FRANCHISING IN CANADA

By Paul Jones

I INTRODUCTION

Franchising is one of several methods available to a manufacturer or exporter for distributing its goods and services to consumers. Manufacturers also have the option of setting up chain stores that they own and control, or of selling through sales agents or independent distributors.

However in more mature economies, such as Canada, the market is much competitive. Many manufacturers who traditionally sold their products through other peoples' stores, or through independent distributors, are finding that in order to remain competitive they need to improve the quality of the shopping experience or the amount of service that they provide with the product. Accordingly many North American manufacturers are trying to upgrade their dealership systems by offering more support to the dealers. In return they often want more control over how the dealership is operated. Dealership systems are evolving into franchise systems.

For certain types of products and services, franchising can be a superior form of distribution. Franchisees who own their own business often provide better service and better retail experience. They can adapt franchise systems to the tastes of the local customers.

The other main advantage of franchising, particularly when compared with chain stores operated by the manufacturer, are that the franchisees provide much of the capital needed to develop the system. Often this encourages the fast growth of the system. Fast growth leads to wider recognition of the trade-mark or brand. Wider brand recognition in turn leads to greater sales.

There are disadvantages to franchising. One disadvantage is that is that it is more difficult to control franchisees because they are independent business people. Franchisors cannot simply issue orders to franchisees, but often have to achieve consensus through long discussions. There is a debate within the franchise sector as to the appropriate mix of corporately owned chain stores and independent franchisees that is best for distributing goods and services. Jeffery L. Bradach of the Harvard Business School wrote a book in 1998 called *Franchise Organizations*, in which he came to the conclusion that there is not a single correct answer. Rather is better to have both corporately owned stores and franchise stores in a distribution system.

There are some industry examples in North America which suggest that this is true. When video stores first became popular, the competitive advantage of a video store system was initially in its absolute size, which allowed the system to negotiate better

terms and prices with the movie studios. Thus Blockbuster Video found a good source of capital and expanded through corporately owned stores. But home videos are not as popular now and more service and a better retail experience are required to remain competitive. Accordingly Blockbuster Video has now changed its strategy to include more franchising in North America.

Companies that distribute through chain stores in their home markets often choose to franchise in international markets. In North America, Starbucks owns the stores and uses an incentive plan for managers to ensure good service and a quality retail experience. However internationally it uses franchising so that the local master franchisees in each country will assist it in adapting to the local market.

A Chinese company wishing to distribute its products or services in North America should definitely consider using franchising. The North American markets are mature and highly competitive. Hong Kong manufacturers have found it difficult to establish their brands in the Canadian market, and have often restricted themselves to selling to Chinese Canadians. Sometimes they have used the Chinese Canadian market as a way of learning more about Canada and how to sell their goods and services to all Canadians, or even to Americans.

A. Franchising in Canada

Franchising in Canada is highly developed and is present in many retail and wholesale sectors. It is estimated that forty percent of the retail sales in the Province of Ontario are through franchised stores. In Canada it is estimated that franchise businesses account for almost $90 billion in sales annually. Many of the franchisors are familiar American names such as MCDONALDS, BURGER KING, MAIL BOXES, ETC., OR HOLIDAY INN.

For American franchisors, Canada is often their first foreign expansion. They find that Canada has fewer franchise regulations than in the United States and that there are fewer franchise disputes that result in court cases. And of course Canada is culturally relatively close to the United States. However there are still important differences and the products often have to be adapted to the Canadian market.

There are also many Canadian franchise systems competing with the Americans. Some times they are even more successful than the Americans and systems such as UNIGLOBE, SECOND CUP and YOGEN FRUZ have expanded into the United States with good success.

B. The Canadian Market

In 1997 Canada had a total population of 29,969,209 with an average GDP per head of $19,703.00 U.S. It is thus equal to only about eleven percent of the American population and is not as rich. However Canada tends to have a more even

distribution of its wealth and factors such as this have led to it being regularly ranked first of all the countries in the world by the United Nations with respect to the quality of life.

In contrast to the United States, the Canadian population is concentrated in fewer areas. Almost 38% of the population lives in the Province of Ontario and Canada's population is more urbanized than the American population. For example the City of Toronto has over three million people, making it larger than all of the other nine Canadian Provinces except Quebec and British Columbia. This is an advantage for those wishing to introduce a new product. It is easy to cluster the first few outlets within easy reach of a large percentage of the population. And because of Canada's small size relative to the American market, some American competitors do not focus as clearly on the Canadian market. This leaves opportunities in Canada for other retailers.

Another factor to consider is that Quebec, which represents almost twenty-five percent of the Canadian market, is primarily French speaking with a distinctly different culture. Advertisers often choose to develop separate advertising campaigns for the Quebec market. Simply translating the English campaign does not usually work as well. Franchisors sometimes award a separate master franchise for the Quebec market, or develop a separate advertising fund for Quebec. If Quebec is considered a separate market, the proportion of the Canadian market that is clustered around Toronto and Vancouver becomes even higher.

Both Toronto and Vancouver have large Chinese speaking populations. Chinese is now the third most commonly spoken language in Canada. It is much more common to hear Cantonese or Mandarin on the streets of Toronto than it is to hear French. And within he Canadian Chinese community, the use of Mandarin is increasing as more immigrants arrive from China. On Chinese language radio stations, advertising in Mandarin will soon equal the amount of advertising in Cantonese.

II DESIGNING A FRANCHISE SYSTEM FOR CANADA

Franchisees are independent business people who invest their money to operate a business under the franchisor's trade-mark. Because they use the franchisor's trade-mark, they must adhere to the franchisor's system of doing business so that the trade-mark will have a uniform meaning throughout the Canadian market. To start a franchise system, a franchisor must first develop an idea and develop a proven business system. Then the important elements of the business system must be written down in a manual that the franchisee can follow. To ensure that the trade-mark and the manual are protected, and to ensure that the franchisees conform to the franchisor's rules, the franchisor must also develop a contract that will govern the relationship. Because the parties are independent business people, this contract will be enforced by the courts according to law. Franchisees will want to review the contract carefully before agreeing to buy a franchise.

A. The Canadian Legal System And Franchising

A franchise agreement is essentially a contract or licence to use a franchisor's trade-mark and other intellectual property in the operation of a business. It is more detailed and comprehensive than other trade-mark licences because franchisees are more closely integrated with the franchisor. In Canadian law this results in a divided jurisdiction over franchise arrangements.

Canada is a federal state comprised of ten provinces and three northern territories. The northern territories are lightly populated and depend upon payments from the federal government to maintain their government infrastructure. Each province has its own legislature. Thus both the federal Parliament and the provincial legislatures may make laws affecting residents in each province. The *Constitution Act of 1867* sets out the division of powers between the provincial and federal governments.

The federal Parliament generally has the power to regulate inter-provincial trade and certain other specific matters. However the provinces have the power to set the rules regarding the formation of contracts. With respect to franchising, this has led to an interesting problem. The franchisor's trade-mark must be registered under the federal *Trade-marks Act*, and Section 50 of the *Trade-marks Act* sets out certain rules with respect to the licensing of trade-marks. Because a franchise agreement is also a contract, to the extent that the federal government does not pass laws regarding trade-mark licences, the provincial governments are able to pass laws regulating the formation of franchise agreements.

As will be discussed later, the Province of Alberta, which has about nine percent of Canada's population, has had a law regulating the selling of franchises for many years. As at the time of writing this legislation, the Ontario Legislature was in the process of passing a law similar to Alberta's that will require the disclosure of all material facts regarding a franchise system before the franchisee is required to pay money or sign a franchise agreement. It is expected that this law will be in force by the end of the year 2000.

The remaining eight Canadian provinces do not have any legislation regarding franchising. In these provinces there is no requirement to make any particular disclosure when selling a franchise. However if some representations are made about the franchise they must be true and not misleading, otherwise the disclosure will violate the criminal offences section of the federal *Competition Act* or the common law restrictions on negligent misrepresentation.

All of Canada, except for the Province of Quebec, uses a common law legal system derived primarily from the British system. This means that for matters were the legislature has not passed a statute, the law is determined by cases that have previously been decided. In theory the courts are bound by previously decided cases, but in truth the law is always evolving.

The Province of Quebec is a mixed civil law and common law jurisdiction, with a *Civil Code* derived partly from French law and partly from British law. In matters of contract law, Quebec more closely follows the French civil law model. The civil law model is based on new law being derived from broad general principles that are logically developed by legal scholars, or are stated in a civil code. China has been developing its new legal system primarily along civil law lines. For example the Contract Law passed by The National People's Congress on March 15, 1999, used the German Civil Code as a reference point.

While each province has its own court system, for commercial matters there are three levels of courts. There is a trial level (which has a different name according to the province), and a court of appeal at each provincial level, and a single Supreme Court based in Ottawa. There is also a Federal Court system, consisting of a trial division and an appeal division, which handles matters wholly regulated by the Federal Government such as trade-marks. Unlike China, no distinctions are made between cases involving only Canadians and cases involving Canadians and foreigners. Although each province has its own court system, the judges in such systems are appointed by the Federal government. In contrast to China, Canada does not consider itself to have a problem with local protectionism by judges.

B. Intellectual Property Laws

For a franchise system, the most important intellectual property laws are the federal *Trade-marks Act* and the *Copyright Act*. The *Patent Act* is less important to most franchisors unless they have a particular product or part of the system that is protected by patent. Trade secrets and confidential information are not protected by statute and thus must be protected by a contract between the parties or by the rights that exist at common law.

1. Trade-marks Act

Trade-marks must be registered in each country in order to obtain protection. Canada is a "first to use" jurisdiction, meaning that priority is given to the person who first used the trade-mark in Canada in determining the ownership of a trade-mark. In contrast, China is a "first to register" jurisdiction meaning that priority is given to the first person who registers the trade-mark, irrespective of who first used the trade-mark.

For foreign franchisors it is important to register their trade-marks in Canada as soon as possible. It is perfectly legal for a Canadian to travel to the United States, see a business and trade-mark that are successful, and return to Canada to register and use the trade-mark, unless the American owner has first registered in Canada. Many American franchisors wanting to start franchising in Canada have discovered too late that a stranger has already registered their trade-mark. The cost of

registering the trade-mark in advance is significantly less than the cost of trying to take back the trade-mark from the Canadian who holds the registration.

Many Chinese-Canadian businesses have used the names of famous businesses in Hong Kong or China as their own, and some have registered them in Canada as their own trade-mark.

There are three ways in which a foreign franchisor who is not yet using a trade-mark in Canada can obtain registration and protection. Registration in Canada can be obtained based on registration by the franchisor in its country of origin and use of the trade-mark in its country of origin or in another country, provided that the trade-mark is not confusing with a trade-mark that has been previously used or made known in Canada. Registration may also be obtained in Canada based on the franchisor having made the trade-mark known in Canada, such as through extensive advertising. This is primarily of assistance to Americans, and even for Americans it is not easy to obtain. The third method is to make an application based on proposed use in Canada. However to eventually obtain the registration in Canada it will be necessary to actually commence use of the trade-mark in Canada in the ordinary course of business and to provide the trade-marks office with a declaration of such use.

There are approximately 2,200 Chinese character trade-marks now registered in Canada. However it is very difficult to conduct a search of such trade-marks to determine if an application will be confusing with a trade-mark that has been previously used or registered in Canada because the government has filed most of the them under the single heading "CHINESE CHARACTER DESIGN". Searching Chinese trade-marks in the Canadian system requires particular inventiveness and skill.

The Trade-marks Opposition Board (a government tribunal that hears disputes regarding the registration of trade-marks) previously held that the test for confusion between Chinese character trade-marks was that of the average Canadian who did not understand Chinese. This meant that the sound and the meaning of the trade-mark, and sometimes the appearance, would not be taken into account when determining confusion. Chinese character trade-marks were thus afforded very weak protection.

But a decision of the Federal Court Trial Division in December, 1999 has changed the law so that Chinese character trade-marks are now afforded better protection. Provided that such trade-marks are used to sell to the Chinese community, and that it is accepted that there is a significant Chinese community in the area where they are used, the test for confusion will be that of the average consumer of the wares or services associated with the trade-mark, i.e. that of the Chinese Canadian community. This means that the sound, meaning and appearance of the trade-mark will all be taken into consideration. This is a great improvement and long overdue.

Once the application is filed, trade-marks are reviewed by a government examiner to ensure they are suitable for registration. They are then advertised in the government journal and for a period of two months following such advertisement, a person may file a notice opposing the registration of the particular trade-mark. If no oppositions are filed, the application is allowed, and subject to the payment of a further fee of $200.00 Canadian, or the submission of a Declaration of Use were the trade-mark application is based on proposed use, the trade-mark is entered on the register. Registration of a trade-mark where no response is required to the government examiner and there is no opposition generally costs about $1,500.00 Canadian, including government fees.

Trade-mark registrations are valid for a period of fifteen years, after which time they may be renewed in the discretion of the owner. The trade-mark owner may licence other persons, such as franchisees, to use the trade-mark pursuant to Section 50 of the Trade-marks Act. There is no requirement that these trade-mark licences be registered with the government, as there is in China.

Trade-mark owners have the option of making such a registration to evidence the fact that they have retained control over the character or quality of the wares or services used in association with the trade-mark. Most franchisors do not make such registrations. But it is important for franchisors to ensure that they retain control over the character or quality of the wares or services used in association with the trade-mark, and retain evidence of the exercise of such control. There is a significant advantage in requiring each franchisee to give public notice, by means of a sign, that the use of the trade-mark is by means of a licence agreement with the franchisor.

2. Copyright Act

Unlike trade-marks, copyrights are protected by treaty, and a copyright that is valid in China will be protected under the Canadian *Copyright Act* without further registration in Canada. Franchisors use copyright to protect their franchise manuals, advertising materials and other written items. Sometimes Canadian franchisors register their copyright in their operations manual in order to have a certificate to present to a franchisee who disputes the ownership of the manual. The obligation is then on the franchisee to challenge such registration. Most franchisees would choose not to challenge the copyright registration.

For foreign franchisors there are special copyright issues. If the operations manual has to be translated into English or otherwise modified for use in Canada, the author of the translation or modification automatically acquires copyright in the translation together with the copyright held by the franchisor as the original owner and author. Canadian copyright law consists of not only the right to make a copy of a work, but also the right to receive credit for having produced it and the right to approve or not approve modifications. These latter two rights are also known as "moral rights".

The usual practice in international franchising is that the master franchisee will perform the necessary translation at its expense, often using a third party consultant or writer. International master franchise agreements usually provide that the franchisor is to retain all the copyrights in the translations. In order for this to happen, it is necessary for the translator or author to waive their moral rights in the translation and assign their copyright in writing to the franchisor.

3. Trade Secrets and Confidentiality

Copyright only protects the particular expression of an idea, it does not protect the idea itself. If it is not appropriate to protect the idea by means of a patent, or if the idea cannot be patented, the only protection available is to maintain the idea as a trade secret or as confidential business information. While there is some protection at common law for trade secrets in the absence of a contract between the parties, court cases in such matters can be expensive.

Franchisors in Canada therefore usually ask potential franchisees to sign confidentiality agreement before they give such potential franchisees copies of some of the more detailed information that describes the franchisor's system.

C. Preparing a Franchise Agreement

Franchise agreements are not easy contracts to prepare. They are agreements for the operation of an entire business, for a period of 10 to 20 years into the future. Franchisors usually use a standard form contract for all the franchisees. Franchisees do not trust franchisors if the franchisor negotiates different types of franchise agreements with every franchisee. They are always wondering which franchisee received the better deal. Thus a franchisee agreement must be designed to cover a wide variety of circumstances over a long period of time.

This means that it is impossible to predict all of the changes that will occur to the business. Such a problem is common to long term relationship contracts. The solution to this problem in franchise agreements is to provide in the agreement that the franchisor has the power to change certain things in the franchisor's discretion. While this power is necessary to allow the franchise system to adapt to changes in the market place, franchisees sometimes feel that franchisors abuse their discretionary power. In the United States and Canada franchises are seeking to have laws passed to restrict the franchisor's discretionary power with respect to certain significant parts of franchise agreements.

Unlike the United States, in Canada there are few laws that specifically govern the relationship between the franchisor and the franchisee, or the contents of a franchise agreement. The Alberta *Franchises Act*, 1995 has two provisions that govern the relationship. One imposes on each party a duty of fair dealing in the performance and enforcement of a franchise agreement. This is similar to Article 60 of China's

new *Contract Law* of March 15, 1999 and Article 4 of China's *Measures for Administration of Franchise Operations (Trial Implementation)* of November 14, 1997. The other provision prohibits a franchisor from restricting or prohibiting franchisees from forming organisations of franchisees. The *Franchise Disclosure Act, 1999* that is currently being debated in Ontario will have similar wording.

Accordingly the franchisor has the right to design its own franchise relationships by its choice of the provisions that are put in its franchise agreement. In certain areas there are some limitations imposed by common law.

1. Structures

There are several structures that a franchisor may choose for entering the Canadian market. For foreign franchisors their choices will be governed by the degree of commitment that the foreign franchisor has to the Canadian market. The choices are:

(a) **Single Unit Franchises** - In this situation, the franchisor directly or through a wholly owned subsidiary in Canada, locates its own potential franchisees and enters into franchise agreements directly with each local franchisee. The franchisor should then assume most of the cost of adapting the franchise system to the Canadian market.

(b) **Area Development Rights** - In this scenario the area developer does not have the right to sub-franchise or sell unit franchises. Within a specific area it may either develop its own stores and enter into franchise agreements with the franchisor, or it may locate and recruit prospective franchisees who will enter into franchise agreements directly with the franchisor. In the latter case the area developer will share in the licence fees and or royalties from the franchisees that it recruits.

Area development agreements do not usually grant a right to use a trade-mark and therefore they often do not technically qualify as franchise agreements according to the definition of a "franchise" found in many laws in the United States.

(c) **Master Franchises** - A master franchisee has the right to sub-franchise or sub-licence to unit franchisees in Canada. The master franchisee assumes significantly more responsibility for the running of the Canadian operations, and the foreign franchisor has less responsibility. Franchise fees and royalties should be shared appropriately, as the master franchisee has greater responsibility.

Both foreign franchisors and Canadian franchisors should first develop some corporately owned units in Canada before starting franchising. The foreign

franchisor should use these units to adapt its system and products to the Canadian market place. Persons contemplating bringing a foreign franchise system to Canada should incorporate the cost of the development of the pilot projects or corporate units into its business plan. It should be clearly established as between the franchisor and franchisee as to who will bear the risk of loss in the event that the pilot projects cannot be made to work.

2. Territory, Encroachment And Other Methods of Distribution.

One of the fundamental issues in preparing a franchise agreements is to decide whether or not the franchisee will be granted an exclusive territory in which only the franchisee may use the trade-mark. Many fast food franchisors, such as MCDONALDS, only grant a licence to use the trade-mark at the specific address for the restaurant. They reserve the right to develop another restaurant under the trade-mark as close to the existing franchisee as they wish. Generally speaking a franchisee does want to have a restaurant using the same trade-mark opened nearby, as it would compete with his business. Franchisees consider such a practice to be an encroachment on their rights. Accordingly it is usually only practised by strong, well known franchisors.

This policy developed because new franchisors often granted too much territory to the franchisees. Some of the franchisees did not fully develop business in their territory, resulting in lost opportunities for the franchisor.

One compromise is to have a provision in the franchise agreement that gives a new franchisee an exclusive territory for the first few years. After that the franchisor has the right, if population or the business in the territory has grown, to send a notice to the franchisee requiring that the territory be divided to allow for the establishment of a new store. The notice gives the existing franchisee the first right to buy the new franchise. An important factor in implementing these provisions are the criteria chosen to decide when to split a territory. In the hotel industry, such disputes are common and each franchisor has what are known "Impact Policies". Despite the choice of specific criteria, splitting of a territory is still in the discretion of the franchisor.

Another issue to consider in designing a franchise system is whether or not the franchisor will have the right to sell the trade-marked product in other channels of distribution, for example the right to sell the trade-marked product in a supermarket that carries a wide range of goods, instead of in the franchisee's store that carries only the products of the franchise system. With the development of e-commerce and the internet, many franchisors are being very careful to reserve to themselves the right to sell their product or services over the internet. Many franchisors are discovering that it is important to work with the franchisees in e-commerce distribution, and are drafting policies whereby the burdens and benefits are shared between the franchisor and the franchisee. These policies also usually control the

development of web sites by franchisees to ensure that they have a uniform appearance.

3. Term, Initial Fee And Renewal

The term of franchise agreements or master franchise agreements in Canada varies according to the type of system and the choice of the franchisor. The most common terms are between 10 and 20 years. While shorter terms give greater control to the franchisor, the franchisee will want a longer term in order to amortize the cost of the initial fee paid to the franchisor. The initial fee is divided by the number of years in the term and that amount is added to the cost of doing business in each year in the franchisee's business plan. If the term is longer, the portion of the initial fee allocated to each year will be lower and the possibility of the franchisee making profits will be greater. The franchise system requires the franchisee to also invest a significant amount of money in developing the retail store, such as a restaurant, then the franchise agreement should have a longer term in order to allow the franchisee to fully amortize his investment.

There is another reason for giving a franchisee a longer term. Some feel that franchisees will work better when they have the incentive of being able to sell their business and make a profit from their work in building up the business. In order to do this the term must be long enough to allow the franchisee a reasonable time to build up the business, and yet still have some time remaining in the term of the initial franchise agreement that can be sold to a new franchisee.

On the other hand franchisors are concerned that if they grant a long-term franchise agreement, they may have greater difficulty in getting rid of a difficult franchisee. Unlike some states in the United States, there are no provisions in Canadian law requiring franchisors to automatically renew a franchise agreement, although many franchisees would like such a law. Accordingly it is still easier to simply not renew a troublesome franchisee than to terminate such a franchisee. With termination there is usually a significant risk of court action, and evidence must be collected in advance to prepare for this. The evidence must show that the franchisee has specifically breached the portion of the franchise agreement such as to justify termination. If a renewal clause has been properly drafted, it should not be necessary to meet this standard when deciding not renew the franchise agreement of a troublesome franchisee.

A compromise solution that is common in North American franchise agreements is to grant, for example, a franchise agreement with an initial term of 10 years, renewable at the option of the franchisee without payment of a further franchise fee for a further 10 years. In order to renew the franchise agreement it is required that the franchisee not have committed any defaults under the franchise agreement. Once the second 10 year renewal term has ended, there is no automatic right of renewal.

Further it is often then specified that the franchisee must pay a further fee if he wishes to have another franchise agreement.

In master franchise agreements, if a large territory is being granted, a market study should be used to establish a reasonable estimate of the number of units can be developed in the territory, within the initial term, in order to further assess the appropriateness of the initial fee. This problem is sometimes overcome by having the initial fee paid over time as new units are opened. When doing such a market study in Canada, it is important to decide whether the franchise system will be introduced into Quebec (which will require translation of the system into French).

4. Quality Control

Franchisors must ensure quality control both in the construction of any retail location that will be used by the franchisee, and in the continuing operation of the franchised business. Sometimes franchisors will build the retail location with their own funds and sell the turn-key operation to the franchisee. However this method ties up the franchisor's capital, so some franchisors prefer to retain control over the construction, but to use the franchisee's money. While some franchisees want to use a contractor of their own choosing, it is usually cost effective to use one of the contractors that has experience with the franchisor's requirements and methods. In order that the franchisor retains control over the construction but uses the franchisee's money the franchise agreement should specify that only fixed price construction contracts will be used, and that any money given by the franchisee to the franchisor to pay the contractor must be held in trust. Often it is easier for the franchisee to pay the contractor directly.

A franchise agreement will usually contain general clauses requiring a franchisee to operate the franchised business in accordance with the franchisor's instructions. It is inherent in the nature of a franchise system that the franchisor must have some discretion to change instructions to introduce new methods and adapt its system to changes in the market. All of the details of the operation of the franchised business for a period of 10 years cannot be set out in the franchise agreement. Accordingly only the general categories of control are set out in the franchise agreement, and details are set out in the operations manual. The operations manual should be updated regularly by the franchisor.

Franchise agreements often wish to state that the terms of the operations manual are incorporated by a reference to become terms of the franchise agreement. Although there is no Canadian case law on this point, there is a potential problem with having the franchisee agreeing to a specific term in an operations manual by signing the franchise agreement. Many of these terms will be drafted in the future and at the time of signing the franchise agreement they are not known. Some franchisors try to overcome this problem by disclosing the operations manual to the franchisee, in confidence, at the time of signing the franchise agreement (or earlier if

required by law). A better solution is to draft the quality control provisions of the franchise agreement broadly and to provide that in the case of conflict between the operations manual and the franchise agreement, the franchise agreement shall govern. This means that in order to default a franchisee for non-compliance with the quality standards one must show a pattern of conduct in order to prove a general breach of the provisions of the franchise agreement. The specific breaches will of course be based on the operations manual.

This section of the franchise agreement should also specify who will be the full-time operator or manager of the franchised business, as opposed to being only a passive investor. The manager should be one of the owners, and should be required to devote their full time attention to the franchised business. Some franchisors may further provide that any communications between the franchisor and the manager will be legally binding on the franchisee corporation and all its shareholders.

5. Performance Standards

When a master franchisor is selling a large territory, the franchisor is concerned that the prospective franchisee will not fully develop the territory. For his own reasons, a franchisee may find that the income from a small portion of the territory is satisfactory for his purposes and will thus not make the effort to fully develop the territory. To overcome this problem franchisors selling master franchises in particular often want to insert clauses into the agreements requiring the opening of a certain number of units, or the achievement of certain sales levels, in a specified time.

When a foreign system and product is brought into the Canadian market, various unforeseen difficulties are usually encountered and the performance standards in the agreement are often later found to be overly optimistic. For this reason clauses are sometimes inserted into such franchise agreements that allow for the renegotiation or readjustment of such performance standards rather than having the franchisee's rights automatically terminate. If the parties cannot agree through negotiations, the setting of the appropriate new performance standards may be referred to arbitration.

6. Sourcing Supplies and Volume Rebates

Franchisors generally require either that the franchisee purchase the products sold in the franchise system from the franchisor, or from a third party suppliers approved by the franchisor. This provision is often a source of friction between the franchisor and the franchisee. Franchisors insert such clauses for two reasons. One is to ensure that the products sold in the franchised business satisfy the franchisor's standards with respect to quality. The franchisor must control the quality of the products sold, or services offered, in order to maintain the distinctiveness of its trade-mark.

The other reason that franchisors prefer this method is because they use the volume buying power of the franchise system to obtain significant volume rebates from third party suppliers. Some franchisors use these funds to subsidize their royalty income. To ensure that franchisees are thus not over-charged for products, there is often a clause in the agreement specifying that the sale of products will be at competitive wholesale prices. Sometimes this is not sufficient to satisfy franchisees, and other problems arise if in addition to the volume rebates, the franchisor agrees to sell only the products of a certain supplier in the franchise system in return for a certain amount of money. These exclusivity agreements with suppliers are becoming more common.

One way to reduce friction is to clearly specify in the franchise agreement and in the disclosure document how suppliers are chosen and how the money received as rebates is used. Another is to allow the franchisees to form a cooperative buying group to purchase the supplies they need based on competitive bids from suppliers.

For foreign franchisors, products being imported into Canada have to meet Canadian labelling and packaging requirements, and in certain areas, Canadian safety and other approval standards. For example, retail products in Canada have to have certain words on the packaging in both French and English. Non-prescription drugs require a Canadian Drug Identification Number and must conform to Health Canada parameters.

Adapting a product for the Canadian market can be a significant expense. It may be more appropriate to source the product from approved third party suppliers based in Canada. Where products are imported, the franchise agreement should clarify who will be responsible for the payment of custom duties, freight and transportation charges, insurance, and who will bear the risk of currency fluctuations (i.e. in what currency will the products be priced as between the franchisor and the franchisee).

7. Royalty Fees

It is generally accepted in North America that a franchisor should make its profits from the stream of continuing royalties from the franchisees, rather from the initial fees from the sale of franchises. This means that the initial fee should basically cover the cost of the franchisor in helping each franchisee to set up its business. It also means that the profits of the franchisor should therefore vary with the success of the franchisees.

The most common form of royalty fee is set as a percentage of the gross sales of the franchisee. This means that the franchisee must pay a certain amount to the franchisor, whether or not the franchisee makes a profit. There are two reasons for favouring such a structure. One of them is that it is the franchisee rather than the franchisor who has the greatest ability to control the costs in the individual franchises. The other reason is that profits are much more difficult to define than

gross sales, because the parties have to agree on what is an acceptable expense for operating the business.

There are other structures that are used to establish royalty fees. Some franchisors use a minimum dollar amount, plus a percentage of gross sales, and others use one fixed fee. The minimum dollar amounts are used to establish performance standards. If a franchisee does not work hard to exploit his territory, he will still have to pay the minimum royalty fee. Similarly fixed fees are used as an incentive to franchisees.

Some franchise systems, typically ones that involve the retail sale of a variety of products that the franchisor has manufactured or purchased, define the royalty fee as a percentage of profits. The formulas for doing this are often relatively complex, and there is usually a committee composed of representatives of the franchisor and the franchisees to resolve disputes resulting from the interpretation of their formula.

Some franchisors do not charge a royalty fee, because they feel that they make sufficient profit from the system by requiring the franchisees to sell only their products. Generally speaking these systems are in the minority, as franchisees are often concerned that they are purchasing the supplies at inflated prices. In fast-food franchising, systems that made significant profits from the sale of marked-up supplies and equipment that the franchisees were required to buy have generally disappeared in favour of systems that sell supplies at comparative wholesale prices, and receive royalties as a percentage of gross sales. The latter method is much more transparent and more likely to have the trust of the franchisees. There are however some types of products for which the zero royalty system does work.

The franchisors usually require weekly or monthly reporting of sales by the franchisees together with the payment of royalties. They also usually require the delivery quarterly or annual operating profit and loss statements, so that they can assess how well their franchisees are performing. Finally, a franchise agreement must also reserve to the franchisor the right to audit the franchisee to ensure that the sales are being properly reported.

8. Advertising and Marketing

Generally a franchisor will use funds contributed to an advertising fund by the franchisees to develop advertising materials, point of sale materials, promotional materials, brochures, lay outs, radio or television scripts and other marketing items. To pay for this they require a separate contribution, called an advertising contribution, that is usually calculated as a percentage of gross sales. The franchise agreement should carefully set out how such monies are to be used. There should be a clear separation between the expenses for which the monies from the advertising fund can be used, and the expenses that are to be paid by the franchisor

itself. Franchise agreements often make provision for an annual report to the franchisees of how the monies from the advertising fund were used.

When a franchise system is starting up, there are usually not enough franchisees or sales to generate sufficient money in the advertising fund to operate a significant advertising campaign. Often in the beginning the franchisor will be spending significant amounts on advertising from its own resources. To solve this problem some franchise agreements for new franchisors specify that the franchisee must spend a minium percentage of sales on advertising. Until an advertising fund is set up and an advertising contribution to the franchisor specified, all of the money will be spent by the franchisee on advertising in its local market. As the system grows, the franchisor reserves the right to set up an advertising fund and require advertising contributions on an increasing scale, up to a maximum percentage. The provisions are usually also made for the coordination by the franchisor of cooperative advertising programs by franchisees who are all located in one city or the same media broadcast area. An example of such programs would be advertising in the telephone directories.

In international franchises there are problems with advertising funds. The items developed by the franchisor in its home country may not work in the new country because of the differences in the cultures. Generally franchisors have not had much success with unified international advertising funds and have usually set up specific advertising funds for each country. Then the advertising funds for a specific country may purchase from the advertising fund of the head office only those promotional materials that will work in that country.

In Canada advertisers have established that for some types of advertising it is necessary to have separate campaign materials for Quebec. Simply translating the English language materials will not be effective in the Quebec market place. A master franchisee in Canada may wish to consider either having a separate advertising fund for the Province of Quebec or perhaps the right to sub-franchise the Province of Quebec.

9. Intellectual Property Protection and Non-Competition Covenants

Canadian franchise agreements usually contain several provisions regarding protection of the franchisor's trade-marks and copyright, such as requiring the franchisee to warn franchisor of any infringements that come to its attention. Several of the concerns have already been discussed in this article in the section on Intellectual Property Laws.

To further protect not only the trade-marks and the copyright, but also the trade secrets and other confidential business information of the franchisor, it is common to provide in the franchise agreement that the franchisee may not use or disclose the trade secrets and confidential information of the franchisor that he learns while

operating the franchise. In Canadian law there is no time limit required for such restrictions. The courts do however distinguish between specific trade secrets or business information, and the general knowledge that is acquired from being a franchisee. Where the trade secret of confidential information could have been easily discovered by someone with knowledge of the product, the courts will only protect the trade secret or confidential information for a limited period of time.

It is often expensive to prove that a former franchisee has actually used trade secrets or confidential information to set up a competing business or assisted a competitor. For this and other reasons, franchisors often require that the franchisee agree not to operate or participate in a competing business during the term of the agreement and for a specified time, and in a specific geographical area, after the expiration or termination of the franchise agreement. Historically courts have been reluctant to enforce such non-competition covenants because of a general policy that individuals should not be restricted from earning a living. In some states in the United States, such non-competition covenants are prohibited and/or unenforceable, or greatly restricted.

In Canada non-competition agreements between businesses will generally be respected, so long as they do not result in a monopoly position for one of the parties. While the franchisee usually incorporates a corporation to enter into the franchise agreement, it is important in that the franchise agreement specifies who will be the full-time operator of the franchise and requires at a minimum that such individual enter into a separate non-competition covenant. The franchisor may also require that certain close relatives, such as a wife or husband, also agree not to compete. This is necessary because franchisees sometimes try to avoid the non-competition restrictions by having their spouse set up a business. Such business then employs them, and they hope to rely on the policy that the courts do not want to stop people from earning a living. Sometimes courts see through such arrangements.

Accordingly it is important that the non-competition covenant be carefully drafted to ensure that it is enforceable. Each person who agrees not to compete should receive some sort of compensation from the franchisor. It appears that in Canada the compensation need not be as great as would be required under the Chinese Labour Department rules for such covenants.

Finally it is also important that these sections deal with the issue of system improvements. The Canadian market place is relatively mature and any retailer must be constantly adapting its systems and methods in order to remain competitive in the market place and maintain its market share. Some of the adaptations will constitute intellectual property and the franchise agreement should specify who will own such adaptations.

10. Assignment

Franchisees may want to sell the franchised business before the end of the franchise agreement for many reasons. They may want to receive the profits from their work in building the business. They may not have been as successful as they hoped and would rather sell the business and get some money than be terminated by franchisor because of their defaults. In such cases it is in the franchisor's interest to allow the franchise agreement to be assigned to a new franchisee.

If the term of the franchise agreement remains the same, the franchisor will generally not charge a new franchise fee. It will however charge an administration fee for costs incurred in reviewing and approving the proposed purchaser as a new franchisee, and preparing the legal documents that are required to effect the transfer of the franchise agreement.

Franchisors reserve the right to approve proposed purchasers in their discretion. While the proposed purchaser obviously has to meet certain financial criteria and pass the training course, some criteria used by franchisors for approval are disputed by franchisees. Franchisees often want to get the best price for their franchise and sometimes convince a purchaser to pay too much for the business. Or they may sell it for too little, in which case the franchisor usually has a right of first refusal to purchase the business. If the franchisee is allowed to sell the business at a very high price, it is possible that the new franchisee will not be able to make sufficient profits to pay back the monies borrowed from the bank to pay the high price. In these cases the purchasing franchisee may become discouraged and try to cut expenses by reducing quality, in order to increase profits. To prevent this the franchisor should specify in the franchise agreement that it has a right to not allow the assignment of a franchise agreement if it thinks that the purchase price is too high. Franchisors further require that the selling franchisee continues to guarantee the obligations under the franchise agreement, including the payment of royalties, for a certain period of time after the sale. If a selling franchisee knows that this will be required, we will be more careful about the purchase price that he accepts for the business.

This part of the franchise agreement should also make provision for the assignment of the franchise agreement if the principal operator of the franchised business dies or becomes disabled. Generally the estate of the franchisee is allowed to sell the business within a limited time period, such as one year, provided that it either hires a qualified manager or the franchisor to operate the business during that time.

11. Dispute Resolution, Default And Termination

As with any long-term relationship, disputes are likely to arise from time-to-time. Generally in franchise systems both parties are trying to maximize sales, and thus they have a common goal that allows for the successful resolution of many disputes. Going to court to resolve a dispute is expensive and generally unpopular. For this reason in North America many institutions have promoted Alternative Dispute Resolution methods over the last decade or so. These include negotiation, mediation and arbitration.

In franchising it has become common to insert clauses requiring the negotiation and mediation of disputes. These do not bind either party but encourage the franchisor and the franchisee to work out their dispute between themselves, or with the help of a third person. Arbitration has not proved as popular in Canada as it is in the United States. Arbitration can be just as expensive as going to court in some circumstances. The primary benefit of arbitration in Canada is usually the fact that the dispute is kept confidential. In court cases the files are open to the public. There has also been some concern that arbitrators cannot act quickly enough to issue an injunction to protect intellectual property, or maybe not be authorized to do so because trade-marks and copyrights are federal matters, whereas the law governing arbitrators and their powers is set by the provincial governments. For this reason, in Canada arbitration is usually used only in international franchising, or where special technical expertise is required on the part of the arbitrator.

Generally speaking Canadian common law will require notice to a franchisee of a default under a franchise agreement and an opportunity or time to cure such default, where reasonable. Accordingly franchise agreements generally classify the defaults into three types. There are some defaults that cannot be cured, and therefore no notice other than the termination notice is required. Examples are abandonment of the business, bankruptcy, seizure of the assets of the franchisee by creditors, and sometimes the commission of a criminal offence by the principal operator of the franchised business. Some defaults have a short notice period. These are generally with respect to the payment of royalties and other monies. If these are not remedied quickly the amounts owed can build up until it is almost impossible for the franchisee to cure the default. These default periods range from 5 to 15 business days. Finally a longer written notice period is usually required for all other material breaches of the franchise agreement in order to allow the franchisee an opportunity to cure the default. These time periods usually range from 15 to 30 days.

Franchisors often also insert a clause stating that if the franchisee receives a certain number of notices of default within a year, notwithstanding the fact that each default has een cured, the franchise agreement can be terminated. These clauses have some problems in their interpretation and enforcement. They are not often relied upon.

On termination the franchise agreement should provide that the franchisee immediately stops using the franchisor's trade-mark and other intellectual property and removes all the signs and other items from the business. If the franchisee fails to do this the franchisor often reserves the right to enter the business and remove the items.

Generally speaking the courts will not allow the franchisor to enter upon the premises of the franchisee's business if the franchisee resists. Accordingly such clauses should be drafted very carefully and with specific details to assist the franchisor in arguing that the franchisee clearly agreed to entry on to the premises by the franchisor.

Franchisors often also insert into franchise agreements clauses allowing them to purchase the franchised business on termination. This allows the franchisor to maintain control over a prominent franchise location. Some franchisors provide that the purchase price will be the net book value of the franchisee's assets, not including goodwill. Others provide a fair market value purchase price based on negotiation or arbitration. This is a sensitive area in franchisor/franchisee relationships.

12. Choice of Law and Forum

Canadian franchisors have to reconcile two conflicting objectives when choosing the appropriate law for the interpretation of the franchise agreement. Generally contracts are best enforced by a court located in a same jurisdiction as the assets that the franchisor wants to seize or that will be used to pay damages pursuant to the court's judgment. This would mean that the franchisor should choose the law of the franchisee's province as the governing law, and some Canadian franchisors do this. In Canada, except for Quebec, there are not great differences between the laws of the various provinces.

Other franchisors prefer to have all their franchise agreements governed by the law of one particular province, so that they know more precisely what to expect. They also then often specify in the franchise agreement that all court cases are to be heard in the city where their head office is located. This reduces the costs to the franchisor of having its management employees travelling to other provinces in order testify and give evidence in court cases. On the other hand the franchisee now bears the burden of travelling to the franchisor's home province to commence a court action or to resolve a dispute.

13. Personal Guarantees and Other Security

Canadian franchisees almost invariably incorporate a company to own the franchise. Canadian franchisors therefore ask all of the individuals who own the franchisee company to personally guarantee the obligations of the franchisee company under the franchise agreement. It is felt that these guarantees are often very effective in

motivating franchisees to ensure that the franchised business complies with the franchisor's quality standards.

Some franchisors also register a security interest against the assets of the franchisee in order to make it easier for them to seize such assets in the event of non-payment under the franchise agreement. Where the franchisees borrow money from the banks to develop the franchised business, which it is very common, the banks will insist that their security interest for the money loaned will be ranked in priority to any security interest held by the franchisor. Ensuring that this is done in accordance with *Personal Property Security Act* of the particular province requires the involvement of lawyers. For this reason some franchisors find the registration of security interests to be too costly.

Where franchisors do not sublease the location of the franchise to the franchisee, they sometimes require that the franchisee lease the signs from the franchisor. The franchisor retains ownership of the signs that use its trade-marks, and thus is more likely to get a court or landlord to assist it in recovering the signs when it terminates the franchisee.

D. Real Estate And Leasing Issues

Despite the fact that in Canada franchisees can own the land upon which the franchised business is located, this is rarely done because it ties up scarce capital that could be used in developing the business. Some franchisors have purchased the locations of stores that they then lease and franchise to franchisees, using their greater capital resources and ability to borrow. However, generally speaking, most chain stores and franchises in Canada use leased property rather than property that they own outright so that they can use their capital to develop the franchise system.

In Canada landlords have the right to re-enter leased premises if the tenant fails to pay rent or otherwise breaches the lease, provided that such re-entry is peaceful. This right of re-entry is significantly stronger than the rights available to a franchisor who has no leasehold interest in the property. For this reason it has sometimes been the pattern in Canadian franchising for franchisors to lease the premises for the franchise from a landlord, and then sublease them immediately to the franchisee. This gives the franchisor more opportunity to terminate the franchise without having to incur the expense of going to court. This right of re-entry for a landlord without going to court is different from what exists in Chinese law.

However where the franchisor leases the premises, the franchisor is also responsible to the landlord for the payment of rent. If the location does not prove to be a good location, or if the franchisee does not prove to be a good franchisee and is terminated, or if there is a downturn in the economy generally, the franchisor must still continue to pay rent to the landlord. This is a risk that some franchisors are not

willing to bear, particularly after their experiences in the 1990 - 1991 recession in North America.

Since the recession it has become more common in Canada for a franchisor in Canada to require that the franchisee lease the premises directly from a landlord and to require that the landlord enter into a separate agreement with the franchisor allowing the franchisor to take over the premises of the franchise, if the franchisor choses to do so. Provisions are also made in such agreement to allow the franchisor to enter the premises to remove its signage. Thus the franchisor has many of the benefits with respect to enforcement that it would obtain by leasing the premises, but does not have responsibility for the rent unless it chooses to do so at the time that the landlord decides to terminate the franchisee.

Another advantage of having franchisees lease the premises is that they can use the leasehold improvements as security for the money that they borrow from the bank to develop the franchise. Canadian law permits such leasehold mortgages. Chinese law currently does not allow leasehold mortgages. This makes it easier for both the franchisor and the franchisee to finance the growth of the system using borrowed money. If the system is well planned it will grow and make sufficient profits to pay the money back. All Canadian banks have a separate department at their head office devoted to franchising.

III FRANCHISE SALES AND DISCLOSURE DOCUMENTS

Once a franchisor has designed a franchise system for use in Canada, and prepared the appropriate franchise agreement, it is ready to try and sell franchises to franchisees. This is the only area of franchising that is currently regulated anywhere in Canada. In the Province of Alberta, the *Franchises Act, 1995* requires that a disclosure document that discloses all material facts about the franchise system, including items specified in the regulations, be given to a prospective franchisee 14 days before the franchisee signs the franchise agreement, or pays money to the franchisor. The franchisor is not required to register the disclosure document with the government, or even provide the government with a copy.

At the time of writing this article, Ontario is in the process of adopting a similar law that is expected to be in force by the end of the year 2000. While the Ontario law may have a broader definition of a franchise than the Alberta law, the disclosure requirements are likely to be very similar. Alberta requires that a disclosure document include copies of all proposed franchise agreements, contain financial statements and include information regarding the franchisor and its directors and officers, and information about the franchise agreement. These requirements are similar to Article 12 of the Chinese *Measures for Administration of Franchise Operations (for Trial Implementation).*

Most prospective franchisees will ask the franchisor how much money they will earn from the franchise. Franchisors usually provide prospective franchisees with a

model balance sheet (called a "pro-forma") for a franchised business showing possible profits at different sales levels. However if they provide information as to actual sales by existing franchisees, or suggest to the prospective franchisee that he or she will make a certain amount of money, they are said to be making an "earnings claim". If earnings claims are made, they must be made according to the regulations, and must be included in the disclosure document. Because of this regulation, some franchisors try to avoid making earnings claims. This makes it difficult for their sales people to respond to the question that prospective franchisees most frequently ask.

Failure to give disclosure documents or a misrepresentation of a disclosure document can result in the franchisee having a right of action against the franchisor for damages and the recission of the franchise agreement. This will require that the franchisor buy back the franchise and compensate the franchisee for any losses. In Ontario franchisees have for the first time in Canada managed to sue a franchisor as a group, known as a "class action". This case was based on an alleged breach of the franchise agreement by the franchisor with respect to the pricing of products that it required the franchisees to buy. The ability of the franchisees to combine all of their court actions against the franchisor gives them significant leverage over the franchisor. Franchisors will have to take greater care in the future to ensure that their franchise agreements and their disclosure documents accurately reflect their franchise system.

Franchisors in Canada generally locate franchisees by advertising regularly in newspapers and magazines. They also set up booths at various trade shows where people wishing to buy a franchise come to look at the opportunities available.

Leads from all of these sources are then sent further information about the franchise system and asked to fill out an application form. Application forms should be reviewed by the franchisor's lawyer to make sure that the forms comply with the Human Rights Code in the various provinces and do not ask inappropriate questions. The franchisor then reviews the franchise application submitted by the prospective franchisee and decides whether or not it wishes to proceed.

To ensure that prospective franchisees are committed to the franchise system, franchisors usually ask for an initial deposit amount, which may or may not be refundable, and ask the franchisee to sign a confidentiality agreement regarding information that will be provided to them about the franchise system.

Franchisors will try and match the franchisee to a suitable location, but it may be some time before the parties agree on a location. Once the location has been agreed upon they would then proceed to deliver a copy of the franchise agreement (and possibly a disclosure document) to the franchisee for review prior to signing. If the franchisee is to lease the premises directly from the landlord, the offer to lease and the franchise agreement should be submitted at the same time to the landlord and the franchisor.

IV WHERE TO LEARN MORE

Franchising in Canada is an attractive option for a foreign manufacturer or exporter wishing to distribute its goods or services to Canadian consumers. It is an especially attractive where the goods and services require local service or preparation and it is an advantage to give the local distributer an incentive to provide quality service. Further it requires less capital investment than setting up chain stores. Not only do the franchisees pay for the right to own a franchise, but they use their own money and money borrowed from a bank using the franchisee's credit to set up the individual retail stores.

Although Canada is a much smaller market than the United States it has several advantages. Franchising is less regulated than in the United States, and therefore costs less to design a franchise system for use in Canada. The Chinese Canadian market is larger in Canada in proportion to the total population than in the United States, and it would provide a useful point of entry for a Chinese franchisor. And Canada now gives better protection to Chinese character trade-marks than does the United States.

Once established in Canada, a franchisor could then consider expansion into the United States, based on lessons learned adapting to the Canadian market. The similarity between the American and Canadian cultures, and Canada's membership in the North American Free Trade Association, would make such move easier.

To learn more about the Canadian market and franchising in Canada, one of the best ways would be to contact the Canadian Franchise Association at:

2585 Skymark Avenue, Suite 300
Mississauga, Ontario L4W 4L5
Canada
Telephone: (905) 625-2896 Fax: (905) 625-9076
Web Site: www.cfa.ca.

They have a variety of publications for sale and have various events throughout the year that provide educational opportunities. They hold trade shows in Vancouver in April and in Toronto in September where member franchisors and non-member franchisors set up booths to advertise their franchises to the public. They also hold an annual convention in January and a legal symposium every Fall.

For further discussion of the types of clauses that make up an international franchise agreement, one of the best references available is *Guide to International Master Franchise Agreements* published in 1998 by Unidroit, Via Panisperna, 28, 00184 Rome, Italy. The magazine *Canadian Business Franchise* also has a regular series of articles on the components of a franchise agreement, in addition to its articles on Canadian franchises.

It is available from:

Canadian Business Franchise
338A Tennyson Avenue
Victoria, BC V8Z 3P6
Telephone: (250) 383-8855 Fax (250) 383-8889
web Site: www.cgb.ca Email cgb@island.net.

For more specific information or assistance, foreign franchisors should contact one of the lawyers or consultants that are already members of the Canadian Franchise Association.

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Paul Jones set up his own law office JONES & CO. since 2004. His practice is focussed on franchising, trade-marks, marketing and distribution. He assisted the Government of the Province of Ontario in the development of its new franchise legislation. He may be reached at:

Telephone: (416) 703-5716
Fax: (416) 703-6180
Email: pjones@jonesco-law.ca
Web Site: www.jonesco-law.ca