Buying a Franchise in Canada:

Understanding and Negotiating Your Franchise Agreement

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UNDERSTANDING FRANCHISING

1. WHAT IS FRANCHISING?

Franchising, or as we sometimes call it "business format franchising," can be defined as an ongoing contractual relationship between the franchisor on the one hand and the franchisee on the other. Under the franchise agreement, the franchisor grants the franchisee the licensed right for a period of time to —

- market a product or service,
- use the franchisor's trade-mark and business system, and
- use the franchisor's "know-how" in the operation of the business.

In exchange, the franchisee is required to —

- conform to the franchisor's business system, methods, and procedures;
- maintain the franchisor's quality standards; and
- pay a fee to the franchisor (which is usually an initial franchise fee and a continuing monthly or weekly royalty).

The franchisor is the entity that grants franchise rights to the franchisee. Although a franchise agreement is different than a lease, you might think of it in lease-like terms in which a "landlord" leases space in a building to the "tenant" for a period of time under a "lease." In exchange for this right to use the space, the tenant pays the landlord "rent." When the lease expires or is terminated, the tenant no longer has the right to use the space. During the term of the lease, the tenant must comply with the provisions of the lease and the rules and regulations under it.

Franchising is not entirely similar, but it's similar enough for our purposes. Instead of the franchisor granting you the right to rent space, the franchisor is granting you the right to use its business system and its trade-mark. In exchange, you agree to pay the franchisor a fee — normally an initial franchise fee and an ongoing royalty based upon a percentage of the gross sales generated by your franchised business. In addition to the initial franchise fee and royalties for the use of the franchisor's business system, you must also comply with the franchise agreement and with the franchisor's operating procedures, which is normally set out in its operations manual. Strictly speaking, you don't "buy" the franchise. You acquire the licensed rights to use the franchisor's business system and trade-mark for a period of time. When those licensed rights have expired or are terminated, they revert back to the franchisor. The franchisor can, if it so chooses, license the franchise rights to somebody else.

You can see business format franchising in action virtually everywhere (e.g., restaurants, hotels, real estate companies, food court outlets, travel agencies, convenience stores, printing stores, camera stores, tax preparation outlets, cash advance outlets, muffler shops, fast food outlets, and, believe it or not, law firms). All you have to do is visit your local shopping centre or strip mall to see how prevalent franchising has become. In one form or another, you're surrounded by franchises. In 2004, franchised businesses accounted for the employment of at least 1,000,000 Canadians, so even if you don't particularly like fast food outlets in your local mall, or relish the thought of yet another muffler shop down the road, you must realize that it's a phenomenally important segment of our economy, and our standard of living is in part based on the vibrancy of this industry and its ability to create opportunities, livelihoods, and jobs for others.

It must also be remembered that franchising is, more than anything else, a means of business expansion, using capital obtained from the franchisee to fund expansion. (The cynics among us have an acronym for this. Its called OPM and it stands for Other People's Money.) The franchisor's business is being expanded not only through the franchisee's efforts but also due to direct and indirect contributions of money by the franchisee. It has been said that companies that do not need to franchise (because they have the capital necessary to finance expansion), don't. (Starbucks is an example of one of the companies that don't need to franchise.)

For a hundred different reasons, franchising works well. But it doesn't always work, and it's important for all prospective franchisees to realize that.

2. IS A LICENSE AGREEMENT THE SAME AS A FRANCHISE AGREEMENT?

Sometimes franchisors will deliberately call their contracts "license agreements" instead of franchise agreements. This is largely done for marketing reasons. Franchising is often perceived as the home of fast food and French fries. Calling the contract a "license agreement" may give the agreement and, I suppose, the franchise system an air of panache and sophistication that a franchise might lack in the eyes of mortals. Nevertheless, you should be aware that all franchises are essentially "licenses." A license is the right to use the property of another; it does not convey ownership. Accordingly, if there is a fee such as an initial license fee and/or an ongoing royalty fee, and there is the licensed use of the licensor's trade-mark, and the licensee has been granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system substantially prescribed by the licensor, then it is a franchise, whatever the licensor calls it.

Ontario and Alberta have specific legislation governing franchising, which provides definitions of what a "franchise" is, regardless of what the "licensor" has called its business model.

3. A BRIEF HISTORY OF FRANCHISING

Back in the mists of ancient time (when a Quarter Pounder with cheese meant nothing and Colonel Sander's parents were still in diapers), it's said that franchising was born. Although some have suggested it started in England with the Crown granting exclusive territories to tax collectors for the collection of the 13th century equivalent of GST, for us in the modern world, common wisdom seems to agree that it started with the Singer Sewing Machine Company in the United States. Singer licensed retail stores to sell their sewing machines and sewing supplies in the 19th century. This evolved over the 20th century, and other businesses adopted the model; chief among them being soft drink bottling companies and gas stations.

For those of you who might recall the 1960s and 1970s as being the salad days of rock and roll, free love, and funny cigarettes, it was also the heyday of franchising. The United States became the grand central station of franchising activity; so much so that franchising became the subject of government legislation and regulation. (Around this time, the Alberta government also got involved with franchising legislation and regulation.)

The government did not get involved in the regulation of franchises because it needed the money, or because it wanted to take over the McDonald's corporation and run it like the US defense department. Although McDonald's and some other well-known brands were working rather nicely, thank you very much, the state legislators got involved because many other concepts were not running as well. Some consumers (in this case, those voters who were acquiring the franchises) lost their shirts (and their houses) as a result of getting into franchises in which the franchisor wasn't capitalized enough, or misrepresentations were made by franchisors or their salespeople to get the consumers into the deal. Complaints were made to politicians and the government reacted.

Laws were enacted that treated the sale of a franchise like a "securities" offering, which required franchisors to make disclosure of material facts to franchisees and to give them some time (i.e., 14 days) to do their due diligence and think about the deal before they signed on. In short, the politicians got involved because a few bad operators caused them to get involved. (Government doesn't tend to get involved unless events force it to or people are pressuring it to.)

4. US DISCLOSURE AGREEMENTS AND REGULATIONS

Since the 1970s, US-based franchisors have been subject to a witches' brew of state and federal laws governing the sale and operation of franchises to franchisees. Currently, US-based franchisors are subject to either the Federal Trade Commission Rule on franchising or a regulatory review in select states. The Federal Trade Commission Rule on franchising requires disclosure of all material facts to prospective franchisees through the use of a disclosure document (sometimes referred to as a Uniform Franchise Offering Circular [UFOC]). Franchisors can also be subject to regulatory review in approximately 15 US states that currently have legislation specifically regulating franchisors. As of the date of writing, those states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin (although some registration requirements differ markedly in these states).

In these registration states, unless the franchisor obtains or otherwise qualifies for an exemption from the authorities, a document similar to a securities prospectus must be prepared by the franchisor's lawyers, and must usually be filed with and approved by the state regulatory authority together with the franchisor's franchise agreement, sublease, trade-mark license agreement, general security agreement, and other agreements that normally comprise the package to be signed by the franchisee.

In most cases, the franchisor's audited or reviewed financial statements must also form part of the disclosure package, which is in and of itself an expensive undertaking. But the state authorities don't just "rubber stamp" a franchisor just because the franchisor has submitted the documentation to the regulators. The state regulatory authorities read and review the material and may reject the franchisor altogether, or impose conditions on the franchisor's ability to trade in franchises in that state. This could mean that the franchisor is required to hold a portion of collected initial franchise fees in escrow for a period of time or it may mean capitalization requirements and other conditions.

As you might appreciate, the preparation of these documents by hordes of well-paid attorneys, the vetting process with state regulatory agencies, and the tangled web of rules under which franchisors are required to lawfully "sell" their franchises is extremely complicated, very specialized, and lawyer intensive. It costs a lot of money to start a franchise in the US. Franchising south of the border is not for the faint of heart or those who live in abject fear of large legal bills.

5. ARE US-BASED FRANCHISORS REQUIRED TO GIVE CANADIAN FRANCHISEES DISCLOSURE DOCUMENTS?

US-based franchisors do not always give out and are not always required to give out disclosure documents to prospective Canadian franchisees. As a prospective Canadian franchisee, you might not be provided with this information even if you ask for it.

It's possible this material could be on the public record and a great deal of information can be learned about a US-based franchisor from its UFOC. Accordingly, if you have been approached by a US-based franchisor, but have not been provided with a copy of its UFOC, you should ask for it. If the US franchisor refuses to give you a copy of its UFOC (your heightened sense of suspicion having now been justifiably aroused), you might well wonder why, given that it is normally a publicly obtainable document and you can probably get a copy of it from the private company FRANdata <www.frandata.com> or from FranchiseHelp <www.franchisehelp.com>.

The following list outlines the types of "material facts" that would be useful for you to know in advance of making your decision to buy into the concept:

- Bankruptcy and previous convictions of principals
- Outstanding litigation against or by franchisees
- Net worth of the franchisor
- Expected range of a franchisee's initial investment costs
- Product and service restrictions

- Number of units that have ceased doing business (i.e., failed) in the previous 12-month period
- Names and addresses of existing franchisees
- What the standard form of franchise agreement looks like
- Other facts that the franchisor's lawyers have deemed to be material and therefore must be disclosed
- Litigation against the franchisor and its directors and officers

A good reason why you might not be given a copy of the disclosure document is because its irrelevant to you and has little or no bearing on the franchisor with whom you would be contracting, such as in circumstances in which a prospective Canadian franchisee is not contracting directly with the American franchisor (which is subject to US regulation), but with a Canadian subsidiary or master franchisee (which may not be subject to US regulation). In other words, this information could be very valuable to you if you were negotiating and contracting directly with the US-based franchisor that is the subject of the disclosure document.

Quite often, the American-based franchisor has "master franchised" or otherwise licensed its rights to franchise all of Canada (or certain Canadian provinces) to someone else; normally an unrelated Canadian company with different directors, officers, and shareholders than the US franchisor and with a totally different corporate history. (See Chapter 3 for more information on master franchising.) Or perhaps the US franchisor has created a Canadian subsidiary to franchise in Canada, and this subsidiary company is not bound by US laws. In that case, all the information you have obtained on the franchisor isn't quite as helpful as you might have first thought because the franchisor isn't the party you're dealing with.

For information on Canadian disclosure documents, see Part 3 of this book.

6. HAS THE US AGREEMENT BEEN CONVERTED TO A CANADIAN AGREEMENT?

Be mindful of US agreements that have not been Canadianized. A US agreement is relatively easy to spot and not just by the spelling of colour, labour, centre, and neighbour! A US agreement may contain references to the Lanham Act rather than our Canadian Trade-marks Act or it may refer to Chapter 11 instead of our Bankruptcy and Insolvency Act.

The US agreement might have "offering circular" provisions in the agreement that don't directly relate to Alberta or Ontario. It may contain terms such as FTC or UFOC, which mean little or nothing to us in Canada. You probably won't find a reference to GST or PST either. Measurements might also not be expressed metrically. Bilingual packaging and labelling may be totally ignored as well.

The fact that products and equipment may have to be imported from the high currency US into Canada may not have been considered in anyone's pro forma financials, putting the Canadian franchisee in a competitive disadvantage — if not abject hardship — if all the inventory has to come only from one bakery in San Francisco or one factory in Boston. The fact that products imported into Canada may have import duties attached to them, or may not in fact be importable at all, or that such products may require different packaging and labelling than required in the US may have been totally missed by our cousins south of the border (who might not expect to see French on the back of Cornflakes boxes, and all other boxes sold in this country). If that weren't enough, the currency that you'll be paying your royalties with will be US dollars, even though your customers will be paying you with Canadian dollars. So US franchise agreements in which the minor (but important) distinctions between our two nations are not dealt with are cause for concern if you are on the receiving end of such an agreement.

The US agreement will usually choose a US state as the governing law of contact and the place in which all legal proceedings concerning the contract will be heard, rather than a nice city such as Vancouver or even a sensible place such as within the province in which the franchised business just happens to operate.

In very extreme cases, the franchisor's US lawyers will somehow have forgotten about the border between Canada and the US and will require Canadian-based franchisees and their principals to comply with all sorts of inapplicable US laws including, of all things, the Patriot Act! (Don't laugh; I've seen it done!) Try to avoid entering a contract in which Canadian law and Canadian concepts have not been dealt with. It simply means the franchisor's lawyers failed both history *and* geography, and suggests that the franchisor doesn't really want to spend the money to convert its US agreement into a Canadian one. If they aren't prepared to spend the money to convert their US agreement to a Canadian one, how do you think they'll be dealing with their Canadian franchisees?

It's possible that a US-based franchisor may not vet its standard US franchise agreement with Canadian counsel before it starts granting franchises in Canada. If the agreement is governed by US law, you may well be bound by some or all of these US laws. If the agreement is governed by the laws of the jurisdiction in which the franchised business is located (e.g., BC), then perhaps the franchisor has some enforceability problems down the road, as the US concepts that supposedly apply to the agreement will have limited or no applicability in Canada. (At the very least, it will make lawyers that deal with conflicts of law happy, content, and wealthy!)

There also seems to be a different style and tone from the usual Canadian form of franchise agreement when compared to the style and tone of the usual US agreement. Some US-based franchisors have been more than surprised when they have discovered that the ironclad, tough, and controlling form of agreement filled to the gunwales with legal provisions that overprotect the franchisor is regularly and resoundingly rejected in the Canadian franchisee marketplace as too ironclad, tough, controlling, and filled to the gunwales with too many provisions that overprotect the franchisor. Canadians are, after all, the only people in the world that say thank you to bank machines; you'd expect our franchise agreements would be polite as well.

What seems to be forgotten in all this is that some of the same legal specialists who might review the US agreement on behalf of the Canadian franchisee may well be the same people who write these agreements on behalf of the Canadian franchisor. (It's a small fraternity after all! In Canada, no more than 50 Canadian lawyers specialize in franchise law at the time of writing this book.)

If you have retained a lawyer with some familiarity with franchising (and my advice is that you should), he or she will know what is normal for the Canadian marketplace. Your franchise lawyer will advise you about what is not normal, what is over-the-top, what is overreaching, and what is just plain wacky (see references to the Patriot Act, above). It may well be that your franchise lawyer may tell you, "This agreement is way out of line and nobody in their right mind should sign it."

In short, if the American franchisor hasn't Canadianized it US form of agreement, you should ask the very sensible question: Why?

7. LABOUR ISSUES

Provincial labour relations boards have looked at franchised retail and restaurant labour issues with great scrutiny. There have been stronger attempts by unions to protect their members' bargaining rights, or to expand these rights to more retail and food sector workers. Franchised establishments will, by necessity, be involved.

It is important to assess from the franchisor whether any corporate or franchised stores in the system are the subject of a collective bargaining agreement, or are the subject of a certification drive by a union, or have already been certified. It may be that a certification drive in another part of the province could eventually affect the franchised business being acquired by you. This knowledge in advance will at least allow you to assess whether unionization of your franchised business would have any substantial or negative impact upon its economics or viability.

It is common knowledge that trade unions are moving into sectors such as retail and food services, and you should be aware of the potential for certification. Certainly in British Columbia (and perhaps other provinces), any actions or statements by you to dissuade a union certification may backfire by being deemed as an unfair labour practice. Caution, restraint, and legal advice are urged in these circumstances, together with aspirin.

8. GOOD FAITH, FAIRNESS, AND REASONABLENESS

The Ontario and Alberta franchise laws impose a statutory duty of fair dealing in the performance and enforcement of the franchise agreement. The other provinces do not have such legislation but case law (that is, judge-made law) would indicate that there may be a "common law" duty of good faith and fair dealing in some provinces, but the law is somewhat divided on this point.

It's important to note that it's not just the franchisor who must deal fairly with the franchisee. The franchisee must deal fairly with the franchisor as well. In my experience, there are ample cases of franchisees acting unfairly to the franchisor, underreporting or withholding royalties, deliberately not following the system, and carrying on the business in more or less permanent state of "cold war" with the franchisor. In other words, there are bad apples and bad actors among franchisees. Fairness and good faith, then, work in both ways. Franchisees who act unfairly and in bad faith will (and should) face the same legal sanctions as franchisors who do.

Regardless of whether you have an issue with the franchisor over some element of the franchise system you don't like, such as new requirements by the franchisor, interpretation of the operations manual, or for any other reason, withholding royalties, underreporting gross sales, undermining the franchised system, or misrepresenting information may well breach this duty of fair dealing as well as breach the franchise agreement. If it comes to litigation, such tactics won't look good in court and may well exacerbate your legal situation. Both you and the franchisor must act fairly under the agreement towards each other. You must take the high road.

While acting for franchisees "discussing" the franchise agreement before it is signed, I have, in some cases, been able to persuade franchisors to add a provision to their agreement to the effect that "the parties will deal with each other fairly and in good faith." "If it's the law anyway," I argue, with only a touch of embellishment, "why not state it in the agreement?"

If they aren't prepared to do this, my polite and measured response is: "Sorry, did I hear you correctly? You've made all sorts of representations and provided all sorts of comfort to my client about how fabulous this franchise is, how great the location is, how good the other franchisees in the system are, how successful the system is, and how you see the franchisees as your 'partners' and your 'family,' but you won't covenant in the agreement to treat the franchisee fairly and in good faith? Did I hear that correctly? Does that mean you want the right to treat them unfairly and in bad faith?"

I'm happy that most franchisors who I've "discussed" this with will agree to such a request. It needn't be done in the body of the agreement. It can be done in an addendum to the agreement (an addendum being a modification to the franchise agreement that forms a part of the agreement and is usually attached at the end of the document). It can also be in the form of a "letter agreement" as long as it's signed by both parties and acknowledged to be a modification of the agreement.

Although what might be called the standard Canadian form of franchise agreement usually provides for the franchisor acting reasonably in most circumstances in which it can exercise discretion (e.g., "the franchisor, acting reasonably shall…" or "subject to the reasonable approval of the franchisor") there may be issues in which you may want to add "reasonableness" language (e.g., "the franchisor, acting reasonably shall …" or "the parties, each acting reasonably and in good faith, shall …"). Remember, pick carefully and don't nitpick!