That's also why you want to be in a franchise, because the franchisor can do the marketing studies and do the research and analyze the data and come up with the fancy advertising campaigns that a single operator can't. This is going to be especially true in our brave new world of the digital age where information has become terribly important in retail in particular.

The reason we have the large, big-box stores is because the large stores can aggregate massive amounts of information they collect from those UPC codes that are flashing through the checkout machine. They're keeping track of the inventories, they're keeping track of how demand is shifting on a daily basis and they're moving product around in ways that dramatically reduce costs and respond much more quickly than has ever been true in the past to shifts in demand.

That's a value that comes with large scale, and that's where franchising comes in. That benefit of large scale, aggregating all that information, can then be parcelled out to small operators who can't compete otherwise. The days in which you could open up the local store and not have access to that information and not be able to respond in the same ways are very, very quickly disappearing. That's also true, of course, with Internet sales.

The risks that franchisees face, the risks I enumerated earlier, the risk of misrepresentation and the risk of opportunism, are costly for the economy. When franchisees end up getting into a franchise that doesn't deliver on its promises and invests those funds, and those funds then disappear, that's wasted investment funds in the economy. That's not a good thing. That's one of the reasons we don't want that in the stock market. We don't want people taking their investments and putting them into fly-by-night stocks. We'd rather have those investments in legitimate businesses and operations that are going to be around. We want people to be able to make wise investment decisions. This is really emphasized by one study. Francine La Fontaine, another Canadian, although she's at a US university now, demonstrated there was a 77% failure rate for franchisors over a five-year period in the United States; that is to say 77% of the franchise operations systems that came into existence disappeared within five years. Now, of course that means the franchisees' investments went with them.

The risks of franchising are also costly because even though it's at 45% of the economy now, we may be looking at too little franchising in the economy. If franchising is risky and potential franchisees understand those risks, they understand the risks of misrepresentation, but more importantly they understand the risk of opportunism, that they're going to be vulnerable, that $30,000 is going to be vulnerable, they can be kind of over the barrel--"Well, what can I say? I can't walk away from this thing even if that amount is being extracted by decisions the franchisor is making"--then some people are going to decide not to become franchisees, not to get into this relationship. That can mean, from the point of view of the economy, we don't have enough of it going on. By "enough," the technical way of thinking about it would be, we don't have the efficient scale. The volume of franchising can be too low because we don't have enough people going into it because they don't get enough protection against the risks and they know they can't protect themselves through their contracts.

It may also be that we're not getting the right mix of people in franchising, we're not getting the best potential franchisees, which is to say we're getting people who have few opportunities on the outside but not the people who have better opportunities on the outside who nonetheless may be the most productive people as franchisees. And, in fact, you hear franchisors speak frequently about the difficulty that they feel they face in identifying good franchisees.

One of the things I talk quite a bit about in my work in a lot of different areas is--and this is one of the main lessons of this combined field of law and economics that I'm in--it's frequently the case that people see law and free markets as being opposed to one another, that introducing law into markets disturbs free markets. It's important to really focus on the fact that free markets require a legal structure. This is the mistake that has caused a lot of problems in eastern Europe and Russia, to sort of say, "OK, let's open up

to free markets," but there wasn't the legal structure in place to support those free markets and they haven't taken off.

You need legal structure to support free markets. You need contract law, you need property law, and as I've been drawing the analogy, with securities, regulation and corporate law. In securities you need a way of protecting owners and investors from the abuse of their funds by managers and brokers through their control. By doing that, that's what makes that free market start to work. The New York Stock Exchange promulgates a thick book of rules and regulations privately, overseen by the securities commission, but privately generates those rules because they know that those rules are what will attract investment and that's how you get the efficient scale.

Corporate law establishes that there are fiduciary duties on the part of managers and directors so that when managers and directors are handling those funds of the stockholders, they're under an obligation to manage those funds in the interests of the stockholders. That's law that generates and supports an efficient market. In the sort of comparative work these days, one of the reasons it is thought that the US and North American markets are doing so well is because the securities regulation and corporate law have developed in much better paths than in Europe, for example, and it's the legal structures that are supporting the growth in these areas in North America.

I've mentioned the types of risk that are out there in franchising, emphasizing the opportunism problem. There are a variety of places in which you can come in and regulate, structure the market, the various types of things you can do to support these relationships. One is basic contract law. Obviously, you need basic contract law. The second one is disclosure law, like we have in Bill 33, which I think is an essential and very important component of that proposal. This is also what you see in the Federal Trade Commission rules in the United States--that's federal law--in California and in Alberta. California disclosure law has been there since 1971. You can then move on to registration law, where you require franchisors to register with an agency of the government. That has been true in California since 1971 as well, and is an aspect of Tony Martin's Bill 35.

You can then take another step down, or up, and introduce substantive relationship law, by which I mean rules and regulations about behaviour within this relationship once it has started so we can deal with the misrepresentation problem at the outset through disclosure law. Registration law also addresses that kind of problem.

But then we've got this relationship that's now supposed to last for 15 or 20 years. What do we do about the opportunism problem? That's where we start looking at substantive relationship law. That's where you start looking at putting in provisions that govern or can impinge on termination and non-renewal decisions, such as requiring that there be termination or non-renewal only for good cause. That's where you can find legal provisions requiring that there be notice of a potential default under the franchise agreement and an opportunity for the franchisee to cure that default. This is where you find phrases or obligations set in terms such as "good faith and fair dealing."

Substantive relationship law has been around in the US in the auto and petroleum marketing area since 1956. The Automobile Dealers Day in Court Act was 1956 in the US. In California it has been around since 1981. Again, it is an aspect of Tony Martin's bill, which actually contains a lot of the best features of what you can find in North America in terms of thinking about how to handle franchising.

Good faith and fair dealing terms are in all US contracts. It's an implied term in any contract in the United States, in any industry, no matter where you are. There's an implied duty of good faith and fair dealing. So it's nothing special. You don't need it in a piece of legislation; it's always there. In fact, when I started doing research on franchising back in 1986 or 1987, what I was doing at the time was reading thousands of franchising cases and looking at how the term "good faith and fair dealing" was being interpreted in those settings, and to what extent was it addressing the problems of opportunism, to what extent did the courts understand what was happening in a franchise relationship, and therefore what "good faith and fair dealing" might mean in that context.

The Vice-Chair: You have about 10 or 11 minutes left.

Dr Hadfield: Yes, OK. You have the modes of enforcement in the handout there, so I'm just going to move on to the next one so that I can talk specifically about what I think is necessary here.

Interjection.

Dr Hadfield: There should be one that says, "What's necessary?" It's missing from the pile. That's too bad. This is the one I think is most important.

There are different ways in which you can achieve the goal of getting the kind of commitment you need in franchising. One of them is through reputation, and for a lot of people who feel that there's not a need for any kind of regulation here that's what there's an appeal to: "We don't need to worry about franchising because franchisors won't treat their franchisees badly because it's bad for business to treat their franchisees badly." To some extent, that's true. What that requires is that the information about what franchisors are doing to franchisees has to be free-flowing, available and low-cost.

When I put on my last slide here, which you can look at in the handout, there are two main things I think it would be a good idea to focus on in terms of what might be added to Bill 33 to better achieve the goal of supporting franchising as an economic activity. This isn't exhaustive. These are just the two I've chosen to focus on here that I think are most important.

One is this term of "good faith and fair dealing," a substantive obligation as to how the franchisor can exercise discretion. You can call it whatever you want. Currently, we have the term "fair dealing" in Bill 33. You can call it "good faith and fair dealing." You can call it "commercial reasonableness," as has been suggested by some other people who testified before you.

What's important here is not what you call it but what you understand it to mean and what eventually courts or other enforcers understand it to mean, including what franchisors understand it to mean. What I'm going to suggest to you is that what it needs to be understood to mean is that franchisors are explicitly obligated to exercise their discretion as if it were their own assets at risk. Because if they're not, that means they're taking advantage of the fact that there is a separation of ownership and control and making a decision that, if they were the ones who had to renovate the outlet, would not be a good business decision. Sometimes it will be, but how do you decide if it's a good business decision or if it's advantage-taking? You ask, "Would the franchisor have done it with their own outlet?"

The second thing I think you need to focus on is low-cost enforcement because all the legal rules in the world are not going to make a difference unless there's an ability to make use of those. I've suggested a few ways here in which you can achieve low-cost enforcement. One is to give associations a class standing in civil litigation. That's a feature of Tony Martin's bill which I think is important to look at in terms of making it possible to hold the franchisors to that obligation. Again, why do you want to hold the franchisors to the obligation? Because that's how you generate efficient volume of franchising. That's how you get people in franchising.

Another way of getting some low-cost enforcement, and take the emphasis off "enforcement" there, is to put in place dispute resolutions that are low-cost, like mediation, non-adversarial approaches, to say, "Wait a second. I don't really understand why you're asking me to renovate like this," or "This is high-cost," or "Maybe you don't understand how this is going to impact on the outlet."

Third, and I want to emphasize this one in particular, government can do something important in supporting the private mechanisms that are out there to give franchisees the kind of commitment from franchisors that they need, and that franchisors want as a whole in order to generate interest in franchising. They can support the reputation mechanisms and can do that by supporting the flows of information, by allowing information to flow. It's important for the stories about what franchisors have done and what franchisees have experienced to be out there and available at low cost to potential franchisees, so that they can make judgments about what to do, because that's what provides the check on franchisor

behaviour that will in the end probably be most effective. That's really what makes the reputation mechanism that says, "Look, a franchisor's not going to cheat their franchisees because they won't be able to sell franchises." For that to work, that information has to be flowing. That's what you want franchisors to be doing, is paying attention to that.

For example, I think there should be a real push for the government to make sure that information is flowing, that it's not made confidential by confidentiality agreements, that franchisees are protected against lawsuits in the event they talk about what's happened to them as franchisees.

I'm not going to go into detail because of the time, but there are ways in which the government could play a role in structuring these mechanisms; for example, by mandating participation in an Internet Web site that publicizes information about the experience of franchisees with particular franchisors, that prospective franchisees could then access in order to assess, just as they're assessing investment levels and how you've been in this, so that the information is there. At the end of the day, I think that's one of the most effective things we can do. Thank you.

The Vice-Chair: Thank you very much, Dr Hadfield. We've got about five minutes for questions here. First of all, the Liberal caucus.

Questions

Mr Richard Patten (Ottawa Centre): First of all, welcome to Ottawa Centre. I gather you've had a good trip flying down from Sault Ste Marie. I guess you're ready to--

Mr Tony Martin (Sault Ste Marie): Another fine city.

Mr Patten: Another fine city.

Thank you for that presentation. I thought that was excellent. I'd like to come back to one thing you mentioned, and that was that one of your colleagues pointed out the 77% failure rate for US franchisors. (1) I wonder if you have any more recent information on what the situation is in the Canadian context and (2) could you elaborate on your comment that perhaps there's "too little franchising" in Canada?

Dr Hadfield: I don't think there's more recent information in Canada. This is not an industry that's been studied very extensively at all in Canada, so that data has just not been collected.

In terms of there being too little franchising, the only way we could know what the amount of franchising could be is to say, "Theoretically, have we made this as attractive as it could be?" We know that in any industry, in any economic relationship, if there's a risk of opportunism, of being taken advantage of, then one of the things that's going to happen is fewer people will go into it. Saying that there could be too little franchising is to say that to the extent that there are unaddressed problems of opportunism and it's risky, people will stay out of it.

Anecdotally, you can know that because, for example, I would say that I wouldn't go into it because the risks are there. It wouldn't be that I would worry that I was getting in with a fly-by-night operator. I just know there's no protection against the exercise of that control power in those ways. It's just not there, and you can't write it into the contract. It's not going to work to write it into the contract. So that's where the prediction comes from.

Mr Martin: We do have a couple of articles written by Professor Hadfield that we'll make available to the committee and to the people who are here today. One is Problematic Relations: Franchising and the Law of Incomplete Contracts; the other is The Price of Law: How the Market for Lawyers Distorts the Justice System. There are a couple of pieces of research that I've had done--Richard, I've been handing this stuff out as we've gone along--by Susan in legislative research. It's a summary of an article on franchise contract terms, like what it says and what it doesn't say, and another article that was put together by the

American Franchisee Association, Avoiding the Traps--Boilerplate that Bites: The 10 Most Dangerous Contract Terms. I'll be handing those out in a few minutes.

I wanted to ask Professor Hadfield to maybe expand a little bit on the issue of mediation and dispute resolution mechanisms. There's been the suggestion that what's already in place in Ontario that forces people into mediation before they go to the courts would catch this and deal with it. What's your view on that?

Dr Hadfield: The problem with mandatory mediation as it's now structured--and this is happening throughout; there's nothing special about franchising here--is that it is done in the context of lawsuits that have already been filed and an adversarial structure that's already been put in place. You've hired lawyers. You've filed a complaint or made an application; you've had an answer. So the positions have generally been hardened at that point, and most franchisees are probably not taking that step until things have gotten to an extreme point, like they've been terminated.

The idea of a low-cost form of resolution that supports this relationship would be a mediation mechanism that would kick in at a point at which the relationship can still be saved, at which we can deal with problems at an early stage so that the mediation would be low-cost and would not involve lawyers and legal suits. It might involve calling up, for example, the mediation arm of a private organization and saying, "I've just received this letter that says I have to make these changes to my outlet or the royalty rate is going up 2% next year, and I don't like this," doing nothing ahead of time other than getting that information out and then having a structured way in which you can talk with the other side.

As a way of comparison in a very different setting, in family law, the less legal structure that you have up front, the more likely it is that the mediation is going to be effective, because the positions haven't been hardened. You want to keep this out of that adversarial approach, really, to think about doing something quite different, very problem-solving oriented rather than litigation oriented, which is the way mandatory mediation is structured right now.

The Vice-Chair: We have a quick question by Mr O'Toole.

Mr John O'Toole (Durham): Thank you very much for your expert presentation. We've heard from a couple of people slightly different interpretations of some of this stuff. I think we all understand that there are sort of dominant-subordinate roles with the franchisor and the franchisee. Some have clearly described it as, "One takes the money out of the top and the other takes the money out of the bottom, if there is any." It's an unusual, rather risky position to be in.

I'm more interested in having you explain the way we've described fair dealing. That is something I'm interested in. I'm surprised that you would say that it's implied, so why put it in there? In most contracts, people would want to be going in with unencumbered integrity, so there's an implied element to it. The presenters on previous days asked us to strengthen it. One of them suggested putting "commercial reasonableness" in its place and said it's very much defined in case law. It's not a case that it's ambiguous or untested in court. You've said quite the opposite. You say that not only is it not necessary--it's implied--but it's no stronger than "commercial reasonableness."

I'm not in a position academically to question you, but I want that clarified. If we moved at all to improve it, I would suspect that might be one thing, to clarify fair dealing and not end up with a whole book of regulations of what fair dealing is and wait for the courts to define it. They said "commercial reasonableness" has gone through the discipline of being defined in property matters and other issues.

Just one other thing, and this isn't related to what I've just said. The right to associate—

The Vice-Chair: Where has that one-minute question gone?

Mr O'Toole: She's an expert. We've got to hear from them more importantly than the others, perhaps.

If you looked at the Internet and you had these associations--and just think of what's actually going on today at the academic level. You can get your PhD on-line. Do you understand? It's emerging as one way of chatting around the world about McDonald's. You don't have to be too brilliant to figure out that whole exposure will be part of the right to associate. They'll say: "This is my horror story," and "This is my success story." You figure it out. I would think that would be automatic and implied. The right to associate would imply the technology association as well. But I think more important is the commercial reasonableness question.

Dr Hadfield: Let me clarify what I meant when I said it's implied. In the United States, it's part of contract law that it's implied. That is not part of Canadian contract law, so it is not implied in Canada. I don't mean to say that it would not be a good move, if that's where you're going. To strengthen the language to put in commercial reasonableness would be better than just saying "fair dealing." These are terms that have some legal meaning.

My point was to say that if what you're hoping to accomplish by putting language like that in there and then potentially strengthening that language--if your goal is to deal with this problem of opportunism, because that is what is costly, that's the risk that we need to address in franchising--then "commercial reasonableness," all of these terms, when they get interpreted by the courts--I remember what I did when I did this work 15 years ago. I would go and look at, what does "good faith" mean in the franchising context? Even if you've seen it in other areas, it ends up having an industry-specific meaning.

In the US cases, for example, what "good faith" and "fair dealing" came to mean was that the franchisor could exercise business judgment. That is to say, the franchisor could make the decisions without taking into account the impact on the franchisee, and the reason for that was the courts did not understand the nature of this relationship. They saw it like an employment relationship. They said: "Look, the franchisor is the one in charge. They're the company. They're the one that makes the decision about whether to change the number of lines of automobiles in this dealership or whether or not to discontinue this branch of the business." They were missing the opportunism problem. They were missing the essential feature of the franchising relationship.

My concern would be that you could strengthen the language, certainly, from "fair dealing" to "good faith" to "commercial reasonableness," but what's going to happen in the courts is the term of "commercial reasonableness" will be defined in the franchising industry, in the franchising context. That is not currently there in the law; there isn't an established meaning for that. My suggestion to you is that the best thing to do to deal with this problem would be to make explicit what that means in this setting, and what it means in this setting is the franchisor should be making decisions with respect to those assets as if they were their own; that is, to take into account--you can fill in that, whatever language seems to work from that point of view.

To be clear, I would say, yes, "commercially reasonable" would be a better term, would give the courts a little bit more to work with in accomplishing this. But again, if you don't want to just leave it up to the courts and then 10 or 20 years from now say, "What have they done with that term?"--they could take that term and it could end up being exactly the same as it is now, with that problem having not been addressed.

The Vice-Chair: Thank you very much, Dr Hadfield. It's a pleasure to have you here with us this morning.

Toronto, Ontario, Canada