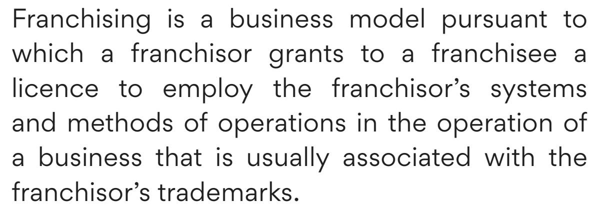
15.

Franchising



Franchising is a business model pursuant to which a franchisor grants to a franchisee a licence to employ the franchisor's systems and methods of operations in the operation of a business that is usually associated with the franchisor's trademarks.

The franchisor also provides its know-how and expertise, along with continuous support, in return for compensation, which usually is a continuous royalty fee.

Typical Franchise Structures

There are three typical franchise structures in Canada:

- **Unit franchises**
- **Area development franchises**
- **Master franchises**

In recent years, a new franchise structure has been developed by our firm for the benefit of our clients whereby a franchisor proposes to become an equity co-shareholder (50%-50%) in the franchisee entity. This concept carries many advantages, namely: (a) the total investment for a franchisee is much less, therefore increasing the potential pool of good franchisee operators/ investors; (b) it permits the franchisor to benefit (50%) from the profits generated by the franchise operations; (c) the franchisor can count on a reliable franchisee operator; (d) the franchisor has access to all franchisee information and statistics; (e) the franchisor is not engaged in the daily operations; (f) the franchisee entity still continues to benefit from lower tax rates, as it is not considered to be controlled by the franchisor; and (g) such a concept can be considered when contemplating having either a wholly-owned corporate store or a typical fully-franchisee-owned franchise unit.

Unit Franchises

A unit franchise – whereby a franchisor grants a right and licence to operate a franchise directly to a single franchisee for a single location – is a common approach to franchising in Canada. Franchisees may acquire multiple unit franchises, but Canada tends to not have the large multi-unit franchisees that are common in other jurisdictions, such as the United States.

Area Development Franchises

Under an area development franchising arrangement, a franchisee is typically granted the right (and the obligation) to develop a number of unit franchises in a large geographical territory. This model can be advantageous to a franchisor seeking to rapidly expand its franchise system but still wishing to maintain a direct relationship with the unit franchisee. An additional benefit to the franchisor is the reduction in the number of franchisees it needs to manage. Area developers must have access to sufficient capital and are usually more experienced than single unit franchisees. An area development agreement will usually contain a development schedule that sets out the number of franchises the area developer is required to develop and over what time period. The franchisor's remedies (if the franchisee fails to meet its development obligations) may include the franchisee's loss of market exclusivity or its loss of rights to develop further franchises.

Master Franchises

Under a master franchise arrangement, the master franchisee is usually granted an exclusive territory (as in the area development arrangement) but is also granted the right to sub-franchise. The master franchisee has the responsibility to recruit prospective franchisees and to fulfill some or all of the roles usually fulfilled by the franchisor. Typically, the master franchisee keeps part of the royalties paid by the sub-franchisees, with the result that the franchisor will earn less royalty income than in a standard franchise model.

The master franchise model is often employed by foreign franchisors entering a new market, as it reduces the investment in overhead and supervision that a franchisor would otherwise have to make if it employed a unit franchise model. The master franchise model contains the highest degree of risk to the franchisor's brand, as the franchisor is relying on the master franchisee to service the sub-franchisees and maintain quality control. The master franchise agreement may contain provisions for the potential assignment of the unit franchisees to the franchisor or to a subsequent master franchisee in the event of the default or failure of the master franchisee. A master franchise agreement will usually contain a development schedule (as in the case of an area development franchise), with similar remedies in the event of the failure of the master franchisee to meet its development obligations.

Provincial Legislation

In Canada, franchising is regulated at the provincial level. There is no federal equivalent to the US Federal Trade Commission's Franchise Rule.

Six provinces (Alberta, Ontario, Prince Edward Island, New Brunswick, Manitoba, and British Columbia) have their own specific franchise legislation.

Although there are differences among the franchise legislations of the six provinces, there remains a high level of consistency. The legislation is generally viewed as "disclosure legislation" as opposed to the "relationship legislation" view that is common in some other jurisdictions. However, there are relationship elements in the provincial legislation. For example, the legislation imposes on the parties to a franchise agreement a duty of fair dealing in the performance and enforcement of the franchise agreement. The duty of fair dealing includes (in most provinces) the duty to act in good faith and in accordance with reasonable commercial standards. Franchisors are also prohibited from interfering with the rights given to franchisees to associate with other franchisees and to form or join an organization of franchisees. The legislation nullifies any provision of a franchise agreement that purports to limit the application of the law of the province or to restrict the jurisdiction or venue to any forum outside the province. Any purported waiver or release by a franchisee of its rights or of an obligation imposed on a franchisor under any of the franchise legislation is void.

Generally speaking, franchise legislation applies to franchises that operate either wholly or in part in the applicable province. Alberta restricts the application of the legislation to franchisees that are Alberta residents or that have a permanent establishment in Alberta.

Whether or not a business is considered a franchise is determined by the definition of "franchise" in each of the provincial franchise acts. However, the definition of a "franchise" is very similar across all the provinces. Each province's legislation captures the essential business relationship between a franchisor and a franchisee and all the rights and duties that flow from their agreement. These include the right of the franchisee to sell goods and services that are substantially associated with the franchisor's trademarks and logo and the franchisee's duty to make continuing payments to the franchisor. It doesn't matter what the parties call the business structure; if it fits the definition of a franchise under provincial legislation, it will be considered a franchise. A provision in an agreement that provides that the parties do not intend for the relationship to be considered a franchise will have no bearing. Similarly, the parties cannot contract out of the franchise legislation.

The franchise legislation in each province requires the delivery of a disclosure document to a prospective franchisee at least 14 days prior to the execution of any agreement relating to the franchise or the payment of any money to the franchisor or the franchisor's associate. A distinguishing feature of Canadian franchise legislation is that in addition to the considerable number of enumerated items that must be disclosed in a disclosure document, each disclosure document must disclose all "material facts." Material facts include any information about the business, operations, capital, or control of the franchisor or the franchisor's associate or about the franchise system that would reasonably be expected to have a significant effect on the prospective franchisee's decision to acquire the franchise or on the value or price of the franchise. Case law has determined that the disclosure document must be individualized to the particular franchise at hand. For instance, if there is a lease associated with a particular franchise location, it must be included as part of the disclosure document. In the event that a "material change" occurs during the time period following the issuance of the disclosure document and the execution of the franchise agreement or the payment of any money by the prospective franchisee, the franchisor must provide a material change statement. A material change is (a) any change in the business, operations, capital, or control of the franchisor or franchisor's associate or (b) a change (or prescribed change) in the franchise system that would reasonably be expected to have a significant adverse effect on the value or price of the franchise to be granted or on a franchisee's decision to acquire the franchise. This definition also includes a decision to implement such a change, made by the board of directors of the franchisor or franchisor's associate or by senior management of the franchisor or franchisor's associate who believe that confirmation of the decision by the board is probable. The franchisor's disclosure obligation ends upon the issuance of the franchise agreement; however, the renewal of a franchise, the transfer of a franchise, or the grant of an additional franchise location can revive the requirement for disclosure.

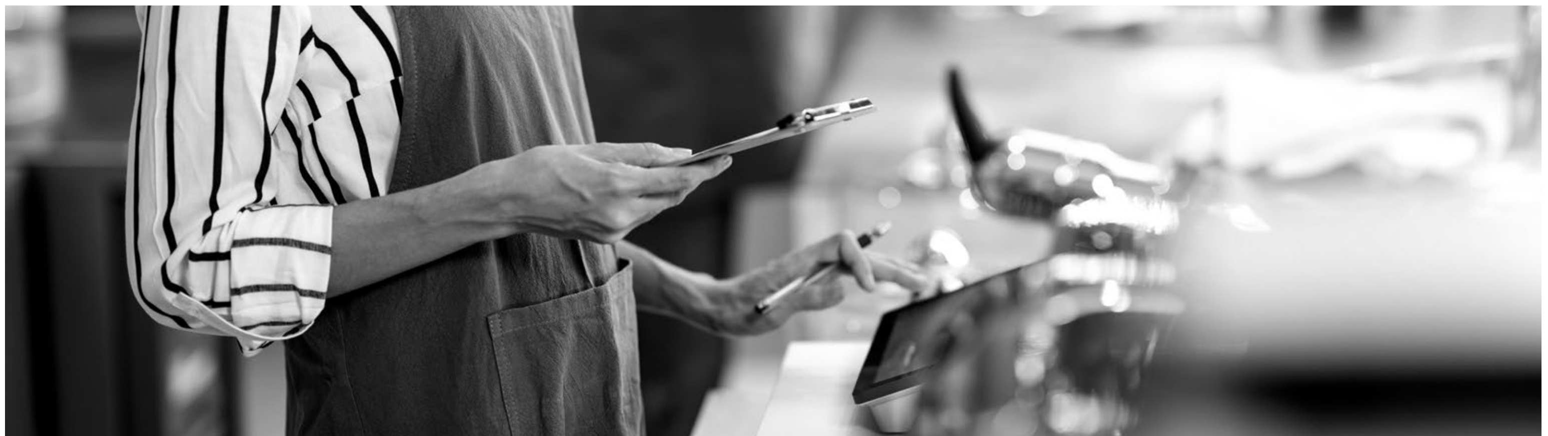
A franchisor must provide financial statements of the franchisor with the disclosure document unless it qualifies for an exemption.

The financial statements must be audited or prepared in accordance with generally accepted accounting principles that are at least equivalent to the review and reporting standards applicable to review engagements, set out in the Canadian Institute of Chartered Accountants Handbook. It is important to recognize that consolidated financial statements of the franchisor's parent company will not be sufficient. Where the franchisor has operated less than one year, the disclosure document needs to include only the franchisor's opening balance sheet. There are a number of exemptions from the obligation to provide a franchise disclosure document in the franchise legislation of the various provinces. Some of these exemptions are generally regarded as being somewhat ambiguous and are therefore difficult to rely upon.

The consequences of failing to give disclosure, or giving late or deficient disclosure, are serious and include a right of rescission. If no disclosure document is given at all, the right of rescission extends for a period of two years after the franchisee enters into the franchise agreement. Where the disclosure document is given late or is deficient, the right of rescission continues for a period of 60 days after the disclosure document is given.

A number of judicial decisions have determined that where the deficiencies are significant, the disclosure is treated as not having been provided at all, giving rise to the two-year right of rescission. Where the franchisee maintains a valid case for rescission, the franchisor is required to (a) refund to the franchisee any money received from or on behalf of the franchisee; (b) purchase from the franchisee its remaining inventory at a price equal to the purchase price paid by the franchisee; (c) purchase from the franchisee any supplies and equipment that the franchisee purchased pursuant to the franchise agreement, at a price equal to the purchase price paid by the franchisee; and (d) compensate the franchisee for any losses that the franchisee incurred in acquiring, setting up, and operating the franchise, less the amounts set out in paragraphs (a) to (c). In addition, the franchisee is entitled to retain all the profits that were earned through operation of the franchise. The fact that the franchisee has earned a profit does not relieve the franchisor of its obligations.

A franchisor can be liable to a franchisee for any losses the franchisee incurs as a result of misrepresentations contained in a disclosure document and as a result of the franchisor's failure to adequately disclose. Directors and officers who sign the disclosure document may also be found personally liable for the aforementioned losses.



Québec

Although the province of Québec does not have a specific statute dealing with franchises, franchises are governed by the *Civil Code of Québec*. It imposes the obligation of good faith upon both parties (somewhat equivalent to the obligation of "fair dealing") at every stage of the franchising arrangement. This includes, among other things, the obligation for both parties, at the pre-contractual stage, to disclose any information that could be material in the other party's decision-making process related to entering into the franchise agreement.

One must also be aware of the notion of "contract of adhesion." Contracts of adhesion are contracts imposed on another party (i.e., agreements in which the essential stipulations are imposed or drawn up by one of the parties – generally the franchisor – and are not negotiable).

Under Québec law, most franchise agreements are considered contracts of adhesion. The main consequence of such a legal qualification is that when a contract is found to be a contract of adhesion, some of its clauses or paragraphs may ultimately be declared void by a tribunal or the inherent obligations may be reduced by the civil courts if the courts consider those obligations or paragraphs to be "abusive." Even though Québec does not have a law governing the franchise industry, more and more courts are ordering franchisors to pay damages when they act contrary to their "implied obligations". These obligations derive their sources from Section 1434 of the *Civil Code of Québec*.

One must also note that the franchise model is extremely popular in Québec. Indeed, Québec is one of the Canadian provinces that proportionally has the highest concentration of franchisees in Canada. The joint study carried out and published in December 2018 by Raymond Chabot Grant Thornton on behalf of the *Conseil québécois de la franchise* (CQF), in collaboration with the *Ministère de l'Économie et de l'Innovation*, Fasken and Banque Nationale reveals that Franchising represents sales in Québec of nearly $60 billion per year, nearly 10% of the total jobs held in Québec (or more than 405,000 direct and indirect positions), and a net annual growth rate of 6% in the number of franchisors registered between 2013 and 2016, with nearly 450 active franchisors. The Québec franchise industry therefore represents a powerful economic engine and a key development factor, active in all regions, in very diversified business sectors.

Considerations for Foreign Franchisors

Tax Issues

Under the *Income Tax Act* (ITA), royalty payments are subject to a 25% withholding tax. The United States–Canada Income Tax Convention reduces this withholding tax payable to 10%. In addition, US franchisors can apply for a foreign tax credit from the US Internal Revenue Service that is equivalent to the amount paid in Canada.

Withholding the appropriate amount of tax is the responsibility of the franchisee. As a result, this translates into less upfront revenue for the franchisor. Although it may be tempting for franchisors to simply increase the royalty fee, franchisees will be naturally resistant to any additional cost increases. Alternatively, both parties should take care to contractually carve out the characterization of the specific payments for items other than the royalties for the right to use the franchisor's intellectual property, as this may considerably reduce the withholding tax burden.

For general information on taxation in Canada, see Chapter 7.