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Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Corporate/Commercial Group, Stanley Kugelmass at 416.593.3943 or skugelmass@blaney.com.

"Over the last year, the Financial Services Commission of Ontario has been aggressively monitoring the compliance by mortgage brokers and mortgage administrators..."

INCREASED REGULATORY ENFORCEMENT OF COMPLIANCE OBLIGATIONS OF MORTGAGE BROKERS AND ADMINISTRATORS

Kelly J. Morris

Over the last year, the Financial Services Commission of Ontario ("FSCO") has been aggressively monitoring the compliance by mortgage brokers and mortgage administrators with the provisions of the *Mortgage Brokers, Lenders and Administrators Act, 2006* (the "Act"). FSCO's enforcement activities have focused primarily on whether mortgage brokers and administrators have implemented the policies and procedures required under the Act.

The penalties for non-compliance with the Act are stiff. The Superintendent of Financial Institutions has the power to impose administrative monetary penalties for contraventions of the Act by mortgage brokerages or administrators (or entities that should be licensed as mortgage brokerages or administrators) of up to $25,000, and may impose administrative monetary penalties of up to $10,000 for contraventions of the Act by an individual who is, or should be, licensed as a mortgage broker or agent.

In 2009, FSCO imposed over 100 administrative monetary penalties totalling almost $100,000 against mortgage brokers. These include numerous penalties of $1,000 to mortgage brokerages that failed to file an annual information return and numerous penalties of up to $1,000 to mortgage brokerages that failed to hold proper E&O insurance.

In addition, the Act prescribes more serious offences for which the penalties are fines of up to $100,000 and imprisonment for up to one year for individuals. Corporations found guilty of such offences are subject to fines of up to $200,000, and every director who has acquiesced or participated in such an offence, or failed to use reasonable care to prevent the offence, is also guilty of an offence. These offences include carrying on business as a mortgage broker, lender or administrator without a proper licence; failing to comply with an applicable standard of practice; and providing false or deceptive information while carrying on the business of a mortgage broker, lender, or administrator.

Mortgage Brokerages - Required Policies

Under the *Mortgage Brokers: Standards of Practice Regulation,* mortgage brokerages are required to establish and implement policies to ensure that the brokerage and its authorized brokers and agents comply with the requirements under the Act. Mortgage brokerages should adopt written policies and procedures with respect to:

- Disclosing which party (or both) the brokerage represents (or whether it represents both parties);

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- Verifying the identity of borrowers, lenders and investors;
- Determining suitability of a mortgage or mortgage investment for borrowers, lenders and investors;
- Identifying and disclosing the material risks of a mortgage or mortgage investment;
- Identifying and disclosing potential conflicts of interest of the mortgage broker;
- Receiving incentives, other than money, by agents or brokers (other than from the brokerage) for dealing in mortgages;
- Paying incentives, other than money, to agents or brokers of other mortgage brokerages;
- Ensuring that brokerages, brokers and agents comply with their responsibilities under the Act;
- Ensuring that brokers and agents are adequately supervised;
- Handling and responding to complaints;
- Handling and retention of records;
- Managing trust accounts;
- Filing annual information returns and financial information; and
- Maintaining errors and omissions insurance.

Preparing the written policies is a necessary first step to ensuring compliance with the Act. However, it is equally important that all licensed brokers and agents (and any other affected staff) are aware of their obligations under such policies. Accordingly, mortgage brokerages should provide (and document) the training provided to staff on their policies, and should perform ongoing training and monitoring to ensure that staff are complying with those policies.

FSCO's Compliance Review of Mortgage Brokerages

In May 2010 FSCO released its *Report on FSCO's Compliance Review of Mortgage Brokerages* (the "Report"), which examined the compliance by mortgage brokerages with the requirements under the Act. FSCO's review, which included on-site inspections of approximately 10% of all mortgage brokerages in Ontario, focused on standards of practice of mortgage brokerages, and in particular those relating to policies and procedures, oversight and corporate governance.

The Report found that "most mortgage brokerages have written policies and procedures that are generally in compliance with the standards of practice under Ontario Regulation 188/08 [the *Mortgage Brokers: Standards of Practice Regulation*] …in many cases, the brokerages had communicated their policies and procedures to their mortgage brokers and agents". The areas FSCO specifically identified for improvement are:

- Syndicated mortgages;
- Restrictions on payments by the brokerage;
- Provisions governing payment of incentives other than money; and
- Records retention.

FSCO Examiners asked the selected mortgagee brokerages a number of questions to determine compliance with the Act, and categorized the responses as either low risk, medium risk or high risk. High risk activities were those for

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which 25% or more of the responses failed to comply with the requirements under the Act. High risk activities identified by the Report include the following:

- Signage and promotional materials failing to prominently disclose the brokerage's licence number and legal name;
- Failure to maintain records of training provided to brokers and agents;
- Policies and procedures failed to include:
    - provisions to ensure compliance of brokerage, its brokers and agents with the requirements of the Act;
    - provisions for incentives other than money for dealing in mortgages:
        - to brokerage's brokers and agents by other persons, or
        - to another brokerage's agents or brokers;
    - requirement to notify FSCO of any brokers or agents not suitable to be licensed;
    - requirement to terminate access of brokers and agents to the software provider on termination of employment;
    - provisions requiring the brokerage to pay fees for trading in mortgages only to licensed entities or entities exempt from licensing requirements and not to pay fees directly to another brokerage's brokers or agents;
    - requirements that documents and records be retained for six years after the expiry of the mortgage in Ontario; and
    - requirement that documents be returned to borrowers, lenders or investors on demand;
- Mortgage brokerages that deal in syndicated mortgages failing to have policies and procedures with respect to such syndicated mortgages; and
- Trust bank account records failing to distinguish between trust funds and other assets of the brokerage.

Mortgage Administrators - Required Policies

The standards of practice applicable to mortgage administrators, including the obligation to establish policies and procedures to ensure compliance with the Act, are enumerated in the *Mortgage Administrators: Standards of Practice Regulation*. Mortgage administrators should establish written policies and procedures with respect to:

- Verifying the identity of lenders;
- Advising lenders if the mortgage administrator will pay or receive fees from any other person in connection with the administration of the mortgage, or if the administrator will receive a referral fee in connection with the lender;
- Identifying and disclosing potential conflicts of interest to the lender;
- Ensuring that all mortgage administration agreements contain the information required by the *Mortgage Administrators: Standards of Practice Regulation*;
- Ensuring that all individuals acting on behalf of the mortgage administrator are adequately supervised;
- Handling and responding to complaints;
- Handling and retention of records;
- Managing trust accounts;

"The standards of practice applicable to mortgage administrators… are enumerated in the Mortgage Administrators: Standards of Practice Regulation."

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- Filing annual information returns and financial information; and
- Maintaining errors and omissions insurance.

Review of Mortgage Administrators by FSCO

The examinations of mortgage administrators currently being conducted by FSCO require the mortgage administrators to produce the following documents for inspection by the FSCO Examiner:

- Current audited financial statements;
- Policies and procedures, including training procedures and manuals;
- Standard mortgage administration agreement, which must contain all the terms required by the *Mortgage Administrators: Standards of Practice Regulation*;
- Listing of officers, directors, offices open to the public and trust bank accounts;
- Most recent monthly reconciliation statement for trust accounts;
- Documentation confirming compliance with required $25,000 financial guarantee; and
- Information as to the number of mortgages administered and their dollar value, the number of syndicated mortgages and their dollar value, the number of mortgages in arrears and their dollar value and the number of lenders/investors.

If you are a mortgage brokerage or mortgage administrator, we can help you prepare the necessary policies and procedures to ensure compliance with the Act and the Regulations. We can also assist if you are selected for an examination by FSCO. ■

ALL THAT GLITTERS: THE *MIDAS* TOUCH ON FRANCHISE AGREEMENTS

Todd Greenbloom and Daniel I. Horovitz

A recent Court of Appeal decision has challenged the validity of historically standard franchise practices. Before this decision was released, a standard franchise agreement renewal provision would require that the franchisee release the franchisor from any and all potential lawsuits based on past events; likewise, a comparative release clause would apply where a franchisee would want to assign its franchise to a third party. In *405341 Ontario Limited v. Midas Canada Inc.*, the Ontario Court of Appeal was of the view that inclusion of such a release clause in a franchise agreement is contrary to the spirit and intent of Ontario's franchise law.

This article will briefly summarize the history and context of the decision, and provide information and commentary that will be of importance to both franchisors and franchisees.

The Way It Was

Ontario's franchise law act is formally known as the *Arthur Wishart Act* (2000) ("the **Act**"). The three main principles of the Act are: (i) franchisors and franchisees owe each other a duty of good faith; (ii) potential franchisees are entitled to certain disclosure by the franchisor prior to signing a franchise agreement; and (iii) franchisees have the right to associate with each other. Moreover, section 11 of the Act clearly states that no party to a franchise agreement can contract out of the provisions in the act. In other words, no franchise agreement can include provisions that the Act prohibits, even with the consent of both parties.

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For years, standard franchise agreements provided that the agreement could not be renewed unless the franchisor was released from any potential liability arising from events that occurred under the franchise agreement to the date of the renewal. If a franchisee felt that the franchisor was treating it unfairly, it nonetheless had to give up its right to sue in order to extend the term of the franchise agreement. Franchisees agreed to these provisions because, in return, they received the right to continue operating their franchised business.

The Ontario Superior Court of Justice in the 2006 case *1518628 Ontario Inc v. Tutor Time Learning Centres* determined that the franchisee could not recant the release it had given to the franchisor, whereby the franchisor was released from the failure to provide disclosure in exchange for what was effectively the franchisor's consent to an assignment of the business by the franchisee. In that case, the purchaser of shares of a franchisee was not provided with the disclosure required by the Act. The franchisee's business failed and was sold to a third party who then operated the business outside of the franchise system. At the time of the sale, the franchisee indicated that it had the right to rescind the franchise agreement because of the failure of the franchisor to provide disclosure. At that time the franchisee owned money to the franchisor. Ultimately, a settlement was reached between the franchisee and the franchisor, which included a release in favour of the franchisor. The settlement was reached with the advice of counsel, and with the franchisee being fully aware that it was renouncing any claims it had arising from the failure to receive proper disclosure. Once the sale to the third party was completed, the franchisee attempted to rescind the settlement on the basis that the release was contrary to the Act. Justice Cummings did not accept the franchisee's argument and concluded that section 11 of the Act does not apply to releases given by franchisees to franchisors in the settlement of disputes for "existing, known breaches of the act in respect of its disclosure obligations." Justice Cummings reached this conclusion in part because, in his view, "[t]he settlement of a claim arising from and consequential to an existing statutory right of rescission is not in itself "a waiver or a release" of that statutory right to rescission. It is a release of the claim arising from having exercised the right of rescission or being in the position to exercise the right of rescission."

Arguably, the Tutor Time case stands for the proposition that releases in franchise agreements stand up to the Act where the franchisee is aware of the breach and obtains legal advice, and it accordingly supports the practice of obtaining releases as a precondition to renewals or assignments. In *Midas*, the Court of Appeal clarified that this is not the case.

The Way It Is

In *Midas*, the franchisee alleged that the release was contrary to the part of the Act dealing with the right of association. Section 4 of the Act states that franchisees have the right to associate with each other, and any provision in a franchise agreement prohibiting that right is considered void. In this case, the franchisor attempted to use the general release provision to prevent the franchisee from joining a class action suit against it. The class action dealt with a change to the franchise system's supply chain system and not with disclosure. The franchisee argued that in upholding the right to associate, section 4 "encompassed the right of franchisees to join

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in class proceedings with other franchisees for the purpose of enforcing their rights against the franchisor."

The court agreed and looked beyond the mere facts of the case. It attacked the very idea of contractual releases in franchise agreements, stating that "requiring franchisees to give up any claims they might have against a franchisor for purported breaches of the Act in order to renew their franchise agreements unequivocally runs afoul of the Act" (at para 30). The purpose of the Act, the court noted, is to protect franchisees. Section 11 embodies that sentiment.

The court distinguished its decision from *Tutor Time* because the franchise agreement in *Midas* was signed before the breach arose and so the obligation to give the release was signed without any knowledge of the breach. Not only was *Tutor Time* distinguished, but the instances where *Tutor Time* might apply were narrowed. *Tutor Time* might otherwise have continued to govern in those instances where a franchisee right had crystallized into a claim. But the *Midas* decision went beyond merely distinguishing *Tutor Time*, by declaring that "the distinction between rights and claims is artificial. The claims in the class action are derived from rights that the class members are seeking to assert" (at para 27). Ultimately, the court held that release provisions in franchise agreements are void.

The Way It Appears To Be Heading

Midas holds a number of implications for future franchise agreements. Most obviously, if a franchisee is faced with a contract renewal, and has multiple grievances against the franchisor, the franchisee can renew the contract and retain the right to sue. Likewise, if a franchisee wants to assign its franchise to a third party, and has made allegations against the franchisor, the franchisee can sell and also retain all of its rights to sue.

From a franchisee's perspective, *Midas* means a newly acquired freedom to pursue its rights while maintaining its livelihood. From a franchisor's perspective, this decision may open up the possibility of scenarios where, for example, "trouble-making" franchisees cannot be forced out of the system at renewal time.

From a practical point of view, the decision in *Midas* suggests that solicitors must re-think how they draft franchise agreements. In the future, franchise agreements may be drafted to bring the "release" desired by the franchisor closer to the *Tutor Time* facts then the *Midas* facts. It might be possible accomplish this goal by forcing a true settlement as opposed to imposing a condition that benefits the franchisor to the detriment of the franchisee. In other words, solicitors may think of trying to achieve an win-win situation instead of a zero sum game with the franchisor holding all of the cards.

Franchisors and franchisees operating under current franchise agreements should continue to act in good faith towards one another, and approach each other on all issues, whether in preparation of contract renewal or otherwise, openly and honestly.

Conclusion

Midas has not changed the basic principals of franchising. Before Midas every franchise agreement imposed on each party a duty of fair dealing in its performance and enforcement, and that still remains the governing principle of the franchise relationship. What *Midas* has done is clarify the extent to which the Courts may apply that principle. Franchisors may now have to

"A code of conduct creating new obligations for credit and debit card providers as well as payment card networks... came into effect on August 16, 2010."

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exercise more caution in how they seek to interpret and enforce their agreements, and franchisors working with their solicitors may need to be more creative in structuring their affairs to achieve results close to their expectations but making the duty of fair dealing paramount. ■

MERCHANTS AND CONSUMERS TO BENEFIT FROM NEW CODE OF CONDUCT FOR THE CREDIT AND DEBIT CARD INDUSTRY

Patrick Gervais

A code of conduct creating new obligations for credit and debit card providers as well as payment card networks (for example, electronic payment systems) came into effect on August 16, 2010 (the "Code of Conduct").

The purpose of the new Code of Conduct is to ensure that merchants are fully aware of the costs of accepting credit and debit card payments and to allow merchants and consumers greater choice and flexibility of payment options. Credit and debit card providers will have greater disclosure obligations regarding interest rates, fees and payment options.

Although compliance with the Code of Conduct is voluntary, the federal government is prepared to introduce legislation to regulate the industry should the new Code of Conduct not be adopted by industry participants.

The credit and debit card industry had until May 17, 2010 to adopt the code and until August 16, 2010 to implement most of the changes. Payment card networks and acquirers have until February 17, 2011 to implement new disclosure requirements and card issuers will have up to May 17, 2011 to re-issue cards already in circulation that contravene new branding requirements.

The following are highlights of the new Code of Conduct:

No more preferential branding of payment networks

New branding rules require that payment networks available on cards be indicated in a clear manner and that there be no preferential branding of certain payment card networks. Payment networks must be equally branded with brand logos of the same size and in the same color schemes and on the same side of the card.

Debit and credit options can no longer co-reside on a same card

Given the different characteristics and costs associated with credit and debit accounts, new rules prohibit the issuance of a card offering both options. This new rule is meant to limit consumer confusion by creating a physical distinction between credit and debit cards.

New income and spending thresholds for premium cards

Premium cards with higher than average handling fees can only be targeted to individuals who meet specific spending habits or income levels and may only be given to consumers who apply for or consent to such cards. Premium cards will no longer be offered to consumers who do not meet minimum thresholds.

More information in monthly statements and merchant agreements

Payment card network agreements and monthly statements to merchants must now be presented in a more clear and simple manner. Monthly statements will include effective merchant dis-

"The objective of the Code of Conduct is to provide consumers with more information regarding various payment schemes... which will foster more competition within the payment card network and card industry."

count rates for each type of payment card (the total fees paid by the merchant divided by the total sales), handling fees, the number and the volume of transactions for each type of transaction, the total amount of fees applicable to each rate and details of each fee. More information will enable merchants to better assess whether higher costs associated with certain payment networks are warranted.

New notice periods
Merchants must receive a minimum of 90 days notice of any rate or fee increase or the introduction of a new fee related to any payment card network and 180 days for any change to the fee structure, for example a fee per transaction replacing a monthly service fee. Merchants will be allowed to cancel their contracts without penalty should they choose not to accept fee increases.

Negative acceptance no longer permitted
Merchants will need to provide their express consent to any new product or service and merchants will not be obligated to accept new products or services.

More flexibility in network options
Payment card networks can no longer oblige merchants to accept both credit and debit card payments from the same payment card network. A merchant will be able to chose either a credit or debit payment option without being required to accept both options from the same payment card network.

Discounts depending on method of payment
Merchants will be allowed to offer discounts for different methods of payment as well as differential discounts among different payment card networks. For example, a consumer could be offered a discount when paying by debit card instead of credit card and another discount for using a certain electronic payment system such as tap-and-go over another. The goal of providing discounts for different payment methods and payment card networks is to foster competition among networks and card providers and benefit merchants and consumers.

The objective of the Code of Conduct is to provide consumers with more information regarding various payment schemes, the idea being that consumers who are aware of the fees associated with various payment mechanisms will choose the least expensive option, which will foster more competition within the payment card network and card industry.

The new Code of Conduct benefits merchants and consumers by increasing disclosure of costs associated with different payment options. However, compliance may prove challenging for the credit and debit card industry as it adapts to the new requirements and the strict timeline to implement change.

Should you wish to learn more about the new Code of Conduct and how it will affect your business or explore new opportunities in the credit and debit card industry, please contact a member of Blaney McMurtry's Corporate/Commercial Group. ■

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"Even if a business's primary market is North America, there are legal issues that can blossom beyond national boundaries and then rebound to have consequences here."

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GOOD FAITH ADVOCACY AND THE GLOBAL PERSPECTIVE

Michael Schiff

It is becoming increasingly clear that Canadian businesses need to develop and pursue a globally-oriented legal strategy.

Even if a business's primary market is North America, there are legal issues that can blossom beyond national boundaries and then rebound to have consequences here. Environmental control, trade and competition law, intellectual property, and a range of other legal issues can all have international ramifications.

What this means is that companies should engage legal counsel with both the vision and the energy to address issues when they arise abroad. Associate counsel may be retained in foreign jurisdictions to advise on and address local requirements — but there needs to be oversight from lead counsel in the home country. If foreign counsel is given autonomy to make their own strategic choices, they may take a divergent path that will be to the company's peril.

A recent illustration comes from the written dialogue that patent agents have with the Canadian Intellectual Property Office (CIPO) when they are in the process of applying for a patent. This dialogue determines what scope of patent protection CIPO will grant for a company's invention. Traditionally, patent counsel could tell CIPO anything it wanted about the client's invention, as long as what was said did not amount to fraud. However, when Canada's *Patent Act* was rewritten in 1996, there was an explicit duty placed on patent agents to respond to CIPO "in good faith".

The Federal Court of Canada has now given the "good faith" wording some teeth. A new standard is emerging for dealing with CIPO: a standard that has important ramifications for how patent counsel should manage each company's patent estate — both at home, and abroad.

When legal matters are contested between two sides, each side has an opportunity to advocate its own position. The lawyers act as strong proponents for their clients' respective points of view: in fact, they are obliged by the ethics of their profession to represent their clients zealously, within the bounds of the law. However, where there is a power imbalance, courts may expect the stronger side to use its leverage with restraint: for example, the treatment of tenants by landlords, or the treatment of employees by the companies they work for.

The dialogue between a patent applicant and CIPO is even more one-sided, because the hypothetical opponent (someone who might want to use a closely related technology) is not even there. CIPO attempts to protect the public interest in a general sense by making the applicant justify the coverage it is seeking in its application. Still, the debate is *ex parte* (with only one party being represented), so the Federal Court has imposed a requirement that patent counsel deal with CIPO according to a more scrupulous standard of good faith.

For exactly the same reason, patent law in the United States imposes an explicit duty of candor when dealing with the Patent Office there (USPTO). Patent attorneys are required by federal regulation to disclose to the USPTO any and all information they have that is material to the patentability of the invention claimed in the application. This means that they are obliged to

"There is also the matter of what I call interjurisdictional estoppel: *the principle that what you say in a legal context in one country can come back to bite you somewhere else around the globe."*

give the USPTO copies of any articles or other published information that they have about close prior inventions. If the applicant has data that the invention may not work in the manner claimed, this also must be given to the USPTO. If the patent attorney fails to comply with the duty of candor, courts can later find that the applicant is guilty of *inequitable conduct*. This means that the patent cannot be enforced against someone copying the invention, and the attorney may lose their license to practice.

The doctrine of inequitable conduct effectively came to Canada two years ago in a case about the anti-inflammation drug celecoxib (sold under the brand name Celebrex®). In its application for the patent, the company's agent told CIPO that similar compounds that were previously known were not selective for a particular cell-surface receptor. But the company had a publication that showed this wasn't true. The Federal Court decided that by not providing the information to CIPO, the patent owner had failed to deal with CIPO in good faith, and the patent had effectively been abandoned in the application stage.

Last fall, the Federal Court also effectively invalidated a patent granted for the Alzheimer's drug memantine (Ebixa®). During the course of the application, the company's patent agent provided CIPO with four previous publications which he said steered readers away from the use of memantine for this purpose. But the applicant knew full well that another published article led to the opposite conclusion. In this case, the Court arguably went beyond the U.S. doctrine — not just requiring that applicant provide CIPO with the published information, but also refereeing what patent counsel could say about it.

How far will the good-faith requirement go in Canada? This area of law is still evolving, and we will have to wait and see. Patent agents in Canada sometimes file applications that start off with claims that are so broad that they cover previous inventions. They rely on CIPO to narrow the claims in the course of examination. But if an agent had no reasonable belief that the original claims were patentable, then how can filing the application in this condition satisfy the good faith requirement? Arguably, the application was abandoned right out of the starting gate, and the patent owner may never be able to assert the granted patent against a rival.

There is also the matter of what I call *interjurisdictional estoppel:* the principle that what you say in a legal context in one country can come back to bite you somewhere else around the globe.

Consider a situation in which a company has a new patent application for a second-generation product. There is an earlier application already on file for the first generation product which mentions the second generation product as a possible extension. The company's patent agent in Canada tells CIPO that the earlier application doesn't provide enough information about the second generation product to defeat what is claimed in the new application.

But suppose the company's patent agent in Europe has already told the European Patent Office that the second generation product is patentable in the earlier application, and gets generous coverage for it. How could it be proper to tell EPO one thing about the earlier application, and then say exactly the opposite to CIPO later on? Someone challenging the Canadian patent could say that the company had not dealt

with CIPO in good faith, and the patent is invalid.

When pursuing patent coverage in several jurisdictions in parallel, patent counsel is often tempted to let the local associate make autonomous choices. Our illustration about the second generation product shows this is a mistake. Instead, lead counsel managing arguments made in all countries, to ensure that the company's position is consistent around the globe. Foreign associates shouldn't make prosecution choices in terms of the technology of the invention. Instead, their role should be to render the position chosen by lead counsel into local parlance according to local patent law.

The reasons for taking a global view of a company's intellectual property estate will continue to expand. A tempered and internationally consistent position will help ensure robust and sustainable protection for a company's evolving business. ■

Original sources: Patent Act s. 73(1)(a); 37 CFR § 1.56; *G.D. Searle & Co. v. Novopharm Ltd.*, [2008] 1 F.C.R. 477; *Lundbeck Canada Inc. v. Ratiopharm Inc.*, 2009 FC 1102.

Blaney McMurtry welcomes new Associates to our Corporate / Commercial Group

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Jacqueline is with Blaney McMurtry's Intellectual Property practice area. She has a Ph.D. in Genetics from Michigan State, and is a registered Patent Agent.

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