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# BRINGING A FOREIGN FRANCHISE SYSTEM TO CANADA

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## 1. INTRODUCTORY BUSINESS ISSUES

### A. Introduction

A major source of new franchise concepts in Canada is foreign franchisors, primarily those in the United States. Advising such clients requires attention to a particular sub-set of franchise issues that reflects the differences between the Canadian and the foreign franchise laws, and some of the practices associated with international law.

In may also require some sensitivity to cross-border or international business issues. Foreign counsel and their clients often look to their Canadian counsel as their guide to the country and appreciate explanations of Canadian customs and practices.

#### (a) Adaptation

Just because a franchise system and its products have been successful in the United States does not automatically mean that they will be successful in Canada. Notwithstanding the similarities between the countries, there are differences that can be very significant in a competitive marketplace. Mail Boxes Etc., a successful American franchise system, has found that it has had to change its product mix in each country that it entered. In the United States, the primary product is packaging and delivery of parcels. In Canada the primary product is document production. Food tastes vary from country to country and region to region. The Coca-Cola that is sold in Canada is not as sweet as the American product.

Canada also has its internal differences that should be taken into account when evaluating the franchise systems and products. Will the product or system work as well in Québec for example, as it would in Ontario or Alberta. Operating in Québec usually requires significant translation costs and bilingual staff. Some master franchises choose to exclude it from their territory. Would this be acceptable to the foreign franchisor?

An important consideration in adapting the franchise system and its products to Canada is the degree of commitment that the foreign franchisor has to its presence in Canada. Is it prepared to step in and pick up the pieces if things go wrong? Is it prepared to pay some of the costs associated with adapting the product and developing the goodwill in Canada?

#### (b) Products

Sourcing raw materials and products to be used or sold in the franchise business in Canada may raise a variety of issues. To what extent is the franchise system based on the sale of proprietary products that bear the franchisor's trade-mark (such as a particular brand of automobile), and to what extent are the products from approved third party suppliers? 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 items on the packaging in both French and English. Non-prescription drugs require a Canadian drug identification number and must conform to Health Canada parameters. Electrical and other equipment must also meet certain safety and quality standards.

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. Sometimes, it is simply not possible to import the item. Yogurt franchisors often have difficulty with the quotas on dairy products imposed by marketing boards. This affects the price structure and the ability of the American franchisor to use any excess capacity in its plants south of the border.

While generally it is the responsibility of the franchisor to bear the cost of adapting products for importation into Canada, the Canadian franchisee would want to be assured that a sufficient and appropriate range of products will be available for use in Canada.

The other issue to consider in this area is product pricing. Sometimes franchisors use the resale of products to their franchisees as a profit centre in place of, or to supplement, royalties. In other instances, franchisors obtain significant volume rebates from third party suppliers that effectively subsidise their royalty income. To resolve these issues, franchisees often seek a clause in the agreement specifying that the sale of products will be at a competitive wholesale price. For imported products, franchisees should clarify who will be responsible for the payment of customs duties, freight and transportation charges, insurance and who will bear risks of currency fluctuations (i.e. in what currency will the products be priced as between the franchisor and franchisee).

### (c) Advertising

Generally in the franchise system a franchisor will use funds contributed by the franchisee to develop advertising materials, point of sale materials, promotional materials, brochures, layouts, radio or television scripts and other marketing items. Sometimes these items may work equally well in a different country, and sometimes not, depending upon the type of materials and the closeness of the cultures of the two countries. Some types of products and advertising, such as health products, are subject to special regulatory approvals, and therefore must be pre-approved in Canada.

For these reasons franchisors have generally not had much success with unified international advertising funds. Even if the franchisor is developing in Canada by way of single unit franchises, it may be more appropriate to set up a separate Canadian advertising fund. The administrators of the Canadian marketing efforts (which should be specified in the franchise agreement) may then have the option of purchasing appropriate advertising materials developed in the franchisor's home country, or spending the funds to develop new items for the Canadian market. This ensures that advertising contributions by Canadian franchisees will be used to develop appropriate materials for the Canadian market.

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

Canada is a more urbanized country than the United States and it has widely separated concentrations of population that are appropriate for television or radio advertising. Care should be taken in reviewing the proposed advertising or structuring of any franchise agreement to ensure that these differences have been taken into account.

**(d) Training and Human Resources**

If the Canadian franchisee is taking on significant responsibility for the development of the Canadian market, it will have to recruit and retain skilled staff to fulfil these responsibilities. A common problem is that the need for such staff arises before there are revenues from the franchise system to pay their salaries. While the franchisor may prohibit the recruiting of its staff in the agreement, negotiated arrangements for either secondment or specific transfers of personnel (who may be expatriate Canadians) may be possible and desirable.

A similar issue to be addressed is who will be responsible for the training of franchisees. Where will the training take place and in what language? If the training takes place outside of Canada will it have sufficient Canadian content? This is a very important issue for area developers. One area developer for Québec that I am aware of found that it lost many of the franchisees that it had recruited when they had to come to Toronto to be trained in English. Ultimately, the area developer gave up trying to recruit new franchisees. The retention level was too low to justify the cost.

**(e) System Improvements**

The Canadian marketplace is relatively mature and any retailer must be constantly adapting its systems and methods in order to remain competitive in the marketplace and maintain its market share. This is even more important for franchise systems, because implementing changes requires the co-operation of the franchisees at the retail level. While the foreign franchisor will retain the rights for overall product development, who will have responsibility for maintaining competitiveness in the Canadian marketplace? Will that party have the appropriate revenues and incentives to do the job? In considering this obligation, it should be noted that there is a Québec Court of Appeal decision suggested that a franchise system was one in which a franchisor had a certain duty to adapt continually to the changing marketplace, and to take its franchisees interests into account in doing so[1].

Some of the adaptations made will constitute intellectual property. The parties should decide in advance who will own such adaptations and who will be responsible for any registrations or maintenance required. The allocation of these items may not always reflect the cost of developing them. Generally speaking the franchisor retains his ownership of intellectual property items, such as translations of its operating manuals and marketing materials.

## 2. CHOOSING THE ENTRY STRUCTURE

### A. Introduction

Another significant business-related issue relates to the manner by which a foreign franchisor expands its franchise system into Canada, that is, the determination of which means of expansion is best suited for it to enter into Canada. There are several ways with which a foreign franchisor may expand into Canada. For example, a foreign franchisor may choose to grant a single unit franchise to the prospective franchisee, or to offer the franchisee the right (or to obligate the franchisee) to purchase several franchised units and to thereby become a multi-unit franchisee. Alternatively, the franchisor may choose to grant area representation or development rights or under the right circumstances, master franchise rights to the Canadian entity.

Foreign franchisors may also wish to consider expansion into Canada by granting rights to franchises in non-traditional locations such as hospitals, sports stadiums, kiosks, airports and other such venues or by dual branding complementary concepts with an existing franchise system which already has a presence in Canada. Finally, foreign franchisors may decide that to convert an existing business or businesses to their respective franchise systems may be the most convenient and expeditious method of expansion into Canada.

The choice of the entry structure is a decision that deserves much more attention than what is unfortunately given to it in most cases. Serious consequences may flow from both a business and legal perspective if the entry structure is inappropriate for the circumstances at hand. The grant of master franchise rights to a Canadian entity, for example, while tempting for the foreign franchisor for various reasons (most significantly, the infusion of cash resulting from the initial master franchise fee paid by the master franchisee), may be entirely premature and inappropriate in certain situations. If there is a lack of brand awareness or little demand for the product or service in the targeted marketplace, for example, the franchisor and the master franchisee may suffer significant setbacks in terms of their expansion efforts, making it difficult if not impossible for the master franchisee to meet the performance standards set by the

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[1] *Provigo Distribution Inc*. c. *Supermarché A.R.G. Inc.* [1995], R.J.Q. 464 (C.S.Q.); [1998], R.J.Q. 47 (C.A.Q.).

franchisor. An inappropriately chosen master franchisee furthermore may seriously undermine the brand and the reputation of the franchisor's system and ultimately, its ability to expand within the master franchisee's territory for years to come.

Conversely, the incremental sale of unit franchises to even deserving and capable franchisees may not always be the most appropriate or cost effective method of entry into Canada. For instance, if the foreign franchisor grants a unit franchise to an individual in a major urban centre with exclusive rights to too large a territory, it may inadvertently preclude or make it very difficult to sell the area development or master franchise rights to a prospective area developer or master franchisee some time into the future. This is because a party desirous of such expansive rights may not find the opportunity very attractive if a unit franchisee already exits within the target territory. Though, in such event, the foreign franchisor may consider addressing this issue by transferring its franchise agreement with the unit franchisee to the area developer or master franchisee or by carving out the unit franchisee's territory from the territory granted to the area developer or master franchisee, as the case may be. Either alternative, however, may not be very appealing to the foreign franchisor who is often more interested in downloading such rights to its Canadian "partner" without much complication.

It is therefore important to discern and consider as best and as early as possible in advance of any grant, the demand for the product and service, the relative cost of expansion by each of the methods of entry enumerated above, the level of competition in the market, and the aptitude and wherewithal, both operationally and financially, of the prospective franchisees, area developers, area representatives or master franchisees, among other matters. Responding favourably to the first overture of interest from Canada by immediately granting rights to the foreign franchise in Canada without sober thought and analysis is not advisable and is often counterproductive in the long run.

The foreign franchisor's choice of the entry structure will then often determine the nature and extent of the legal documentation and protection required under the circumstances. A foreign franchisor is encouraged to conduct more extensive due diligence on the Canadian entity and obtain the appropriate legal advice to protect the system in Canada in the case where there is a grant of master franchise rights (as opposed to the sale of a single unit franchise) as such a grant inevitably involves greater risk to the foreign franchisor and to the system as a whole. In any event, the legal advice and documentation should be tailored to the specifics at hand, as each situation and relationship will inevitably warrant a different and a unique approach.

No matter how a foreign franchisor ultimately decides how best to penetrate the Canadian marketplace, it is most important not to allow the legal structure of the arrangement to dictate the terms of the business deal itself. Instead, the foreign franchisor should first feel comfortable that the business deal is worth pursuing and only then take steps to ensure that the legal documentation is in place to address and to buttress the terms of the business relationship. Most significantly and as obvious as it may be, the relationship to be pursued should be one that is profitable for all parties concerned as otherwise, the relationship is bound for failure. Having said that, there are certainly occasions where the legal concerns raised by counsel will in fact trump the terms of the deal itself and may determine and alter the format and nature of the arrangement.

### B. Types of Franchising

A foreign franchisor might expand into Canada by utilizing one or more of the following methods of franchising:

#### (a) Unit or Multi-Unit Franchising

The foreign franchisor might choose to sell a unit franchise directly to a Canadian franchisee without involving any intermediaries and without selling any other rights to the franchisee (e.g., to represent the franchisor or to develop the territory). While this approach is the simplest method to enter Canada, it is also the most expensive and time consuming particularly if the franchisor ultimately wishes to saturate the market with its franchises on an expedited basis.

The foreign franchisor may also grant the Canadian franchisee the option (or impose an obligation) to purchase additional franchises within a certain designated territory, and within a specific timeframe. This is very much akin to the grant of area development rights, though in a more restricted manner.

#### (b) Area Representative Rights

Alternatively, a foreign franchisor may wish to grant a third party certain representation rights to assist it in expanding the franchise system in Canada. This is achieved when the foreign franchisor grants a territory (usually an exclusive one) in return for an initial fee paid by the representative. The representative is then required to recruit prospective franchisees from within its territory and to introduce such prospects to the franchisor for an agreed upon finder’s fee. These prospective franchisees would then enter into a franchise agreement directly with the foreign franchisor. Thereafter, the area representative may be entitled to a percentage of any revenue generated by the sold franchises operating within its territory.

#### (c) Area Development Rights

The foreign franchisor could alternatively sell to a Canadian the rights to develop a particular area in accordance with a development schedule. In such a scenario, the foreign franchisor would then require the Canadian area developer to open single unit franchises within a specific territory or territories, often within a specific timeframe. Alternatively, the foreign franchisor may give the area developer the right to locate, recruit and introduce prospective franchisees to the foreign franchisor or to locate an appropriate location for a corporate-owned franchise. The foreign franchisor might compensate the Canadian area developer for its efforts in various ways, including by paying the area developer commissions on each introduction made to the foreign franchisor, or by sharing a percentage of the franchise fee or the royalties paid by the ultimate franchisees.

**(d) Sub-franchising or Master Franchising**

The foreign franchisor may wish to grant a Canadian master franchisee the right to sub-franchise the franchise system in Canada or in certain territories within Canada. In such a case, the master franchisee would typically act in many ways like a franchisor itself, having all of the responsibilities of a franchisor except for the fact that the foreign franchisor would maintain the ultimate control over the trade-mark(s), the franchise system and possibly the training and the sourcing of product supplies. The foreign franchisor would also typically reserve the right to terminate the master franchise in the event that certain performance criteria were not met.

**(e) Entry Structures Advantages & Disadvantages**

Each entry structure has its own set of advantages and disadvantages associated with it. Please see directly below for a brief description of some of the more popular entry structure possibilities referred to above and a cursory summary of their respective benefits and disadvantages. In addition to addressing the above-noted factors, it is integral for the foreign franchisor to give due consideration to the tax issues associated with franchising in Canada, some of which are discussed below at Chapter 5 of this paper.

## C. Entry Structures - Advantages & Disadvantages

| Entry Structure | Advantages | Disadvantages |
|---|---|---|
| 1. **Single Unit**<br><br>(Single unit franchisee is offered only one franchised unit to operate or, over time, multiple units) | ✓ Simplest method of expansion<br><br>✓ Could easily test franchisee to determine whether it is capable of operating as an area developer or representative or master franchisee if it is so inclined | ➢ Most cost inefficient<br><br>➢ Slowest method of expansion<br><br>➢ One difficult franchisee could destroy the brand equity and, for example, prevent the sale of a master franchise for the territory for a number of years |

| Entry Structure | Advantages | Disadvantages |
|---|---|---|
| | ✓ Franchisor could test Canadian market by operating its own unit and advertise the franchise system within a targeted area | ➢ Products and/or services may not be easily sourced in the host country, or may be sourced but only at a prohibitive price point |
| 2. **Area Representative**<br><br>(Area representative agrees to recruit franchisees within a specific territory and where such franchisees enter into a direct franchise agreement with the foreign franchisor) | ✓ Incentives to recruit prospective franchises within certain timelines<br><br>✓ More efficient means of expansion than sale of single unit franchises | ➢ Products and/or services may not be easily sourced in the host country or may be sourced but only at a prohibitive price point<br><br>➢ Area development schedule may in fact impede faster growth if representative feels satisfied with recruiting the minimum number of units required by the performance schedule imposed by the foreign franchisor<br><br>➢ Incentive for area developer to recruit additional prospective franchisees may detract from its ability to perform successfully as a franchisee itself |

| Entry Structure | Advantages | Disadvantages |
|---|---|---|
| 3. **Area Developer**<br><br>(Area developer is granted exclusive rights to open a set number of franchises within a defined territory and upon a specific timeline) | ✓ Includes advantages outlined at Item 2 above<br><br>✓ More tasks (such as recruitment of new franchisees) are downloaded to Area Developer, thereby alleviating the foreign franchisor's workload and reducing overhead costs<br><br>✓ Cost efficient means of expansion as new capital is infused into the system | ➢ Includes disadvantages noted at Item 2 above<br><br>➢ May be premature to grant development rights when developer has not yet proved itself |
| 4. **Master Franchisee**<br><br>(Master franchisee is entitled to sub-franchise to sub-franchisees, collect fees, enter into franchise agreements directly with its sub-franchisees, assist in training and act as franchisor's agent in enforcing system standards) | ✓ Includes advantages outlined at Items 2 and 3 above<br><br>✓ Master franchisee serves as the "franchisor" in the Canadian marketplace and foreign franchisor benefits from downloading recruitment, training, servicing and support of franchisees to master franchisee<br><br>✓ Cost efficient means of expansion as new capital is infused into the system | ➢ Includes disadvantages noted at Items 2 and 3 above<br><br>➢ Most complex form of franchising<br><br>➢ Difficult to locate suitable master franchisee<br><br>➢ May be premature to grant master franchise rights when master franchisee has not proved itself<br><br>➢ A certain loss of control over enforcement of system standards inevitably results |

| Entry Structure | Advantages | Disadvantages |
|---|---|---|
| | | ➢ Most significantly, lower profits may result due to fee splitting with master franchisee. Is the model profitable for both the franchisor and master franchisee? |
| 5.**Conversion Franchise** | ✓ Easily converted to new system<br>✓ Less training required<br>✓ Established clientele | ➢ Re-training may be required to address old or perhaps incorrect practices<br>➢ More difficult to enforce non-competition provisions<br>➢ More difficult to control franchisee "who knows it all" |
| 6. **Partnership/Joint Venture With Canadian Entity** | ✓ Simple method expansion | ➢ Possible loss of control<br>➢ Possible diminution of Trade-marks |
| 7. **Canadian Branch Location** | ✓ Complete control over unit | ➢ Cost of expansion is high |

Given the varied nature of these entry structures and the widely divergent legal consequences of choosing one over another, the foreign franchisor should consult with franchise counsel well in advance of consummating a deal with the interested Canadian entity to assist it to better understand the ramifications of each entry structure. Franchise counsel along with other professionals should be retained to provide the foreign franchisor with the right blend of legal and business advice that is typically necessary to facilitate the deal with the Canadian entity.

Once the entry vehicle is chosen, the foreign franchisor must direct its mind to the business terms most appropriate to the opportunity at hand. Some of the key business terms that should be settled before finalizing a deal with the foreign franchisor's Canadian franchisee, area developer, area representative or master franchisee include the following:

(i) Determining the boundaries of the territory if an exclusive territory is granted.

(ii) Identifying an acceptable initial franchise fee (or master franchise fee, area development fee etc., as the case may be), royalty rates, and other fees to be paid by the Canadian entity.

(iii) Choosing the most appropriate number of years for the term and renewal terms of the agreements. In particular, are the initial and/or renewal terms of sufficient duration to allow the franchisee, area developer or representative to obtain a return on its investment and to otherwise provide itself with a reasonable timeframe in which it could dispose of the equity that it has created?

(iv) Determining whether to impose certain performance standards, and if such standards are in fact imposed, the level of standards and the consequences to be suffered by the Canadian entity in the event the standards are not met. In that regard, it is important to ensure that such standards are in fact realistic given the level of demand for the product or services offered by the franchisees within Canada.

(v) Deciding upon how the Canadian franchisees should lease their franchised locations (either directly from their landlords or indirectly by sublease with the foreign franchisor).

**D. Other Important Questions**

Other important questions to answer before a foreign franchisor launches its franchise in Canada include the following:

- Many foreign franchisors draft their franchise documentation so that all monies paid pursuant to the franchise agreement are paid in their foreign currency. Which party, the franchisor or the franchisee, should then bear the risk of any currency fluctuations? For example, who is responsible for the increase or decrease in foreign currency between the date that a particular payment is due and the date on which the franchisee, area developer or representative actually makes payment?

- Has the foreign franchisor considered the labelling and packaging requirements for products marketed specifically in Canada and who will assume the cost of such compliance?

- What other regulatory requirements must the franchisor and the franchisee, area developer or representative meet before commencing the operations of the franchise in Canada and during the term of the franchise/area development/area representative agreement and who will cover the costs of such compliance?

- Will the foreign franchisor require that the Canadian franchisee, area developer or representative purchase product and/or services from suppliers based in the foreign franchisor's jurisdiction or will the Canadian entity have the option or the opportunity to deal with certain designated Canadian suppliers? Who will bear the cost of any freight and transportation and customs duties of the products delivered by the foreign franchisor or its suppliers to the Canadian franchisee, area developer or representative? Will the Canadian entity need to travel to the foreign franchisor's jurisdiction to receive training and if so, at whose cost? See Chapter 1 of this paper which touches upon the issues of product sourcing as well as training and support.

- Will the advertising fees paid by the Canadian entity be used for marketing and advertising initiatives in Canada or will the foreign franchisor have the discretion to spend such funds for advertising in its own jurisdiction only? Will there be an advertising fund for Canadian franchisees that is separate and apart from that of the foreign based advertising fund?

- Does the foreign franchisor have adequate resources to support and train its Canadian franchisees, area developers or representatives on an ongoing basis? Will the franchisor dedicate a specific person(s) to its Canadian operations or will the Canadian entity need to compete for the attention of the foreign franchisor?

- Has the foreign franchisor considered the issue of the payment of Canadian withholding taxes? Foreign franchisors are required to pay Canadian taxes on income earned in Canada. The Canada Revenue Agency ("CRA") ensures that such taxes are paid by requiring Canadian franchisees to i. withhold a percentage of any payments made to U.S. franchisors and ii. remit such withholdings directly to the CRA. The franchise agreement (or area development or area representative agreement) should account for any withheld royalties, for example, by indicating whether the royalties to be paid are net of withholdings or are to be paid from the gross sales before withholdings.

- Are the operating manuals extensive enough and tailored for the Canadian marketplace?

- Is the Province of Québec included in the foreign franchisor's expansion plans, and if so, has it considered the plethora of issues surrounding the cultural, linguistic and legal barriers of entry into that Province?

- Will the Canadian franchisees derive any benefit from the purchasing power exerted by the foreign franchisor or will the franchisees be bound to purchase their product or services from the franchisor or its suppliers at a premium?

- If the foreign franchisor is granting the rights to a Canadian master franchise, is the master franchisee required to own and operate one or more franchised units? Is this a condition of the master franchise granted to the Canadian entity? What rights has the foreign franchisor reserved for itself to develop the territory or territories granted to the Canadian master franchisee?

## 3. INTELLECTUAL PROPERTY ISSUES

### A. Introduction

A franchise is generally defined as the right to use a trade-mark together with a marketing plan and assistance in running the business in return for fees, and Ontario's *Arthur Wishart Act (Franchise Disclosure) 2000* adopts this model.[2] The trade-mark rights are the foundation of any franchise system, but there may also be copyrights, patents or trade-secrets that are part of the system. One of the first things that should be done when advising a foreign client is to establish which trade-marks, copyrights or patents are important to the operation of the system, and to determine the status of these rights in Canada.

Even if the prospective franchisor is only enquiring about expansion into Canada, it is never too early to suggest an application for trade-mark registration in Canada. Unfortunately for many foreign franchisors Canadians travel a great deal and in the past have noticed new concepts with potential before the foreign franchisor has considered expansion into Canada. They have then registered the trade-marks in Canada for themselves. An example is the RENT-A-WRECK system[3] where the Canadian and American marks are owned by unrelated corporations.

With the development of the internet and e-commerce another aspect to consider is the protection of any relevant domain names in the .ca country code top level domain.[4] Not all franchisors have a clear policy regarding registering country code domain names to protect there trade-marks and some enquiry may be necessary as to the protection desired. Domain names can serve as both addresses and as indicators of the source of the goods or services as does a trade-mark, and therefore domain names should be considered when advising a foreign franchisor regarding its overall brand protection in Canada.

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[2] S.O. 2000, c.3; see section 1(1) and the definition of "franchise."

[3] See for example Canadian Trade-mark registration TMA553, 886 and U.S.P.T.O Registration No. 2,054,649, each held by a different legal entity. In both cases the principals involved have changed since the registration of these trade-marks.

[4] Administered by the Canadian Internet Registration Authority ("CIRA"). For more information see http://www.cira.ca.

## B. Trade-marks

If a foreign franchisor wishes to protect its marks in Canada in advance of actually franchising or otherwise using them in Canada it must file an application to register such marks in Canada. To do so it should consider the basis upon which it will claim a right to registration in Canada, issues related to the bilingual and multicultural nature of Canada, and the treatment of trade-mark licenses in Canada.

### (a) Basis for registration in Canada

Trade-marks must be registered separately in each country where protection is desired. Canada is not a party to the Madrid Convention or the Madrid Protocol that expedite the international registration of trade-marks and are often used by European businesses. The U.S. recently adopted the Madrid Protocol[5] but it is less frequently used by Americans, in part because Canada and Mexico are not members.

Canada does adhere to the *Paris Convention for the Protection of Industrial Property*[6] (the "Paris Convention") which among other things requires Canada to allow foreign applicants from member countries to claim the date of filing the application for registration in their home jurisdiction as their priority filing date in Canada, provided that the Canadian filing is made within six months of the date of the filing in the home jurisdiction.[7]

The Paris Convention also requires that trade-mark owners from member countries be able to register their marks in member countries based on use and registration in their home country.[8] Foreign franchisors that do not yet have a location in Canada may thus still file an application based on registration and use in their home jurisdiction, or alternatively, file an application based on proposed use in Canada, or file an application based on both of these grounds.

If the franchisor does not begin to use its marks in Canada a registration based on registration and use in another country may be expunged from the register if any person requests that the Registrar of Trade-marks issue a notice under section 45 of the *Trade-marks Act* requiring the owner to furnish evidence that the trade-mark was in use in Canada at any time during the three year period immediately preceding the date of the notice. In the alternative, an application based on proposed use will not proceed to registration until the applicant makes a declaration that the trade-mark is being used in Canada.[9] Franchisors intending rely on either or both of these basis for registration should be advised in advance of these restrictions.

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[5] The U.S. became a party on November 2, 2003.

[6] Made March 20, 1883,as revised at Brussels on December 14, 1900, at Washington on June 2, 1911, at The Hague on November 6, 1925, at London on June 2, 1934, at Lisbon on October 31, 1958, and at Stockholm on July 14, 1967, and as amended on September 28, 1979.

[7] See Article 4 of the Paris Convention and section 34 of the *Trade-marks Act*.

[8] See Article 6quinquies of the Paris Convention and section 16(2) of the *Trade-marks Act.*

[9] See section 40(2) of the *Trade-marks Act*. The use may be through a franchisee using the trade-mark under license, subject to certain conditions. See section 40(2)(c).

Foreign franchisors that are from members of the Paris Convention also have the option of applying for the registration of their marks in Canada not on the basis of use in Canada, but on the basis of having made the mark known in Canada.[10] Section 5 of the *Trade-marks Act* sets out the criteria under which a mark is deemed to have been made known. The mark must have been used to advertise wares or services in Canada either in any printed publication circulated in Canada amongst potential purchasers, or in radio broadcasts ordinarily received in Canada by potential customers. Evidence that traveling Canadians have purchased the wares or services in another country is not sufficient.[11] It is also not sufficient to evidence simply that the advertisement was broadcast on a radio station having Canadian listeners. There must also be evidence of reception by actual dealers. For these reasons this basis for registration is rarely if ever relied upon.

Thus for foreign franchisors the criteria for evidencing use in Canada are of significant importance, particularly as e-commerce develops. The general rules are set out in section 4 of the *Trade-marks Act.* If the mark is used on wares, the mark must be used in such a way as to come to the attention of the purchaser at the time of transfer in a sale in the normal course of trade. If the mark is used on services, it must be used or displayed in the performance or advertising of the services. This issue arises frequently in disputes and litigation and there is a significant body on case law interpreting these provisions. Many foreign franchisors now have web sites on which the mark is used in association with their franchising services. Does such use constitute use in Canada? A number of cases have held that such advertising will not constitute use in Canada unless the service is performed in Canada.[12]

### (b) Bilingualism and other language issues

One of Canada's distinctive features is that it is has two official languages, English and French. This means in the test for confusion[13] as between two marks must be analyzed with respect to both official languages. This leads to three tests. Would the average Anglophone find the two marks confusing, would the average Francophone find the two marks confusing, or would the average bilingual consumer find the two marks confusing?[14] When conducting searches to determine the availability or registrability of a foreign franchisor's trade-mark it is necessary to translate it into Canada's other official language and possibly to conduct searches on the translation. Some phrases have primarily one appropriate translation. An example is the phrase "FIRST CHOICE" which in French would usually be "PREMIER CHOIX." If a foreign franchisor wished to register this mark for its wares or services, it would be necessary to search both the English and the French versions to establish its availability or registability.

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[10] See section 16(1)(a) of the *Trade-marks Act,* based on Canada's obligations under Art. 6bis of the Paris Convention.

[11] *Robert C. Wian Enterprises Inc. v. Mady* , (1965) 29 Fox Patent Cases 37.

[12] *Porter v. Don the Beachcomber,* 48 C.P.R. 280 (Can. Ex. Ct.); *Canadian Kennel Club v. Continental Kennel Club,* (1997) C.P.R. (3d) 470 (F.C.T.D.); *Koo Koo Roo v. The Leads Corporation,* [1998] T.M.O.B. No. 97.

[13] As set out in section 6(5) of the *Trade-marks Act.*

[14] *Produits Freddy Inc. v. Ferrero SpA* (1986), 20 C.P.R. (3d) 61(F.C.T.D.).

In other cases there may not be an obvious or easy French version of the trade-mark. If the word "ULTIMATE" is included in a mark there are at least five possible translations for the French version of this word in the trade-mark; namely "ABSOLU," "FIN DE FIN," "FONDAMENTAL," "DÉFINITIF," and "LE PLUS LOINTAIN." Each of these has a slightly different meaning. In these circumstances the judgment as to what searches are necessary and what registrations are necessary to protect the client's interest is more complex. As there is no obvious translation there may not be the same risk of finding a confusing mark in French.

Trade-marks are a federal matter, and the Province of Québec does not have the power to require French versions of trade-marks, as it does with company names. But the Province of Québec is the only significant French-speaking area in North America, and as such many Québecois have long been concerned that English would eventually replace French in Québec, and concerned with the influence of English on the quality of the French spoken in the Province. A large majority of persons residing in Québec are predominantly francophone, and in retail commerce, the provisions of Québec's *La Charte de la langue française*[15], can be said to simply reflect the commercial reality. Foreign franchisors do not have to adopt a French version of their trade-mark, but may wish to for commercial reasons.

Finally approximately 13% of Canadians commonly speak Chinese (Cantonese or Mandarin primarily). A number of Canada's major retailers have adopted Chinese versions of their trade-marks or slogans. Some foreign franchisors may wish to consider developing Chinese versions of their marks if they wish to establish a presence in the Chinese-Canadian market.[16]

### (c) Licensing

A trade-mark is supposed to assist the consumer by indicating the source of the goods or services with which it is used. Partly for this reason trade-mark law historically did not encourage the licensing of a mark to a third person for use on goods produced by that person. Prior to amendments to the *Trade-marks Act* in 1993 each licensee was required to be registered with the Canadian Trade-marks Office. The 1993 amendments replaced this requirement with what is now section 50 of the *Trade-marks Act*. Section 50(1) provides as follows:

> 50(1) For the purposes of this Act, if an entity is licensed by or with the authority of the owner of a trade-mark to use the trade-mark in a country and the owner has, under the licence, direct or indirect control of the character or quality of the wares or services, then the use, advertisement or

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15 L.R.Q., c. C-11, passed by the National Assembly on August 26, 1977.

16 Regarding these issues see Paul Jones, "Federal Court Decision Affords Greater Protection to Foreign Character Trademarks", *Lawyers Weekly*, (31 March 2000) p. 9., and Paul Jones, "Sound, Meaning and Details, There's more to the protection of Chinese-character trademarks than meets the eye", *Marketing Magazine*, (5 June 2000) p. 23.

> display of the trade-mark in that country as or in a trade-mark, trade-name or otherwise by that entity has, and is deemed always to have had, the same effect as such a use, advertisement or display of the trade-mark in that country by the owner.

In other words so long as the trade-mark owner maintains direct or indirect control of the character or quality of the wares or services, use by the licensee constitutes use by the owner.

However Canada has historically been among the more conservative jurisdictions on this issue and implied licenses even between a wholly-owned subsidiary and a parent were unlikely to be recognized.[17] Other jurisdictions, such as the United States, do recognize implied licenses more frequently and accordingly foreign franchisors should be advised that the licensing of the trade-marks from a parent to a subsidiary, or more commonly in franchising from an holding company to a operating company, should be evidenced by written license agreements in a Canadian court, and the license agreements should contain clauses providing the trade-mark owner or its agent the right to inspect the goods and services as to their character or quality, preferably both. They should also be prepared to evidence that some inspections did in fact take place. While such provisions are a standard part of a franchise agreement, the internal organization of a foreign franchisor is another matter.

Section 50(2) provides some relief in this regard, in that to the extent that the franchisor gives public notice, such as on the wares, that the use of the trade-mark by a licensee is a licensed use and the trade-mark owner is identified, there is a rebuttable presumption that the owner is controlling the use.

### C. Domain Names

Franchisors are increasingly using the internet to and web sites to promote their brands. Although a foreign franchisor may have already registered in the .com domain name for its trade-mark, what policy does it have with respect to country level domain names such as the .ca domain? There are many factors that should be taken into account in developing such a policy, such as whether the franchisor is expanding using master franchisees in each country or is using direct franchising from its foreign head office, the nature of the goods and services, and the expected market penetration.

If the franchisor is aiming for widespread consumer recognition of its mark, it is likely that consumers will be expecting a uniform look and feel, and uniform goods and services, whether the web site using the trade-mark is registered in the .com or the .ca domain. It some cases it is prudent to obtain the .ca registration for the mark simply to prevent competitors or disgruntled customers from using it for other purposes.

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[17] *Wilkinson Sword (Canada) Ltd. v. Juda* (1966) 51 C.P.R. 91 (Ex. Ct.); *Gray Rocks Inn Ltd. v. Snowy Eagle Ski Club Inc.* (1971), 3 C.P.R. (2d) 40 (F.C.A.); *MCI Communications Corp. v. MCI Multinet Communications Inc.* (1995), 61 C.P.R. (3d) 245 (T.M.O.B.).

The Internet Corporation for Assigned Names and Numbers ("ICANN") has delegated the authority for the day-to-day administration of the Internet Domain Name System to the Internet Assigned Numbers Authority ("IANA"), who has in turn delegated the administration and assignment of ccTLDs to individual country managers[18]. Each country has been assigned a code by the International Standards Organization, an agency of the United Nations. Each country code manager in turn maintains a list of accredited registrars, and sets the rules and procedures that govern registration in that domain. Registrations are handled by the individual registrars in that country.

In Canada the country code manager is now the Canadian Internet Registration Authority ("CIRA"), a not-for-profit Canadian corporation that took over the job from the original volunteer who had been handling the job since the formation of the internet. It has adopted its own registration requirements and dispute resolution policy[19]. One of the key requirements for the registration of a .ca domain name is having a Canadian presence[20]. A registrant must be one of:

1. a Canadian citizen;

2. a permanent resident (i.e. immigrant)

3. an executor, administrator or other legal representative of an individual listed in 1 or 2 above.

4. a corporation incorporated under the laws of Canada.

5. a trust established under Canadian law, of which more than 2/3 of whose trustees meet one of the requirements in items 1-4 above.

6. a partnership registered under Canadian law of which more than 2/3 of the partners meet the requirements of items 1-5 above.

7. an unincorporated association at least 80% of whose members meet one of the requirements in 1-6 above and 80% of whose directors, officers, employees, managers, administrators or other representatives are ordinarily resident in Canada.

8. a trade union recognized by a Canadian labour board and which has its head office in Canada.

9. a political party registered under a Canadian electoral law.

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[18] See ICANN and IANA, ICP-1 Internet Domain Name System Structure and Delegation (ccTLD) Administration and Delegation, May 1999, available online at http://www.icann.org/icp/icp-1.htm.

[19] The CIRA Domain Name Dispute Resolution Policy may be accessed online at www.cira.ca/en/cat_dpr_policy.html in English. It is also available in French.

[20] See CIRA Policies, Procedures and Guidelines: Canadian Presence Requirements For Registrants (RRPG 05-20001108-00006 Version 1.Z Effective Date: November 8, 2000) available online at www.cira.ca/official-doc/47.RPPG_00006EN.pdf.

10. a government recognized educational institution located in Canada.

11. a library, archive or museum that is non-profit and located in Canada.

12. a government licensed hospital located in Canada.

13. Her Majesty the Queen.

14. a government recognized Canadian Indian band.

15. any Inuit, First Nation or other people indigenous to Canada and their groups.

16. a Canadian governmental entity.

17. a person who meets none of the above requirements, but owns a Canadian trade-mark registration. In this case the .ca domain name must be the precise words of the trade-mark as registered.

18. a foreign public authority (i.e. government or international body) that has published their official mark in Canada. Again the registration is limited to the precise wording of the official mark.

As can be seen by a review of the criteria, the only option obviously appropriate for a foreign franchisor that does not have a Canadian subsidiary corporation is to have a registered Canadian trade-mark (#17). Currently because of a backlog in the Trade-marks section of the Canadian Intellectual Property Office it takes at least a year to obtain an uncontested trade-mark registration. Franchisors who have only applied for registration are not eligible to register their trade-mark as a .ca domain to protect their brand name from dilution or from cybersquatters. Their options are to base their registrations on one of the other requirements, such as the incorporation of a Canadian subsidiary or the formation of a Canadian trust.

### D. Copyrights and Patents

Franchisors generally do not rely on copyright and patent protection to the same extent as they rely on trade-mark protection, but they need to be advised of the basic issues.

Unlike trade-marks, copyrights originating in most other countries are protected in Canada as if they were Canadian through two international treaties.[21] Canadian copyright law does not require that copyrights be registered in order to be awarded damages. A certificate of registration is however *prima facie* evidence as to ownership. This shifts the burden of proving that the claim of copyright ownership is invalid to the defendant in a dispute. In franchise matters this can be an advantage. It is a burden that

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[21] *Berne Convention for the Protection of Literary and Artistic Works,* of September 9, 1886, as revised; and the *Universal Copyright Convention,* as revised at Paris on July 24, 1971.

not many franchisees and their lawyers are willing to assume. Accordingly registration of the copyright to the design of a logo used as a trade-mark, design items used in the layout and décor, and the operations manual should be considered. The registration of copyrights in Canada is relatively inexpensive.

Patents are like trade-marks in that their scope extends only to the country that they are registered in. Further unlike trade-marks they must generally be registered before they are made public, or within one year of being made public, depending on the country. Usually the patent agent who handles the first application for registration will advise the client on its options for filing in other countries. The *Patent Cooperation Treaty*[22] can be used to postpone some of the expense of filing immediately in multiple jurisdictions, but many clients still find such filings expensive and therefore do not file in many foreign jurisdictions.

The result is that a franchise system that is based on a patented process or product in, for example, the United States, may expand to countries where it does not have a patent protection, such as Canada. The question then arises as to the extent to which the success of the system in the U. S. relied upon the protection of the patent that is not available in the Canadian market. Generally the absence of patent protection in these situations in Canada needs to be disclosed.

### E. Trade Secrets

Canada has no legislation specifically governing trade secrets. This is the opposite of the United States where almost all of the states have adopted the provisions of the Uniform Trade Secrets Act. Canada has also not adopted the U.S. position recognizing trade secrets as items of property.[23] Canada's position, as best set out in the decision of the Supreme Court of Canada in *LAC Minerals Ltd. v. International Corona Resources Ltd.,*[24] is that trade secrets will be protected where the information disclosed has a "quality of confidence about it," where a duty of confidence is owed to the disclosing party, and where the recipient has misused the information.

Still confidential aspects of a franchise system may be protectable as trade secrets in Canada,[25] including recipes, formulations and processes. Items such as client lists, supplier lists and commissioned market studies are less likely to be protected, but are protectable if their confidentiality can be evidenced, such as by a confidentiality agreement or provision in a franchise agreement.

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[22] Washington, DC, June 19, 1970, as amended September 28, 1979, and modified on February 3, 1984 and October 3, 2001.
[23] Michael J. Lockerby, Ed., *The Trade Secret Handbook: Protecting Your Franchise System's Competitive Advantage* (Chicago: American Bar Association, Forum on Franchising, 2000) Chapter 5, "Trade Secret Protection in Canada," at p.100. This chapter was written by a Canadian lawyer, Nishan Swais.
[24] [1989] 61 D.L.R.(4th) 14.
[25] *840182 Ontario Inc. v. Dion,* [1993] R.J.Q. 2133 (Cour Supérieure du Québec.).

## 4. PRIVACY ISSUES

### A. Introduction

Knowledge about customer preferences and habits is very valuable information. The dramatic rise of e-commerce and the internet, and the increased use of computers have transformed concepts of customer goodwill, and the ability of the retailer to collect, store and analyze information about customer preferences and habits.

Previously the customer goodwill attached to a brand was often intangible, something that could only be estimated based on sales. Now, depending somewhat on the product, brand managers can more easily develop methods to build customer databases and focus their efforts on improving the relationship with targeted customers. Customers are not as anonymous as they once were, and out of this has arisen the "new" science of customer relationship management, and significant consumer concerns about privacy.

As of January 1, 2004 Canada's federal privacy legislation[26] came into effect for transactions entirely within a province, and many Canadian retailers have had to adjust their sales methods[27]. In addition privacy laws came into effect in British Columbia[28] and Alberta[29] on the same date. Québec has had a privacy law in effect since 1994[30].

Although the common law in the United States long ago developed the tort of invasion of privacy, the federal government in the United States has not yet moved to codify general principles for the protection of personal information. The United States is the centre of the global internet industry, and many internet companies are concerned about the effect that such laws might have on their ability to develop e-commerce and internet marketing. The U.S. Federal Trade Commission reversed itself in May of 2000[31] and recommended that Congress enact legislation to ensure the adequate protection of consumer privacy on-line, because voluntary codes were not seen to be working. Since then a deadlock has developed in Congress over the type of consent that should be required for the use of personal information for marketing purposes, and the degree of access to be afforded to consumers.

However in the United States the consent of the individual customer to the collection, use and disclosure of the customer's personal information for use in customer relationship management programs is still not required in most instances. The opposite is

[26] *Personal Information Protection and Electronic Documents Act*, S.C. 2000, c. 5, as amended.
[27] It should be noted that PIPEDA came into effect for the interprovincial and international collection, use or disclosure of personal information on January 1, 2001. The reasons for the staggered implementation will be discussed later in this chapter. Since January 1, 2004 there has been a much greater awareness of privacy issues among both businesses and consumers.
[28] *Personal Information Protection Act,* S.B.C. 2003, C. 63 as amended.
[29] *Personal Information Protection Act,* S.A. 2003, C. p-6.5.
[30] *Loi sur la Protection des renseignements personnels dans le secteur privé,* L.R.Q., c. P-39.1, as amended.
[31] See Federal Trade Commission, *Privacy Online: Fair Information Practices in the Electronic Marketplace – A Report to Congress* (Washington, DC, Federal Trade Commission, May 22, 2000).

now true in Canada, Europe, Australia and many other countries. Foreign franchisors from most other jurisdictions will find Canada's privacy laws easy to adapt to. American franchisors may be dealing with substantial privacy issues for the first time.

### B. Franchising Issues

A franchise system is not a single entity in the eyes of the law. Rather it consists of a number of legal entities, bound together by contracts that require that all of these individual entities to act in a somewhat coordinated way when selling a product or service under a single trade-mark or brand owned by the franchisor. In other areas the franchisees retain varying degrees of autonomy. The application of privacy laws to the franchise structure results in two significant problems that do not arise for other retailers.

It is the franchisees in a system that have the day-to-day customer contact and thus accumulate knowledge about customer preferences and habits. Franchisors have traditionally dealt with this problem by, among other things, putting provisions in the franchise agreements that the franchisor owns the customer list, or at least requiring transfer of the list or other customer information to the franchisor. Now in Canada and Europe, notwithstanding such provisions, such information cannot be transferred without customer consent. Franchisees and dealers have used privacy laws to resist demands for such transfers.[32]

The second significant problem for franchisors first considering the effect of privacy laws on their systems will be whether privacy compliance standards will be set system wide and perhaps vigorously enforced by the franchisor, or whether franchisees will simply be required to comply with all relevant laws, and otherwise left to their own devices.

There are a variety of factors that will need to be taken into account in making this decision, including:

1. The nature of the product and/or services;

2. The way marketing is currently being carried out;

3. The way marketing will need to be carried out in the future if use of the internet continues to grow;

4. Who owns the customer lists;

5. And the risks of non-compliance.

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[32] Connie Gugliemo, "Ransom: Customer Data" *ZDNet.com* , October 8, 2000. When Motorola required its independent dealers in the U.S. to enter into a new form of agreement requiring them to collect and transfer to Motorola "valid end-user customer information" the dealers resisted citing privacy concerns.

There may also be employment issues and issues regarding the cross-border application of privacy laws.

A fundamental problem for franchise systems is that such systems are designed to present a common identification to the public and their customers, but to retain the advantages of individual entrepreneurship and effort by being made up of separate legal entities. The common identity is maintained by the use by the franchisees of only the trade-marks specified by the franchisors. Each franchise agreement is thus also a trade-mark license agreement.

Trade-marks are considered to indicate the source of the goods or services, and to assist the public and customers by reducing search costs when they are seeking goods or services of a particular type or quality. Accordingly the Canadian *Trade-marks Act* requires that such trade-mark licenses contain certain provisions to ensure that benefits to the public are not lost. Specifically the owner of the trade-mark, or franchisor, must maintain "….direct or indirect control of the character or quality of the wares or services…."[33] failing which the trade-mark will be held to be non-distinctive. Courts have added the requirement that not only must the license agreement contain clauses allowing the owner to exercise such control, but the owner must in fact exercise the control, by, for example, conducting audits of the goods or services and the associated use of the mark[34].

For a franchisor considering how to comply with privacy laws, one of the first steps will be to consider to what extent customers and/or the public see privacy compliance as part of the franchisor's goods and/or services, and therefore to consider the extent to which a common privacy compliance standard is expected for goods and services bearing the franchisor's trade-mark. The franchisor can then go on to consider other issues, such as the best way to market the goods and/or services through the system, and how that is affected by privacy compliance.

Franchisors will have to examine their compliance options in light of the balance struck between the benefits achieved through uniform marketing on the one hand, and both the costs of system wide implementation and maintenance, and the risk to the franchisor of liability for franchisee conduct on the other.

### C. Basic Privacy Principles

Around the world different jurisdictions have developed different ways of describing or expressing the basic principles of their privacy legislation, but they all have similar elements. These elements may be described as follows:

a. Individuals must be given notice of the proposed collection, including use and disclosure, and the specific purposes.

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[33] *Trade-marks Act*, R.S.C. 1985, c.T-13 as amended, Section 50(1).
[34] See for example *Unitel Communications Inc. v. Bell Canada* (1995), 61 C.P.R. (3d) 12 (FC-TD).

b. In order for the data to be collected, used or disclosed, appropriate consent must be obtained with respect to the specified purposes.

c. The data collected must be protected by appropriate security.

d. The individual must have access to the data collected, and to details of its use and disclosure.[35]

Variations exist in the method of ensuring compliance. In the European Union registration is required in order to maintain databases of personal information and the registrar may take an activist role in ensuring compliance with the privacy principles. In other jurisdictions the primary responsibility for ensuring compliance rests with individuals through use of the courts or an administrative tribunal.

Privacy legislation is based on what might be called a "contract" model. As with contracts problems have developed with the nature of the consumer's understanding of the contract that is being proposed, the meaning of some of the terms, and the balancing of interests or fairness of the contract or consent. In traditional contract law these are often referred to as problems of "unconscionability" or "good faith". Thus significant variations are developing between jurisdictions with respect to the limitations or restrictions that they impose on privacy contracts. For example, a number of European jurisdictions prescribe various types of personal information that must be considered sensitive, and either require more explicit consent, or prohibit collection of such personal information altogether.

The United States Federal Trade Commission, as noted above, has set out its privacy principles most succinctly as "Notice, Choice, Access and Security". In the United Kingdom the provisions of the E.U. Data Directive were summarized in eight data protection principles.[36] Canada has chosen to use ten privacy principles, adopted from the Canadian Standards Association ("CSA") Model Code[37], a voluntary code that had been developed by the private sector. The ten principles are:

1. Accountability
2. Identifying Purposes
3. Consent
4. Limiting Collection
5. Limiting Use, Disclosure and Retention

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[35] For an alternative discussion of the basics of fair information practices see Anne Cavoukian and Tyler J. Hamilton, *The Privacy Payoff: How Successfully Businesses Build Customer Trust* (Toronto: McGraw-Hill Ryerson, 2002) at pp 44-45.

[36] See Schedule 1 of the *Data Protection Act 1998* (Chapter 29, London: The Stationery Office Ltd.) The eight principles are:) 1) personal data shall be processed fairly and lawfully; 2) personal data shall be obtained for lawful and specified purposes; 3) personal data shall be adequate, relevant and not excessive to the purposes; 4) personal data shall be relevant and kept up to date; 5) personal data shall not be retained for longer than is necessary; 6) personal data is to be processed in accordance with the rights in the legislation; 7) security measures shall be implemented; 8) personal data shall not be transferred outside the E.U. unless adequate protection is afforded.

[37] The Code is now Schedule 1 of PIPEDA – "Principles Set Out in the National Standard of Canada Entitled Mode Code for the Protection of Personal Information, CAN/CSA-Q-830-96".

6. Accuracy
7. Safeguards
8. Openness
9. Individual Access
10. Challenging Compliance

A fuller discussion of Canada's privacy laws and principles can be found elsewhere and will not be undertaken here.[38]

Privacy laws have little effect on franchisors *per se*. Their primary effect on franchisors and the franchise systems arises out of their effect on marketing and customer relationship issues. Prior to the passage of privacy laws customer information could be collected, used and exchanged between franchisees and franchisors almost without restriction. Now all such activities in Canada must have the consent, either explicit or implied, of the individual customers. The nature of the form of consent used must take into account the "sensitivity" of the personal information, and thus certain sectors, such as child care and financial services, will be affected much differently than vendors of hamburgers and pizza.

The franchisee application forms of all franchisors will have to be revised to take into account Canada's new privacy laws, and in particular the notice provisions of Section 4.8.2 of the Schedule to PIPEDA[39]. Franchise systems that require stores with video or other surveillance may unintentionally find themselves involved in significant privacy disputes between their customers. And consent can only be obtained for identified purposes. Some retail sectors are having difficulty training staff to effectively communicate the purposes for the collection and use of personal information.

Manufacturers and franchisors may no longer simply require by contract that their dealers and franchisees turn over customer information in order to build a customer database and ensure ownership of the customer list. Now the franchisee must obtain the consent of the customer not only to collect and use the information, but also obtain consent for any required disclosure to the franchisor, and consent for the franchisor's proposed uses of the information. While consent to the collection and use of such information in a store may often be implied from the actions of the customers, the same cannot always be said for the disclosure to the franchisor. Further customers cannot be required to provide personal information beyond that ".....required to fulfill the explicitly specified, and legitimate purposes…." of a transaction.[40]

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[38] In addition to the general texts on privacy law see Paul Jones, "Chapter 5, Privacy Laws in Canada: Their Implications for Franchising and Marketing" in Peter Snell and Larry Weinberg, eds., *Fundamentals of Franchising - Canada* (Chicago: American Bar Association Forum on Franchising, 2004).

[39] In a personal communication the Privacy Commissioner of Canada verbally advised the writer that she would not hesitate to investigate a complaint from a prospective franchisee whose personal information was collected by an American franchisor with no other operations in Canada, notwithstanding the jurisdictional questions.

[40] Paragraph 4.3.3 of Schedule 1 to PIPEDA.

Insofar as the marketing programs are administered centrally by the franchisor, they will be affected by the new consent requirement. Examples include marketing surveys, warranty programs, direct mailings, contests and games, data mining, and customer support.

The most significant variables to consider when obtaining consent under privacy laws are the sensitivity of the information, the purposes for which it will be used, and the security under which it will be held. The concept of "sensitive information" is important for determining the appropriate form of consent to be obtained, and the nature of the security to be used to protect personal information. Obtaining the appropriate form of consent, either explicit or implicit, is the key to compliance with PIPEDA.

What is considered "sensitive information" may vary from country to country. Some areas that are considered sensitive by many in North America are not considered sensitive in Europe. The most prominent example is financial information. In contrast to Europe, in the United States the financial services sector was one of the first areas to be the subject of a sector specific law.

Other concerns may arise only if the information is transferred out of the jurisdiction. In British Columbia a union was concerned about outsourcing and obtained an opinion from a lawyer with the American Civil Liberties Union regarding the implications of the *Patriot Act* [41] on information outsourced to a U.S. business for processing. The primary concern was that such information could accessed by the U.S. government without the consent or knowledge of the individuals involved. The Office of the Information and Privacy Commissioner for British Columbia released its report in October of 2004[42] and expressed concern that disclosure of personal information in response to an order under such legislation would constitute "unauthorized disclosure" against which reasonable security precautions must be taken. Since then both the Office of the Privacy Commissioner for Canada and the Office of the Information and Privacy Commissioner for Alberta have announced that similar reviews would be undertaken. Some Canadian banks that have their credit card transactions processed by a supplier in the United States have amended their cardholder agreements to notify cardholders of the transfer of their personal information out of Canada and the risk of its seizure by the U.S. government.

Foreign franchisors in areas such as personal health, education, financial services, child care and senior care may find that Canada's new privacy laws will have significant impact on their methods of customer relationship management.

Privacy laws are not designed to affect franchise systems in particular. Rather they will primarily affect how franchisors design the marketing and employee aspects of their systems. In these areas retailers and franchisors alike are still discovering the full

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[41] *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001*, Public Law 107-56.

[42] Office of the Information and Privacy Commissioner for British Columbia, *Privacy and the USA Patriot Act: Implications for British Columbia Private Sector Outsourcing,* (Victoria, B.C.: October, 2004).

implications of both Canada's new privacy laws, and the implications of having Canadian customers who are slowly and vaguely becoming aware of their new privacy rights.

To ensure continuing compliance, franchisors will have to monitor developments and emerging issues in this area on a regular basis and be prepared to modify their policies as changes occur.

## 5. TAX ISSUES

### A. Introduction

Once a foreign franchisor has decided upon the most appropriate entry vehicle for expansion into Canada and has taken into account the other business and legal considerations referred to above, it will need to consider the most suitable legal structure which it should utilize from a marketing, liability and tax point of view as well. From strictly a marketing perspective, there may be an advantage in having the foreign franchisor incorporate a Canadian subsidiary. This is because prospective Canadian franchisees may feel more assured of the foreign franchisor's commitment to maintaining a permanent presence in Canada and will not likely fear that the franchisor's interest is a short and fleeting one.

To incorporate a subsidiary in Canada (either a federal company or a provincial one) may also better insulate the foreign franchisor from any liability associated with the granting of franchises (or other area representative or development rights) to the Canadian entity and the franchise system in general as it operates in Canada. Conversely, if the foreign franchisor simply grants franchises or other rights to franchisees in Canada directly without utilizing a Canadian subsidiary, it will be more exposed to potential lawsuits commenced by any aggrieved Canadian franchisees. This is not to suggest that the franchisee plaintiff will not attempt to add the foreign franchisor as a party to any such action even where a Canadian subsidiary exists so as to pursue the deeper pockets of the foreign franchisor. Rather, a wholly-owned subsidiary for example will better serve as a buffer, providing the foreign franchisor with a valid argument that it should not be added as a defendant in any action involving a Canadian franchisee.

At times, the marketing, tax and liability considerations may converge and the foreign franchisor will conclude that for these reasons, it should adopt a particular entry structure. Other times however, these considerations intersect in a manner which will force the foreign franchisor to prefer one consideration over the others. For example, the foreign franchisor may conclude that it is beneficial to choose a legal structure on the basis of tax reasons alone, and will disregard any other factors when making its determination in this regard.

As is often the case, the foreign franchisor is based in the United States, so for the purposes of the balance of this Chapter of the paper we will assume that we are dealing with a U.S. franchisor. While much of the following analysis may be employed in respect of franchisors situated in any foreign jurisdiction, there are certainly factors that are unique to the U.S., as there are peculiarities for every foreign jurisdiction, which may cause the U.S. franchisor to arrive at a different conclusion when determining the most tax advantageous entry structure. A U.S. franchisor is cautioned to treat its own circumstances differently and should therefore seek legal and accounting advice that is tailored to its fact situation.

Under the Canadian Income Tax Act ("**Tax Act**"), a U.S. franchisor could be taxed in Canada if it is "carrying on business" in this country. The definition of "carrying on business" is such that even a very minimal degree of business activity relating to Canada may result in tax exposure. Under the tax treaty between Canada and the United States ("**Treaty**"), however, a U.S. entity will not be taxed for carrying on business in Canada unless such business is being operated through a *permanent establishment*.[43] The Treaty, therefore, effectively raises the threshold level of business activity necessary to attract Canadian tax. A key question for tax purposes, therefore, is whether the U.S. franchisor's business in Canada creates a permanent establishment.[44] A permanent establishment will generally be considered to exist if there is a fixed place of business in Canada through which the business of the U.S. franchisor is carried on. A permanent establishment will also be deemed to exist if the U.S. franchisor has an agent that acts on its behalf in Canada, other than an agent of independent status acting in the ordinary course of its business, and that agent has and habitually exercises an authority to conclude contracts in the name of the U.S. franchisor.

Therefore, while a U.S. franchisor selling franchises to Canadian franchisees may be seen as "carrying on business" in Canada, it will not amount to a "branch" in the absence of a fixed location or an active agent acting on behalf of the U.S. franchisor in Canada. A permanent establishment, while technically defined in Article V(2) of the Treaty to include a branch, may be broader for tax purposes (i.e., a permanent establishment includes, for example, a place of management, office, factory or workshop). Cross-border payments made to the U.S. franchisor, therefore, will be characterized and treated for tax purposes in the manner described below as "Specific Transactions".

**B. Business Structures**

There are, in essence, four principal choices of business structures that a U.S. franchisor may wish to consider when expanding into Canada:

(a) Indirectly carrying on business in Canada through a Canadian subsidiary of the franchisor which subsidiary is legally distinct from the franchisor ("**Subsidiary**");

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[43] To qualify for treaty benefits the U.S. franchisor must be a "resident" of the U.S. for the purposes of the Treaty. The Canada Revenue Agency has taken the position, for example, that a U.S. LLC would not generally so qualify, as it is not liable to tax for purposes of Article IV of the Treaty.

[44] Vern Krishna put it best when he stated that "the theory underlying the idea of permanent establishment is to distinguish between trading <u>in</u> a country and trading <u>with</u> a country.´ [Vern Krishna, *Canadian International Taxation*, Carswell Legal Publishers, Toronto - 1995]

(b) Indirectly carrying on business in Canada through a Nova Scotia or Alberta unlimited liability corporation ("**ULC**");

(c) Directly carrying on business in Canada through a branch operation that is a division of the franchisor ("**Branch**"); and

(d) Without carrying on business in Canada through a branch or a subsidiary, but directly entering into periodic business transactions (e.g., granting franchises) in Canada. This would include the receipt of royalties and other payments from its franchisees in Canada ("**Specific Transactions**").

(a) Subsidiary

Under the Tax Act, a Subsidiary is subject to taxation if it has taxable income pursuant to Part I of the Tax Act. The basis for such taxation is the residency of the Subsidiary in Canada. The U.S. franchisor parent may be subject to withholding taxes under Part XIII of the Tax Act with respect to payments from the Subsidiary. The basis for this taxation is payment by a resident of Canada to a non-resident. Interest, dividends, rents and royalties from Canadian sources are payments that are commonly subject to Part XIII tax. The Canadian Subsidiary who makes a payment to the U.S. franchisor parent is responsible for collecting and remitting the withholding tax, failing which, the resident Subsidiary becomes personally responsible for the amount not so withheld. The withholding tax is on gross payments without any deduction for expenses. The rate of this tax is 25%, however, the Treaty reduces the rate from between 10% to 25%, depending upon the type of payment being made to the U.S. franchisor. Dividends to the U.S. franchisor parent are taxed at 5% (assuming the parent holds 10% or more of the shares of the subsidiary) while interest payments are taxed at 10%.

A U.S. franchisor parent generally invests in the Subsidiary by way of share capital or loan. Return on investment, therefore, in the form of either dividends or interest, is subject to withholding tax.

The Treaty provides an exemption for withholding tax on management or administration fees paid by a Subsidiary to a U.S. franchisor parent for managerial services rendered on behalf of the Subsidiary. Managerial services include the functions of planning, direction, control and coordination. As noted above, the Treaty exempts "business profits" earned in Canada by the U.S. franchisor parent from tax for so long as the profits are not earned through a "permanent establishment" in Canada of the U.S. franchisor parent. Management fees are protected from withholding tax because the Subsidiary is by its very nature not generally considered to be a permanent establishment and management fees are considered to be business profits. Both the expense and profit elements of a management fee are shielded by the exemption. To be exempt, any payment on account of management fees must be for legitimate managerial services actually rendered, must be reasonable under the circumstances, and should be evidenced in writing at the time of the transactions to substantiate the basis of the payment.

(b) Unlimited Liability Corporations

Generally speaking, a Nova Scotia or Alberta unlimited liability corporation is treated as though it is a corporation for Canadian tax purposes, but may be characterized as a partnership or disregarded entity for U.S. tax purposes.[45] The flexibility of this hybrid entity provides U.S. franchisors with certain benefits which should be considered when deciding upon the appropriate entry vehicle for expansion into Canada. Please see the chart below for some of the advantages and disadvantages of utilizing an ULC.

(c) Branch

As noted above, a Subsidiary of a U.S. franchisor is subject to tax under Part I of the Tax Act. A U.S. franchisor operating directly in Canada through a Branch, as opposed to indirectly through Subsidiary, is also subject to this Part I tax. The basis for taxation of the U.S. franchisor parent is the fact that the U.S. franchisor is carrying on business in Canada through the Branch operation. The Part I tax therefore arises in both the case of a Subsidiary and a Branch. In the former case, the Subsidiary is taxed; in the latter case the U.S. franchisor is taxed.

In addition to the tax under Part I of the Tax Act, the U.S. franchisor parent operating through a Branch is also subject to a branch tax under Part XIV of the Tax Act. The general purpose of the branch tax is to equalize the Canadian tax position on business in Canada through a branch operation with that of a non-resident who does so through a Canadian subsidiary. Although Part I tax on the Canadian operations of the U.S. franchisor parent will be identical whether such operations are structured in the form of a Branch or a Subsidiary, there would be a differential in the amount of withholding tax paid in the absence of a branch tax.

Branch tax and Part I tax are imposed upon taxable income earned in Canada by the Branch. Under the Tax Act, the branch tax is 25% of taxable income, but the Treaty reduces the branch tax to 5%[46] and creates a cumulative exemption with respect to the first $500,000.00 of earnings in Canada. In addition to this exemption, there is an obvious advantage to commencing business in Canada by way of a Branch so as to facilitate deduction of Canadian losses against U.S. income with respect to initial start-up losses. For this reason, projected earnings in Canada and U.S. income levels are important facts to consider when examining whether to expand into Canada by way of a Branch or a Subsidiary.[47]

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[45] Under the U.S. Internal Revenue Code, it is possible to check-the-box to treat the ULC as a corporation, but the default classification is as a flow-through.

[46] See Article X(6) of the Treaty.

[47] Use of losses is also important here. In addition, it is often possible to subsequently incorporate a branch on a tax-deferred basis.

(d) Specific Transactions
If neither a Subsidiary nor a Branch exists in Canada, then withholding tax applies to the corporation in specific transactions, depending upon the nature of the transaction and the payment. Withholding tax is reduced from 25% to 10% under the Treaty on most royalties in the franchising context. Payments by Canadian franchisees to a U.S. franchisor for product purchased by such franchisees generally do not attract withholding tax.

For ease of reference, certain features of each of the 3 principal business structures along with their advantages and disadvantages are outlined in the charts directly below:

**C. Subsidiary Chart**

| Features | Advantages | Disadvantages |
| --- | --- | --- |
| ✓ Separate incorporated entity from foreign franchisor<br><br>✓ Extra-provincial registration required in each province in which the foreign franchisor conducts business | ✓ Insulates foreign parent from liability<br><br>✓ No withholding taxes payable unless monies repatriated to foreign jurisdiction<br><br>✓ Separate financial statements need to be disclosed in the Disclosure Document but the Parent's financials need not be disclosed<br><br>✓ Cleaner demarcation of business activities, profits and losses of each of the U.S. franchisor parent and Canadian Subsidiary companies | ✓ Withholding taxes will be payable upon repatriation of funds to the U.S. Note, however, that invested capital can generally be returned free of Canadian withholding tax<br><br>✓ Investment Canada Notification or Review may be required<br><br>✓ Cost of incorporation and annual maintenance fees (including the cost of preparing separate financial statements)<br><br>✓ U.S. franchisor cannot utilize any start-ups losses incurred by the Canadian Subsidiary |

| Features | Advantages | Disadvantages |
|---|---|---|
| | ✓ Preferable from a marketing point of view as it demonstrates U.S. franchisor's commitment to Canada | ✓ Thin capitalization rules will apply and negatively impact subsidiaries with a high debt-to-equity ratio (i.e., any interest deductions may be disallowed) |

**D. Nova Scotia or Alberta ULC Chart**

| Features | Advantages | Disadvantages |
|---|---|---|
| ✓ This hybrid vehicle may be treated as a partnership or disregarded entity in the U.S. (flow through entity) and as a corporation in Canada<br><br>✓ Extra-provincial registration required in each province in which the foreign franchisor conducts business | ✓ Treated as a corporation in Canada for tax purposes (with the associated benefits of limited liability in Canada) and as a partnership for U.S. tax purposes<br><br>✓ U.S. franchisor could utilize any losses on start-up<br><br>✓ No need for Canadian residents on the board of directors of a ULC, nor are meetings required to be held in the incorporating jurisdictions | ✓ Requires a U.S. "C Corporation", LLP or LP to hold shares of ULC to insulate U.S. parent from liability of ULC<br><br>✓ Incorporation fees and annual fees are relatively expensive (but much less so in Alberta though) |

### E. Branch Chart

| Features | Advantages | Disadvantages |
|---|---|---|
| ✓ Subject to Parts I (Income) and XIV (Branch) tax<br><br>✓ Extra-provincial registration required in each province in which the foreign franchisor conducts business | ✓ Easy to establish<br><br>✓ Branch tax exemptions for the first $500,000 Cdn of branch profits under Tax Treaty<br><br>✓ Test market, before spending $ on incorporating a subsidiary<br><br>✓ Thin capitalization rules do not apply<br><br>✓ Gains and losses may be utilized by foreign franchisor<br><br>✓ Advertise franchise<br><br>✓ Tight controls over Canadian expansion; recruitment; training and management fees. | ✓ Withholding taxes payable<br><br>✓ Difficult to allocate income and expenses as between U.S. franchisor and its branch<br><br>✓ Branch required to file tax returns re its Canadian income |

## 6. DISCLOSURE ISSUES

### A. Introduction

There are now four provinces in Canada where disclosure issues must be considered when selling franchises. Alberta[48] and Ontario[49] have franchise disclosure legislation and regulations in place. Prince Edward Island has adopted franchise

[48] *Franchises Act,* S.A. 1995, c. F-17.1 (the “Alberta Act”), and Alberta Regulations 240/95, Franchises Regulation, and 312/2000 Franchises Act Exemption Regulation (the “Alberta Regulations”).
[49] *Arthur Wishart Act (Franchise Disclosure), 2000,* S.O. 2000, c. 3 (the “Ontario Act”), and Ontario Regulation 581/00 as amended (the Ontario Regulations”).

disclosure legislation but not yet proclaimed it[50] pending the drafting and adoption of the regulations.

In Québec Articles 6, 7 and 1375 of the Code civil require that both parties to a contract act in good faith towards each other, including during the pre-contractual negotiations. This was affirmed by the Cour d'appel in the Provigo case discussed earlier with respect to the definition of a "franchise" in Québec.

A duty of good faith in pre-contractual negotiations is the opposite of the English common law maxim of caveat emptor. Counsel in Québec are now of the opinion that this duty imposes an obligation on each party to a contract to disclose to the other party any information that may be considered material to the contemplated transaction,[51] and there are now some franchise cases in this area.[52]

Aside from these provisions of the Code civil, there are no further guidelines or specifications as to the contents of the required disclosure. Perhaps as a consequence, franchisors selling franchises in Québec have only lately begun to realize their obligations, and a trend towards disclosure is slowly developing. If a UFOC or disclosure document from another jurisdiction is used to fulfil such disclosure requirements, it is clear that such document must be translated into French. L'Charte de la langue française[53] requires that brochures and commercial advertising must be in French.

There is also a private member's bill that has received second reading in New Brunswick[54] and it is anticipated that other provinces in western Canada may soon introduce similar legislation.

While the Alberta and Ontario statutes drew upon the experience of the United States with franchise disclosure when drafting their laws, and consultations were held with the Federal Trade Commission, the authors of the FTC Franchise Rule,[55] and the North American Securities Administrators Association ("NASAA"), the authors of the

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[50]Bill 43, entitled the *Franchises Act* was introduced on May 12, 2005 and received Royal Assent on June 7, 2005. Proclamation is pending while the regulations are being drafted.

[51] See Bruno Floriani and Anne-Marie Gauthier, "Franchising and the Civil Code of Québec" (1995), 15(2) *Franchise L.J*. 51.

[52] See Cadieux c. St-A. Photo Corporation, Cour supérieure 500-05-006829-947 (le 9 avril 1997) and Investissements Stanislas et Patricia Bricka inc. c. Groupe CDREM inc.[2001] J.Q. no. 3346, Cour d'appel du Québec, District de Montréal, (le 23 juillet 2001) for the application of this principle in a franchise context. See also Bruno Floriani and Anne-Marie Gauthier, "Franchising and the Civil Code of Québec "(1995), 15(2) Franchise Law Journal 51.

[53] L.R.Q., c. C-11; see Sections 52 and 58.

[54] Bill 81, entitled the *Franchise Act,* was introduced on June 28, 2005 and received second reading the next day.

[55] "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," in effect October 21, 1979, 16 C.F.R. Part 436.

Uniform Franchise Offering Circular ("UFOC") Guidelines,[56] the Canadian statutes differ in some fundamental ways from the disclosure requirements in the United States.

Section 5(4)(a) of Ontario's law requires the disclosure of "all material facts, including the material facts as prescribed." Alberta has a similar requirement in its Regulations.[57] To some this differs from the American rules which only require disclosure of the items specified in the regulations, or in the UFOC Guidelines, and do not specifically require the disclosure of all material facts.

Accordingly when reviewing an American disclosure document for compliance with Canadian disclosure document requirements enquiries should be made as to other facts regarding the franchisor or the franchise system that may be considered material by prospective Canadian franchisees. The reviewer should also be sufficiently familiar with the American disclosure requirements to know where the American requirements are broader or narrower than the Canadian requirements.

Set out below is a comparative discussion of the Ontario, Alberta and some American requirements to assist in the review of American disclosure documents.

### B. Standard for Disclosure – The Definition of a "Material Fact"

The concept of a "material fact" is defined in Section 1(1) of the Ontario Act as follows:

"material fact" includes any information about the business, operations, capital or control of the franchisor or franchisor's associate, or about the franchise system, that would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the decision to acquire the franchise; (emphasis added)

This is, word-for-word, the same definition that is in Section 1(1)(o) of the Alberta Act. However, the FTC Rule has the following definition:

> The terms "material", "material facts", and "material change" shall include any fact, circumstance or set of conditions which has a reasonable likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or which has any significant financial impact on a franchisee or prospective franchisee." Section 436.2(n). (emphasis added)

It should be noted that the Ontario, Alberta and FTC definitions are stated in an inclusive manner. It is thus possible that other facts may be material even if they do not

[56] Published By NASAA and available on line at:
http://www.nasaa.org/Industry___Regulatory_Resources/Uniform_Forms/735.cfm

[57] Alberta Regulation 240/95 , section 2(1).

precisely fit the definition. Further, the information need only have a significant effect, as opposed to a "material" effect, which would set a higher threshold.

The use in the Ontario and Alberta definitions of the definite article "the" in front of terms such as "value or price", "franchise" or "decision" contrasts with the use in the FTC Rule of the indefinite article "a" in similar circumstances. The FTC Rule further specifies that the fact in question must have a "reasonable" likelihood of influencing a "reasonable" franchisee or prospective franchisee in order to be material. In contrast, Ontario and Alberta only use the word "reasonably" with respect to information and not with respect to the understanding of the franchisee. This, together with a contrasted use of the definite articles, suggest that the drafters of the legislation in Canada may have intended that the test of materiality be applied individually to the sale of each particular franchise location. If this is true, it is a significant departure from the standard for disclosure used in the United States generally. Unfortunately, there is no way to determine the correct interpretation until a court interprets this section.

In Ontario and Alberta "material facts" would still be information that would reasonably be expected to have a significant effect either upon the value or price of the franchise, or on the decision to acquire the franchise. However, the "material facts" need to have that effect only upon the particular location that is being offered to a specific franchisee. They need not be of general applicability to the system.

In contrast, in the FTC Rule it can be argued that the focus of the definition is on the average reasonable franchisee and that the definition is not so location specific. This distinction has not been considered by the courts in Alberta or Ontario as yet. A prudent franchisor may wish to consider what is the appropriate disclosure for each individual franchise location that it sells to each individual franchisee, particularly, if the franchisor has chosen the location. For example, if the franchisor was aware through its internal operations staff that a competitor had made inquiries about opening a store on the corner opposite the location that was being sold, would that qualify as a "material fact" under the Act? Prudent franchisors may wish to consider developing site specific disclosure checklists and an addendum to the disclosure document for the sale of each particular franchise location.

### C. What is "Material"?

One possible source of guidance in the interpretation of the concept of "material facts" in the Ontario and Alberta Acts are the interpretations of the word "material" as used in the misleading advertising provisions in Section 52(1) of Canada's Competition Act. This provision is in the criminal section of the Competition Act and, accordingly, has been given a relatively strict definition. Whether or not a misrepresentation is "material" under the Competition Act depends on the degree to which the purchaser is affected by the words in deciding to make the purchase. As examples of this interpretation, there are several cases that may be reviewed.[58]

These decisions use the objective test of a "reasonable" person in determining what is "material". The case law under the Competition Act further suggests that advertisements will be found to be misleading only to the extent that they contain statements of fact as opposed to opinion. It is possible that promises of future action are not actionable under the Competition Act, although they may be actionable at common law as misrepresentations.

Another essential element of the test of materiality is the degree to which the fact is used in making the decision to purchase or in determining the value of the franchise. Obviously a number of items will determine the value of a franchised business or be considered in deciding to buy a franchise. Items such as its location with respect to its competitors, the quality of the product development offered by the franchisor, and the training and support offered by the franchisor, can all have an effect on the revenue produced from the franchised business. If an error is made to only one of these items, can it be said to have affected the purchaser in deciding to make the purchase?

It appears that this question has been answered with respect to the common law tort of negligent misrepresentation in the case of Kripps v. Touche Ross (1997), 89 B.C.A.C. 288 (C.A.) (leave to appeal to the Supreme Court denied, November 6th, 1997). In this case, the auditor of a failed mortgage investment company was sued with respect to financial statements that were relied upon by the investors. Despite the fact that the auditor had complied with GAAP, the statements were considered misleading because they did not disclose inter alia that one third of the company's mortgage folio had not paid interest in over 90 days. At the time there was considerable discussion about revising the GAAP guidelines in this respect. One of the defences raised was that the plaintiffs in purchasing the investment had not been affected by the auditor's financial statements, but had made the decision because of the extremely high interest rates offered by the mortgage investment company.

The British Columbia Court of Appeal dismissed this defence saying that it was sufficient for the plaintiff in an action for negligent misrepresentation to prove only that the misrepresentation was at least one of the factors that induced the plaintiff to act to his/her detriment.

Section 7(2) of the Ontario Act and 9(2) of the Alberta Act now partially override the standard set out in Kripps. They provide that if a disclosure document or statement of material change contains a misrepresentation, a franchisee who acquired the franchise based on such disclosure document shall be deemed to have relied on the misrepresentation. This provision performs two functions. Firstly, it relieves the franchisee of the necessity of proving, as was necessary in Kripps, that the

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[58] They are: *R.* v. *Kelly's on Seymour Ltd.* (1969), 60 C.P.R. 24 at 26; *R.* v. *T. Eaton Co. Ltd.* (1973), 10 C.P.R. (2d) 36; *R.* v. *Irving Oil Ltd.* (1978), 47 C.P.R. (2d) 179; *R.* v. *Canadian Tire Corp.* (1986), 14 C.P.R. (3d) 272 at 381; and *R.* v. *Simpsons Ltd.* (1988), 25 C.P.R. (3d) 37 at 38.

misrepresentation was at least one of the factors that induced the plaintiff to act to his/her detriment. However, this provision does not help franchisors in determining what factors are "material facts" that must be included in the disclosure document in the first place. In that regard cases such as Kripps are still relevant.

**D. How to Determine "Materiality"?**

Obviously, a number of items will be considered in deciding to buy a franchise. Items such as its location with respect to its competitors, the quality of the product development offered by the franchisor, and the training and support offered by the franchisor, can all have an effect on the revenue produced from the franchised business. If an error is made to only one of these items, can it be said to have affected the purchaser in deciding to make the purchase? The answer generally is that the items must be at least one of the factors that induced the buyer to act.

What is a "material fact" will vary from sector to sector of the economy and according to the structure of the franchise system. Franchisors, as business people, will obviously be aware of what influences people to purchase their franchises and what makes their product competitive in the market place. It would be very prudent for franchisors to involve sales staff in discussions with respect to these matters. They are the people who know what items interest or turn off a prospective franchisee.

In these meetings sales staff may object to the inclusion of some item in the disclosure document. The question will then be asked to whether it is "material" and therefore required to be disclosed. Unfortunately, the answer is usually obvious from the objections of the sales staff. Why do they not want it in the disclosure document? Usually because in their experience, they feel it will inhibit sales. If it will inhibit sales, then it affects the decision to purchase a franchise. This question is a very good illustration of the definition of "materiality" in the Alberta Act.

**E. Typical Material Facts Not Included in the Regulations**

The concept of "material fact" is open ended, and there are some items that are not required by the regulations in either province, but which obviously may affect a decision to purchase a franchise. The inclusion of disclosure with respect to earnings claims, operating expenses, and patents and copyrights, all of which are not required by the regulations, are discussed separately below. Other factors that may obviously influence a decision to purchase are general market conditions, the market share or position held by the franchisor, and the nature of the competition. These are traditionally part of the disclosure required for the issuance of securities to the public, and are to some extent included in the UFOC Guidelines under Item 1E. However, the descriptions given in many UFOCs of public companies for these items are usually not as extensive as the disclosures given in their Form 10K prepared for the SEC. It is difficult to see how under the Canadian requirements for the disclosure of all material facts the franchise disclosure can be significantly less than the securities disclosure for these items. Accordingly, for disclosure documents for Ontario, the disclosures made in the Form 10K's are often added to the UFOC.

Other items that are not required by the Canadian regulations or the UFOC Guidelines generally relate to issues arising out of cross-border franchising, such as currency fluctuations, import controls, or jurisdiction issues.

Franchisors will have to be clearly warned regarding the breadth of the Canadian disclosure requirements, and it may be necessary to conduct a materiality audit to prepare a Canadian disclosure document.

**F. Items Prescribed by the Regulations**

**1. Introduction**

A general debate initially developed amongst Ontario franchise counsel as to whether or not American franchisors can use an Ontario supplement or "wraparound" with their existing UFOC to fulfil the disclosure requirements in Ontario. There is no equivalent debate with respect to Alberta because of the provisions in the Alberta Regulations cited above that expressly allows such procedure. The Ontario Act and Regulations are silent in this regard.

While some lawyers have prepared wraparounds for use by American franchisees, many American franchisors find it so easy to prepare a new document specifically for Canada from the electronic versions of their UFOC that the question has now become moot.

There are still however debates as to scope and meaning of the requirement to disclose all material facts. Some franchise lawyers take the position that because the Section 6.3 of the Regulations states that "If an earnings projection for the franchise is provided, a statement specifying the reasonable basis for the projection" must be included in the disclosure document. They interpret this provision in the Regulations as limiting the scope of the provision in the statute, primarily because it uses the word "If" at the beginning, thus making the inclusion of an earnings projection optional.

Others take the position that the Regulations cannot materially limit the scope of the statute,[59] that historical sales figures are "material" and are "facts." While there is some concern about the quality of the sales information collected from franchisees, franchisees that pay a royalty as a percentage of sales are highly unlikely to inflate their actual sales figures, and it is inflation of the sales figures that would mislead a prospective purchaser.

Further an earnings projection is not otherwise defined in the Regulations and generally historical sales figures are not by themselves considered projections. In the

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[59] The Supreme Court has recently issued its decision in *Bristol-Myers Squibb v. Canada,* 2005 SCC 26 (May 19, 2004) in which the majority quoted a text on statutory interpretation to state that:

*"It is not enough to ascertain the meaning of a regulation when read in light of its own object and the facts surrounding its making; it is also necessary to read the words conferring the power in the whole context of the authorizing statute. The intent of the statute transcends and governs the intent of the regulation."*

While the quote had been around for a long time, it had not previously been given such high judicial approval.

event that they are considered closely similar, there are franchise systems where sales figures are truly not material to the purchaser, and are not collected by the franchisor. The imposition of the disclosure of historical sales figures on such franchise systems would be unjust. Accordingly the use of the word "If" in the Regulations can be explained without limiting the scope of the requirement to disclose all material facts.

### 2. Franchisor Information

The information required by the Ontario and Alberta regulations is generally similar to the requirements of the UFOC Guidelines in Item 1. There are no specific requirements for cover pages. All of these disclosure requirements generally require information as to the name and address of the franchisor, the name under which the franchisor engages in business, the business form of the franchise, the length of time the franchisor has conducted the type of business to be operated by the franchisee and the length of time that the franchisor has offered franchises for the same type of business, whether the franchisor has offered franchises in other lines of business, including a description of each line the number of franchises sold in the previous years and the length of time the franchisor has offered franchises in other lines.

As between Ontario and Alberta, there are some minor differences. Alberta requires the principal business address of the franchisor, and if the franchisor has an attorney for service in Alberta, the name and address of that person. It may be inferred from the statement that if the franchisor does not have an attorney for service in Alberta, it need not appoint one, unless it is carrying on business in Alberta.[60]

On the other hand, Ontario requires the disclosure of the name and address of the person authorized to accept service in Ontario on the franchisor's behalf. There is no option. It should also be noted that Ontario's Extra-Provincial Corporations Act[61] defines "carrying on business" in Section 1(2) and (3) in a way that does not require a foreign franchisor to obtain an extra-provincial licence, if it takes orders for goods, or offers or sells services of any type, only by use of "travellers" or through advertising or correspondence. In other words, if the franchisor does not have an employee resident in the province to service the franchisees, there appears to be no requirement for an extra-provincial licence. Some provincial officials dispute this interpretation. The disclosure requirements do, however, require that the franchisor appoint a person authorized to accept service in Ontario.

Ontario has a further requirement that where the franchisor is also a subsidiary, the name and principal address of the parent must also be disclosed.

Often there are usually no amendments required to a UFOC to fulfil these requirements. Unusual corporate structures or systems that have been acquired may give rise to additional disclosure items.

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[60] As defined in Section 264(1) of the *Business Corporations Act*, S.A. 1981, c. B-15. Note that the simple solicitation of business in Alberta is sufficient to require an extra-provincial corporation to obtain a licence in Alberta.

[61] R.S.O. 1990, c. E-27, as amended.

### 3. Background of the Directors, Officers and Others

Franchisors in Ontario are discovering that requirements with respect to the directors and officers of the franchisor are creating problems. Alberta only requires the disclosure with respect to directors, general partners and officers of the franchisor who have management responsibilities related to the franchise. For these persons, all that is required is their principal occupation and employer(s) during the five years preceding the date of the disclosure document.

Ontario has no limitation regarding management responsibilities so that the requirement is now all directors, general partners and officers of the franchisor. This is more expansive than the disclosure required not only by Alberta, but also by the UFOC Guidelines. Further, Ontario requires that such disclosure include the name and current position of each person, a brief description of the prior relevant business experience of each person, and the length of time each person has engaged in the line of business associated with the franchise, in addition to their principal occupation employers for the five years immediately preceding the date of the disclosure document. The requirements with respect to prior relevant business experience and length of time in the line of business generally mean that to strictly comply franchisors may wish to consider the circulation of another questionnaire to their directors and officers to fulfil the Ontario disclosure requirements. It should be noted that neither Ontario nor Alberta have a requirement in the regulations with respect to "other executives or sub-franchisors" as is set out in the UFOC Guidelines. To some American franchisors, these variations may not be significant. However, for others, amendments to their basic UFOC will be required.

### 4. Litigation

The Alberta Regulations, the Ontario Regulations and the UFOC Guidelines all require disclosure of convictions, findings of liability in a civil action, and injunctive or restrictive administrative orders, together with pending actions in these areas, against the franchisor and other persons. Unfortunately, each one of these requirements has different wording with respect to the other persons besides the franchisor that must make such disclosures, and the types of judgements or claims that must be disclosed.

Item 3 of the UFOC Guidelines requires disclosure with respect to the franchisor, its predecessor, a person identified in Item 2 (directors, general partners, the principal officers and other executives or sub-franchisors who have management responsibility) or an affiliate offering franchises under the franchisor's principal trade-mark.

The Alberta Regulations require disclosure with respect to the franchisor and its associates and any of the directors, general partners and officers of the franchisor that have management responsibilities relating to the franchise. Alberta does not have a specific requirement with respect to predecessor corporations neither in Schedule 1, nor through a reading of the definition of "franchisor" in the Alberta Act. Accordingly, if there has been a corporate reorganization of the franchisor that leads to the creation of a new corporate entity that offers the franchise, it is arguable that no disclosure of items prior to the reorganization is required by the Alberta Regulations. However, disclosure may be required as a "material fact". In Canadian law, amalgamations are generally deemed not to result in a creation of new corporate entity. Finally, the Alberta Regulations do not have requirements for disclosure with respect to other executives or sub-franchisors that have management responsibilities.

The Ontario Regulations require disclosure with respect to the franchisor, the franchisor's associate or a director, general partner or officer of the franchisor. Again, there is no requirement with respect to predecessor corporations, except possibly as "material facts". Further, in Ontario there is no limitation with respect to directors and officers that requires them to have management responsibilities relating to the franchise. All officers and directors must make the required disclosures.

These variations are not as significant as the variation with respect to the types of litigation to be disclosed, particularly with respect to civil actions. The UFOC Guidelines require disclosure with respect to administrative, criminal or material civil actions with respect to a violation of a franchise, antitrust or securities law, fraud, unfair or deceptive practices, or comparable allegations. The UFOC Guidelines then go on to further limit disclosure with respect to items that are not pending. With respect to material civil actions, it must be something that is other than ordinary routine litigation incidental to the business or which may be significant in the context of the number of franchisees and the size, nature or financial condition of the franchise system or its business operations.

Further, civil actions are limited to a 10 year period immediately preceding the date of disclosure document, where they are essentially private actions arising out of a material violation of a franchise, antitrust or securities law, fraud, unfair or deceptive practices or comparable allegations. Convictions under such laws are also limited to a 10 year period immediately preceding the date of the disclosure document. Finally, the administrative orders must be "currently effective" and must relate to the franchise under a franchise, securities, antitrust, trade regulation or trade practice law.

The Alberta and Ontario Regulations do not have a time limit on the disclosure of civil actions in which the named persons were found liable for misrepresentation, unfair or deceptive acts or practices for violating a law that regulates franchises or businesses.

There are similar requirements in Ontario and Alberta with respect to convictions and administrative orders, except that convictions are limited to the 10 year period preceding the date of the disclosure document.

In Ontario the fact that there is no time limit with respect to the finding of liability in a civil or administrative action, has recently led to expressions of concern that may result in an amendment to the Regulation. There is some suggestion that the time limit was omitted in error. A franchisor that was found liable in certain litigation in 1995 in Ontario and Québec was able to obtain an exemption with respect to the disclosure of financial statements provided that it disclosed such items until July 1, 2003.[62]

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[62] See O.Reg. 9/1, *Exemption of Franchisors under Subsection 13(1) of the Act*, as amended by O.Reg. 204/01 with respect to Pizza Pizza Limited.

A further concern has been the meaning of the phrase "…violating a law that regulates franchises or businesses, including a failure to provide a proper disclosure to a franchisee." What laws do not regulate a business in some way? The broad wording in the Ontario Act contrasts sharply with the very restrictive wording in the UFOC Guidelines, Item 3. The disclosure of all violations of a law that regulates business may lead to the disclosure of a large number of employment standards, labour relations, and zoning cases, for example. This would lead to an absurdity and would not provide the clear and concise disclosure required by Subsection 5(6) of the Ontario Act. It would also deviate markedly from the type of disclosure required in the United States, on which the Ontario legislation is modelled, and does not match the wording used in the initial proposal for the Ontario franchise legislation. It is suggested by some that this is evidence of the haste and lack of consultation with which the regulation was prepared. Accordingly, some Ontario lawyers argue that this phrase should be read ejusdem generis and that it should be interpreted as being restricted to the types of actions described in the UFOC Guidelines or in the Alberta Schedule.

Finally, it should be noted that there are no specifications in either the Alberta or Ontario Regulations with respect to the specific details to be disclosed with respect to each litigation matter. Generally, it is recommended that the UFOC Guidelines be followed in this respect.

The need for revisions to comply with the Ontario requirements will depend on the length of time that the franchisor has been in business, and the litigation that it has experienced.

**5. Bankruptcy**

Item 4 of the UFOC Guidelines requires the disclosure of any bankruptcy filing, within the ten year period immediately preceding the date of the offering circular, made by the franchisor, its affiliate, its predecessor, officers or general partner, in their personal capacity, or as principal officers, general partners of other businesses. It does not require disclosure with respect to directors. The Ontario Regulations have only a six year disclosure requirement, but a different set of individuals who must be disclosed. As noted before there is no requirement with respect to predecessors. There are, however, requirements for directors both in their corporate and personal capacities, including other businesses. The Alberta Regulations also use a six year requirement, but for some reason have omitted the requirement for disclosure with respect to directors, general partners, or officers in their personal capacity. Further in Alberta, the directors, officers and general partners are limited to those who have management responsibilities relating to the franchise.

Compliance with the Ontario Regulations may require the circulation of a questionnaire to directors, but may not require the addition of much material to the disclosure document.

### 6. Financial Statements and Exemptions

The UFOC Guidelines Item 21 requires the disclosure of audited financial statements prepared in accordance with generally accepted accounting principals ("GAAP"). However, the franchisor may use the audited financial statements of an affiliated company if the affiliate absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement.

Unfortunately, neither Alberta nor Ontario has adopted the use of affiliate company statements together with a guarantee. This often creates problems for American franchisors entering Canada. Ontario and Alberta will accept audited financial statements prepared in accordance with Canadian GAAP or standards that at least equivalent. They will also accept review engagement reports (which are not audited statements) provided that such financial statements have been reviewed and comply with Canadian GAAP or other standards that at least equivalent.

The other option is to obtain an exemption with respect to the filing of financial statements. In Alberta, the criteria for obtaining such an exemption are specified are now specified in Section 1 of the Franchises Act Exemption Regulation.

In Ontario the criteria for such an exemption are specified in Section 13 of the Ontario Act and Section 11 of the Ontario Regulations, as amended, and if the franchisor meets these requirements it may simply make a declaration to that effect rather that provide financial statements.[63] In general, the franchisor or a corporation that controls it must have a net worth of not less of $5 million Canadian, within the 5 years immediately preceding the date of the disclosure document must have had at least 25 franchises either in Canada or in Canada and one other jurisdiction, and been engaged in the line of business with the franchisor for not less than 5 years. Finally, during the 5 year period immediately preceding the date of the disclosure document, the franchisor, the franchisor's associate and directors and general partners and officers of the franchisor (or its controlling corporation if it is relying on this corporation to qualify for the exemption) must have not been subject to any judgement or order or award in Canada relating to fraud, unfair or deceptive practices, or a law regulating franchises, or in any other jurisdiction that it is relying on to qualify for this exemption.

### 7. Prescribed Statements

Section 4 of the Ontario Regulations contains four prescribed statements that must appear in every disclosure document together in one section at the beginning of the document. They are with respect to commercial credit reports, independent legal and financial advice, contacting current and former franchisees, and the costs of goods and services purchased under the franchise agreement. These obviously must be added to a UFOC intended to be used in Ontario.

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[63] See section 3(1)(c) of O.Reg. 581/00 as amended by O.Reg. 69/04, s.3 and O.Reg. 199/05, s.1.

The only prescribed statements in the Alberta Regulations are requirements to quote Sections 9, 13 and 14 of the Alberta Act, regarding rights of action with respect to misrepresentations, failure to give a disclosure document, and the effect of cancellation in case of such failure. There are no requirements as to their position, and thus they may be given in an addendum.

### 8. Dispute Resolution

Section 5 of the Ontario Regulations requires that if internal or external mediation or other alternative dispute resolution process is used by the franchisor, then a description of such process must be in the disclosure document, together with circumstances under which the process may be invoked. This requirement is partially covered by UFOC Guideline, Item 17, Instruction (v)(u). Whether additional material must be inserted will depend on the policies of the particular franchisor.

There is also a required statement with respect to the nature of mediation that must be included in all disclosure documents, whether or not the franchisor has a particular process. There are no equivalent requirements in Alberta.

### 9. Initial Fees, Costs and Investment

The wording used in the Alberta Regulations, Sections 7 and 9, is similar to the wording used in the UFOC Guidelines, Items 5, 6 and 7. Franchisors are required to disclose the initial franchisee fee and state the conditions when the fee is refundable. Every recurring or isolated fee or payment to be paid to the franchisor is also to be disclosed. While Item 7 of the UFOC Guidelines has detailed requirements with respect to the initial investment, Alberta only requires "… details of the initial investment required to start business operations". Further, in Section 10 of Schedule 1 to the Alberta Regulations, estimates of working capital are optional. If an estimate is not provided, there is a required statement.

In Ontario, these requirements are in Section 6(1)1 of the Regulations. This Section requires a list of all of the franchisee's costs associated with the establishment of the franchise. It then goes on to prescribe certain items that must be included notwithstanding this general requirement. Items to be included are the amounts of any deposits or franchise fees and their refundability, estimates of the costs for inventory, leasehold improvements, equipment, leases, rentals and all other things necessary to establish the franchise and an explanation of any assumptions underlying the estimate and any other costs associated with the franchise not otherwise listed.

This disclosure requirement is structured in a manner opposite to that of UFOC Item 7. Item 7 does not require disclosure of all of the franchisee's costs, rather only disclosure regarding the items listed. American franchisors will have to review their Item 7 disclosures to ensure that they conform to the higher Ontario standard.

### 10. Operating Costs and Earnings Projections

In the UFOC Guidelines there are no specific disclosures required with respect to estimates of annual operating costs or earning projections for the franchise. Under Section 16 in the Alberta Regulations, if any information is provided to a prospective franchisee from which a specific level or range of actual or potential sales, costs, income or profit from the franchisee outlets can be easily ascertained, then the information must have a reasonable basis, including material assumptions; and include a place where substantiating information is available for inspection. If no earnings claims are made, there is no requirement for a statement to that effect in the disclosure document.

Similarly, Section 6(2) and (3) of the Ontario Regulations state that if an estimate of annual operating costs, or if an earnings projection for the franchise, is provided (as discussed earlier “earnings projection” is not defined) then similar standards must be met.

With respect to operating costs, the wording of Section 6(1) appears to require a list of all of the franchisee’s costs associated with the operation of the franchise. The requirement with respect to an “…estimate of annual operating costs” in Section 6(2) may either suggest that the previous item is limited to only the start-up costs for the franchise, and that the phrase is improperly drafted, or it may be alternatively be interpreted that known operating costs, based on their units, must be disclosed, although projected operating costs are optional.

In either event, it should be noted again that both Alberta and Ontario require the disclosure of all “material facts”. Past sales levels and operating costs levels are facts and not projections. The FTC and others regard earnings information as being material to all prospective franchisees. It is hard to see how information regarding historical sales figures would not be considered material.

### 11. Financing

Item 10 of the UFOC Guidelines, Section 6(4) of the Ontario Regulations and Section 9 of the Schedule to the Alberta Regulations all have essentially the same wording regarding the disclosure of financing arrangements.

### 12. Training

Alberta has no specific disclosure requirements with respect to this item. However, such item may well be considered a “material fact”.

Section 6(5) of the Ontario Regulations requires a description of any training or other assistance offered to franchisees, including whether the training is mandatory or optional, and if the training is mandatory, a statement specifying who bears the costs of the training. The requirements with respect to the costs of mandatory training are found in UFOC Item 6 with respect to other fees. Whether the training is mandatory or optional is found in Item 9 with respect to the Franchisee’s Obligations. A description of the training or other assistance offered is found in UFOC Item 11. Accordingly, most UFOCs comply with this item of the Ontario Regulations without further amendment.

### 13. Advertising and Advertising Funds

The Schedule to the Alberta Regulations has no specific requirements in this respect. However, various aspects of the operation of the advertising fund are most likely to be considered "material facts".

The drafters of the Ontario Regulations decided not to follow the requirements of UFOC Item 11, and have set up some new requirements that appear to differentiate between charges set at arm's length and those set unilaterally by the franchisor. These requirements will require some calculations and addition of material by the franchisor. If a franchisee is required to contribute to an advertising fund (and note that this may include local or regional funds), Section 6(6) requires a statement describing the percentage of the fund that has been spent on national campaigns and local advertising in the two fiscal years immediately preceding the date of the disclosure document; and the percentage of the funds, other than the percentages previously described, that has been retained by the franchisor.

The second statement is to provide the same percentages, and the projected amount of the contribution, for the current fiscal year. Finally, the disclosure document must indicate whether reports on advertising activities financed by the fund will be made available to franchisees.

The requirements under UFOC Item 11B (see Instructions ii(g)) are more extensive than that required by Ontario and certainly include most items that would be considered material facts. However, the calculations described in 11B(ii)(g)(5) regarding the use of the fund are not the statements required by Ontario. Rather, they must be separated to show what has been spent on advertising and what has been retained by the franchisor.

### 14. Restrictions on Suppliers, Product Offerings and Customers

The Ontario Regulations and the Schedule to the Alberta Regulations have very similar requirements regarding restrictions on suppliers, product offerings and customers.

Both require the disclosure of franchisee obligations to purchase or lease from the franchisor, from its associates or from suppliers approved by the franchisor. Alberta goes further to limit this by saying that it must be under the franchisor's or associate's specifications. Ontario does not have such a limitation. The wording in this item is very similar to that used in Item 8 of the UFOC Guidelines. Accordingly, UFOCs prepared in the United States usually contain sufficient disclosure to fulfil the Alberta and Ontario requirements in this regard.

Both Alberta and Ontario also require the disclosure of any restrictions on the goods and services the franchisee may sell, and to whom the franchisee may sell goods or services. This requirement matches the wording of Item 16 of the UFOC Guidelines.

### 15. Rebates and Benefits

Section 12 of Alberta's Schedule to the Regulations requires a statement as to whether or not there are any rebates or other benefits that the franchisor and its associate may receive or are receiving as a result of the purchase of goods or services by franchisees. It must also indicate if any of these rebates or benefits are shared with franchisees, either directly or indirectly.

Section 6(1)8 of the Ontario Regulations has a similar requirement that goes further to require a description of the franchisor's policy, if any, regarding volume rebates. It also requires a statement regarding other benefits received as a result of franchise purchases and whether or not they are shared. It should be noted that the wording, however, is not precisely the same as that used in UFOC Item 8D. Item 8D requires disclosure if the basis on which revenue or other consideration is derived is a result of required purchases or leases. Ontario and Alberta requirements are with respect to benefits from the purchase of goods or services by franchisees, whether or not the purchases are required. Accordingly, American franchisors should review their UFOCs to ensure that disclosures under UFOC Item 8D are sufficient for the purposes of the Alberta and Ontario regulations.

A more difficult question is whether the amount or dollar value of such rebates are "material facts". Certainly this issue is of significant concern to Canadian franchisees who are concerned about the possibility that such rebates result in higher prices to the franchisee and accordingly lower profit margins. Concerns in this area led to an action by the franchisees of the "BULK BARN" franchise system in 909787 Ontario Ltd. v. Bulk Foods Ltd.[64] for certification as a class action with respect to a breach of the franchise agreement arising out of the prices charged for products sold to franchisees. Generally speaking, franchisors will be very reluctant to disclose the amount of the rebate received. However, the greater the rebates received, the more likely these items would be considered material to prospective franchisees.

### 16. Trade-marks and Other Intellectual Property

Despite the fact that a franchise agreement is essentially a licence to use a trade-mark, Schedule 1 of the Alberta Regulations has no requirements whatsoever with respect to trade-marks, and does not even use the word. Possibly, this is because during consultations regarding a previous version of the Alberta Act that attempted to provide for evergreen franchises, there were representations made suggesting that a province did not have power to do this, as trade-marks are exclusively a federal matter under the Constitution Act, 1867. Such discussions should not have affected the disclosure of the status of the trade-marks being licensed, and their omission from the Alberta requirements is puzzling. However, such information may also be regarding as a "material fact" that is required to be disclosed in Alberta.

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64 (August 9, 1999, unreported – Doc. 50261/98 Ontario S.C.J.).

In Ontario, in Section 6(9) requires the description of the rights that the franchisor or the franchisor's associate has to the trade-mark, service mark, trade name, logo or advertising or other commercial symbol associated with the franchise. The requirement with respect to "service marks", which do not exist in Canadian law, shows the extent to which American law was copied in preparing the Ontario Regulations. The wording used here is not precisely the same as used in UFOC Item 13. There, only the principal trade-mark registrations are considered. But if the franchisor has a very large portfolio of trade-marks, what needs to be disclosed in Ontario? Remembering the requirement to disclose all "material facts", it is sometimes suggested that it must be all trade-marks on which the franchisee will depend in the conduct of the business. This may also, therefore, include tag lines or menu items, if they are particularly well known.

Neither Alberta nor Ontario have any requirements with respect to patents, copyrights and proprietary information as exists in Item 14 of the UFOC Guidelines, other than the general "all material facts" requirement. Reviewers should be alert to patents that are claimed in the American UFOC. Sometimes for cost reasons when staring out the franchisor has decided not to apply for a Canadian patent. Disclosure of this difference is generally the best way to deal with this problem.

### 17. Licenses, Regulations and Permits

Disclosure of licences, regulations and permits appear to be another addition by Ontario. It is found in Section 6(10) of the Ontario Regulations. There is no equivalent in Alberta and the closest approximation in the UFOC Guidelines is Item 1E, Instruction vi. Unfortunately, the UFOC requirement is for a description in general terms of any regulation specific to the industry.

Ontario requires a description of every licence, registration, authorization or other permission a franchisee is required to obtain under any applicable federal or provincial law or municipal by-law, to operate the franchise. The wording is considerably broader and more specific than the UFOC requirements and, accordingly, to comply with this requirement, franchisors will have to prepare disclosure items specifically for Ontario.

### 18. Personal Participation

While the wording differs between Alberta, Ontario and the UFOC Guidelines, it is unlikely that the differences regarding personal participation in the business are substantial. In Ontario, Section 6(11) requires a statement indicating whether the franchisee is required to participate personally and directly in the operation of the business, or if the franchisee is a corporation, whether the principals of the corporation are so required. Alberta omits the reference to a corporation, as does Item 15 of the UFOC Guidelines. However, it may be argued that such disclosure may be inferred from either the all material facts requirement or from the regulation itself.

### 19. Territory, Licence Reservations and Encroachment

Both Ontario and Alberta require a description of any exclusive territory granted to the franchisee. Both also require a description of the franchisor's policy, if any, as to whether the continuation of the franchisee's rights or exclusive territory depends on the franchisee achieving a specific level of sales, market penetration or other condition and under what circumstances these rights may be altered. This requirement matches the requirements of UFOC Item 12D.

With respect to licence reservations and encroachment, both Ontario and Alberta require a description of the franchisor's policy, if any, on the proximity between an existing franchising outlet and: (1) another franchise outlet; (2) any other distributor using the franchisor's trade-mark; (3) a corporate store distributing similar products or services under a different trade-mark; (4) a franchise granted for similar products or services under a different trade-mark. Alberta has a further requirement with respect to disclosure of corporate stores using the same trade-mark. These disclosures may be found in UFOC Items 12A, 12B and 12C, respectively.

### 20. Franchise Closure

Both Ontario and Alberta require the name, last known address and telephone number of the franchisees that have been terminated, cancelled, not renewed or required by the franchisor or otherwise left the system within the last fiscal year. In Section 6(15) Ontario limits the requirements to the Province of Ontario, but Alberta's requirement is for the "total operating territory of the franchisor". The requirement of UFOC Item 20E is largely the same and should fulfil the requirements of both provinces.

Both Ontario and Alberta also require three-year summaries of franchisees that have been terminated, cancelled, not renewed or otherwise left the franchise system as usually provided with respect to UFOC Item 20. However, UFOC Item 20 and Section 15 of the Alberta Schedule base the requirement on the previous three fiscal years, allowing the table to be revised annually. Ontario's requirement in Section 6(16) is now also based on the three fiscal years immediately preceding the date of the disclosure statement.

### 21. Existing Franchisees

Section 14 of the Schedule to the Alberta Regulation requires a list of the names, mailing addresses and phone numbers of all existing franchisees presently operating an outlet in Alberta, and the addresses and phone numbers of those outlets. It further requires the disclosure of all franchisor outlets in Alberta in the same manner. If there are less than 20 franchisee outlets in Alberta, then information is to be provided on the nearest 20 outlets. Section 6(17) of the Ontario Regulation is a similar requirement with the exception that there appears to be no requirement for the disclosure of franchisor outlets. All of these items are required by UFOC Item 20.

### 22. Termination, Renewal and Transfer

Ontario requires a description of all restrictions and conditions in the franchise agreement related to termination, renewal and transfer. Alberta only requires disclosure of whether or not these exist and, if so, where in the franchise agreement they can be found. Either way, UFOC Item 17, which requires summaries of these provisions and other aspects would produce a disclosure that fulfils the requirements of both Ontario and Alberta.

### 23. Certificates

Both Ontario and Alberta have specific requirements with respect to certificates as to the reliability of the disclosure documents. Schedule 2 to the Alberta Regulation, provides wording for the Alberta certificate. Disclosure documents must contain no untrue information of material facts; not omit to state a material fact that is required to be stated; and not omit to state a material fact that needs to be stated in order for the information not to be misleading. A certificate must be signed by at least two officers or directors of the franchisor.

Ontario's requirements are found in Section 7 of the Regulations. Two signing officers (unless there is only one officer or director) must certify that the disclosure document contains no untrue information, representations or statements; and includes every material fact, financial statements, statement or other information required by the Act and the Regulation. Ontario does not provide a form for this certificate, but a form can be drafted based on the wording provided.

## G. Summary

Set out below is a table summarizing the previous discussion as to whether the information on a particular topic in a UFOC is suitable for use in Ontario.

## H. Summary of Comparison of Ontario and UFOC Requirements

| **Category in this Paper** | **Use of UFOC Information in Ontario** |
|---|---|
| 1. Franchisor Information | Usually OK. |
| 2. Background of the Directors, Officers and Others | Further due diligence with respect to prior relevant business experience and the length of time in the business must be done. Additions will depend on the responses. |
| 3. Litigation | Further due diligence must be done with respect to all civil and administrative actions where liability was found. Additions will depend on the responses. |

| **Category in this Paper** | **Use of UFOC Information in Ontario** |
|---|---|
| 4. Bankruptcy | Further due diligence must be done with respect to directors. Additions will depend on the responses. |
| 5. Financial Statements and Exemptions | Depends on the existing statements available. |
| 6. Prescribed Statements | These must be added at the beginning of the document. |
| 7. Dispute Resolution | The prescribed statement must be added somewhere in the document. Further additions will depend on the franchisor's policy. |
| 8. Initial Fees, Costs and Investment | Further due diligence must be done. Additions will depend on whether the existing disclosure already conforms. |
| 10. Financing | Usually OK. |
| 11. Training | Usually OK. |
| 12. Advertising and Advertising Funds | The calculations required must be added. |
| 13. Restrictions and Suppliers, Product Offerings and Customers | Usually OK. |
| 14. Trade-marks | Additional disclosure regarding Canadian trade-marks required. |
| 15. Licences, Regulations Permits | Additional disclosure will be required. The extent will depend on the industry. |
| 16. Personal Participation | Usually OK. |
| 17. Territory, Licence Reservations and Encroachment | Usually OK. |
| 18. Franchise Closure | The existing table in the UFOC may require updating to the date of delivery. |
| 19. Existing Franchisees | Usually OK. |
| 20. Termination, Renewal and Transfer | Usually OK. |

| **Category in this Paper** | **Use of UFOC Information in Ontario** |
|---|---|
| 21. Certificate | Must be added. |

Based on the table, it appears that 8 of the 21 items will almost invariably be satisfied by the existing UFOC disclosures. A further three items, being the background of the directors, officers and others, litigation and bankruptcy will require further due diligence, and any additions will depend on the result of such further due diligence. A further 5 items, being items 5, 7, 8, 9 and 18, may require some additions, depending upon the franchisor and the way in which disclosure has been made in any existing UFOC.

The prescribed statements in item 6 above must go at the front of the disclosure document. Franchisors often also include the prescribed statement from item 7 with these statements. The remainder of the additions must comply with the provisions of Section 6(1) of the Ontario Regulations, which requires that every disclosure document shall include items 8 to 20, as above, together in one part of the document.

At a minimum, the additional disclosures to be integrated into the existing disclosures with respect to Section 6 of the Regulations are the calculations required with respect to advertising and advertising fund, the additional disclosure required regarding Canadian trade-marks, the additional disclosure required with respect to all licences or permits, etc., required. Finally, it will also be necessary to add a required certificate, but this requirement is not governed by the preamble to Section 6(1) of the Ontario Regulations.

The three additions that are required and are governed by Section 6 will vary in volume and complexity according to the franchise system, particularly if the franchisor has a large number of Canadian trade-marks that are well known, or if the franchisor is in a regulated industry.

It should be noted when reviewing foreign disclosure documents that the remedy for incomplete disclosure in Ontario is a right of rescission for sixty days. Some franchisors find this an acceptable risk.

## 7. FRANCHISE AGREEMENT ISSUES

### A. Introduction

Many U.S. franchisors are completely oblivious to the fact that their U.S. documentation requires amendment to ensure that they comply with Canadian law and practice. As with the Canadianization of the Uniform Franchise Offering Circular addressed above, it is integral that franchise counsel instruct his or her client that the franchise agreement and schedules be similarly Canadianized for use in Canada.

In an attempt to minimize the legal fees incurred, U.S. franchisors may attempt to restrict the scope of Canadian counsel's retainer to a review and revision of the franchise documentation to bring it in line with Canadian law. This is often the case because many

U.S. franchisors are of the erroneous belief that their U.S. experience should be no different than what may transpire here in Canada, particularly due to its proximity to the U.S. and the many similarities that we share both legally and culturally. It is, however, incumbent upon counsel to raise a number of related legal and business issues surrounding the foreign franchisor's proposed entry into Canada. Such related issues may not have been adequately addressed, if addressed at all, by the U.S. franchisor and Canadian counsel's role in this process is to ensure that the U.S. franchisor is fully cognizant of the differences (both legal and non-legal) between franchising in the U.S. as opposed to doing so in Canada.

While each franchise has its own peculiar set of issues and such issues necessarily vary from franchise to franchise, it is important to highlight some of the more reoccurring questions that Canadian counsel should address when advising U.S. franchisors desirous of franchising in Canada. It is important to address such issues in advance of or contemporaneously with the preparation of the franchise documentation, as the documentation is obviously premised on the resolution of these issues. Such issues might include the following:

- **Organizational Structure -** The U.S. franchisor should first determine whether it desires to have a physical presence in Canada. If it does wish to have such a physical presence, does the franchisor intend on establishing a branch or a permanent establishment in Canada? Alternatively, does the U.S. franchisor wish to simply grant unit franchises, master franchises or area representative or development rights directly from the U.S. to Canadian entities? The U.S. franchisor should retain competent tax and legal advisors to consider these questions and other cross-border tax issues, including, withholding tax issues and the best available methods of repatriating the franchisor's income (i.e., franchise fees, royalties, advertising contributions etc.) from Canada to the United States if that is in fact the desired course of action. See Chapter 5 of this paper for more details regarding the tax related issues surrounding the organizational structure chosen by the U.S. franchisor.

- **Turn-Key Operation and Leasing Strategy -** Does the U.S. franchisor intend on offering the Canadian franchisees a turn-key operation or will the franchisees be required to locate, construct and develop the franchised location themselves? Along a similar vein, will the U.S. franchisor enter into a lease with the landlord at the franchised location and then sublease the premises to the franchisee or will the franchisee enter into a lease directly with the landlord? While it is more customary for franchisors in the U.S. to not take the leases in their own name (but to have their franchisees do so), Canadian franchisors are more likely to negotiate and enter into their leases directly only to then sublet them to their franchisees. Finally, is the U.S. franchisor willing to assume control of its Canadian franchises and their leases, if any, in the event of a default on the part of the franchisees?

- **Franchisor Training and Support -** Will the U.S. franchisor offer similar training and support to the Canadian franchisees as it offers to its U.S. franchisees? Where will such training take place; in the U.S. franchisor's home jurisdiction or in a place more convenient and cost effective for the Canadian franchisees?

- **Regulatory Compliance** - Do the products or services being offered meet Canadian regulatory and industry requirements such as, for example, the standards set by the Canadian Standards Association or other kinds of government or industry-related standards, codes and regulations? What changes to the existing labelling and packaging of the product are required, if any, so that they could meet Canadian packaging and labelling requirements? The U.S. franchisor may wish, for instance, to download the responsibility to address these requirements to its Canadian master franchisees, area developers or area representatives. If that is the case, the U.S. franchisor may wish to clearly establish these obligations in the franchise documentation.

- **Operations Manual -** In addition to "Canadianizing" the legal documentation, it is also important for Canadian legal counsel to review the U.S. franchisor's operations manual to ensure that it is drafted in a manner consistent with federal, provincial and local laws in Canada. While this is frequently not a priority for most foreign franchisors, it is important to note that operation manuals often do have language that is particular to the franchisor's jurisdiction and, as such, is either not applicable, or is contrary to the laws of Canada. In such cases, Canadian franchisees will be placed in an untenable situation; to either abide by the guidelines set out in the operation manuals even though they may be inconsistent with Canadian law or risk breaching their franchise agreement.

- **Currency and Currency Fluctuations** – Another important issue to be addressed by a foreign franchisor when "Canadianizing" its franchise documentation is the currency in which any and all amounts due and owing by the franchisee should be paid to the franchisor. For instance, will the foreign franchisor require that the Canadian franchisee pay such amounts to the franchisor in Canadian dollars on a dollar-to-dollar basis (i.e., simply require payment of all amounts in Canadian currency and leave the amounts payable as is) or will it require that the amounts to be paid first be converted into Canadian dollars? Alternatively, the foreign franchisor may choose to simply leave the currency as is, i.e., to require all payments to be made in U.S. dollars. In the event that payments are required in U.S. currency, U.S. franchisors should be make it clear to their Canadian franchisees that the franchisees will bear the risk of any currency fluctuation between the due date of a payment to be made by the franchisees and the date that the franchisees actually make payment.

  The currency to be chosen ties into the more important issue of the viability and appropriateness of the financial terms and obligations of the franchisee in and for the Canadian marketplace. In other words, has the foreign franchisor considered whether or not the initial franchise fee, royalties and other financial obligations are in fact suitable for the Canadian franchisees? Should, for example, the foreign franchisor consider reducing the payment obligations for its Canadian franchisees, particularly during the start-up phase of the franchisor's expansion into Canada?

- **Security Over Assets** - If a U.S. franchisor wishes to take security over the personal property of its franchisees (in the case of direct franchising), Canadian counsel should prepare security agreements in accordance with applicable provincial law, file registrations as against the franchisees and make whatever arrangements that are otherwise necessary to secure its security interests in this regard. A U.S. franchisor should also be made aware of the super-priority rights ("Purchase Money Security Interests") that may be available to it to take over equipment and/or inventory in the event the franchisee defaults under its security agreement. By registering Purchase Money Security Interests against the assets of its franchisees, a U.S. franchisor's security interest may trump even those security interests that were registered prior to the U.S. franchisor's registration, thereby providing a U.S. franchisor with enhanced security.

- **Restrictive Covenants** - Restrictive covenants, and in particular those prohibiting competition, form an integral part of a U.S. franchisor's strategy to protect and control the valuable investments made by the franchisor in its franchise system. Upon expiration or termination of their franchise agreements, franchisees typically are precluded from operating, owning or otherwise being associated with any business "competitive with or similar to" the business of the franchise.

  Such language, though prevalent, is often too ambiguous, as it does not adequately explain the franchisor's interests that may be protected, the activities restricted and the temporal and geographic limitations of the restrictive covenant. For instance, would such a non-compete provision preclude a coffee-based franchisee from then operating a donut franchise? Theoretically, such franchises may be seen as competitors of each other as both the coffee and donut franchises are "similar" to and "competitive with" each other and do often have the same clientele. Yet, the intention of the drafters of these particular types of restrictive covenant is often not at all clear. In Canada, such an ambiguous restrictive covenant may be void for uncertainty as Canadian courts are reluctant to read down such a covenant so that it becomes acceptable. This would be in contrast to the U.S. where U.S. courts are more interventionist and are willing to use the "blue-pencil" or "reasonable alteration" rules to modify or even delete the offensive provisions. In Canada, therefore, if the franchisor asks for too restrictive or broad a non-competition clause, it may end up with absolutely no protection whatsoever.

- **Advertising Issues** - As mentioned above, the U.S. franchisor should be advised of all applicable packaging and labelling or other advertising requirements that it must meet before its products may be distributed in Canada.

The franchisor should also be encouraged to establish a separate local advertising cooperative or fund for its Canadian franchisees in Canada if it intends on operating one. A separate fund is appropriate as the Canadian franchisees will inevitably prefer to have their funds directed to specific advertising campaigns within Canada and will likely object to contributing to a fund that may be biased in favour of the U.S. franchisees. A separate Canadian fund, furthermore, is recommended particularly when the U.S. franchisor is operating its franchise in Canada through a Canadian subsidiary. Finally, even when the U.S. franchisor is not yet prepared to establish a separate advertising fund for Canada, it should reserve the right to do so in its franchise documentation.

- **Québec -** The U.S. franchisor must consider French language issues, the Québec Civil Code and the unique cultural values and milieu of the Province of Québec before offering any franchises to franchisees in that province. If selling franchises in Québec, for example, each agreement to be executed by the franchisee should contain a language clause to confirm the intention of the parties that the franchise agreement (and all ancillary documentation) be written in the English language only. The following provision may be used in this regard:

    > "The parties hereto confirm that it is their desire that this Agreement, as well as all other documents relating hereto, including all notices, have been and shall be drawn up in the English language only.
    >
    > Les parties aux présentes confirment leur volonté que cette convention, de même que tous les documents, y compris tout avis, qui s'y rattachent, soient rédigés en langue anglaise."

- **Business Name Registrations -** Under the Business Names Act (Ontario), a person operating a business using a name that is dissimilar to the one that such person has incorporated, is required to register the trade name used by that person. The franchisee should be required to register its business name when using the U.S. franchisor's trade-mark in relation to the franchisee's operation of its franchise**.** To better protect the U.S. franchisors' trade-marks, such franchisors should also include a prohibition in their franchise agreements which would prohibit the Canadian franchisees from incorporating the U.S. franchisor's trade-mark into the franchisees' corporate names.

- **Interest Rate Clause** - Unless the U.S. franchisor identifies the rate of interest that its franchisees are required to pay under their franchise agreements for any overdue payments, the franchisor may be forced to accept a the rate set out by the *Interest Act (Canada)* (i.e., 5%). U.S. Franchisors should also avoid charging usurious rates as it may violate the *Criminal Code (Canada).* Finally, interest rates should be specified as an annual rate for otherwise the *Interest Act (Canada*) will cap the amount of interest charged to no more than 5%.

While much of the U.S. franchise documentation may be retained for use in Canada without much modification, Canadian counsel should address several additional issues when revising the documentation to ensure that it complies with Canadian law and practice. A detailed analysis of each and every possible amendment that may be required is beyond the purview of this paper, so a sampling of some of the key provisions and issues will follow instead.

**B. Conversion to Canadian Language and Terminology**.

Counsel should ensure that Canadian English is utilized as opposed to American English throughout each of the franchise documents prepared by a U.S. franchisor. Examples of words in U.S. English that require to be "translated" into Canadian English include the following: trademarks ("trade-marks"), center ("centre") and check ("cheque"). While translating such terms is not motivated by concern for any significant legal consequences and should not impact at all on the deal itself, Canadian franchisees are more likely to appreciate documentation which appears to be tailored to the Canadian marketplace.

In addition, attention should be given to U.S. legal terms which should be converted into Canadian legal terminology. Examples include references to labor ("labour"), state law ("provincial law"), attorney fees ("legal fees"), attorneys ("lawyers"), miles ("kilometres"), unemployment insurance ("employment insurance"), stockholders ("shareholders"), stocks ("shares"), temporary restraining order, temporary and/or permanent injunction ("interim, interlocutory, and/or permanent injunctive or mandatory order") and Certified Public Accountant ("Chartered Accountant").

Finally, and, as noted above, if a franchise is granted to an entity in the Province of Québec, it is important to insert a provision in each agreement which confirms that the English language is the language of preference, if that is in fact the case. Otherwise, the foreign franchisor may be deemed to be in breach of it obligations under the Charter of French Language which requires the use of the French language in certain legal documentation in the Province of Québec, unless agreed to otherwise in writing.

**C. Governing Law and Forum**.

Two of the more significant issues to address when "Canadianizing" a foreign franchise agreement involve the governing law and forum provisions.

Some of the related questions that a U.S. franchisor must address in this regard include the following:

- What law shall govern the franchise documentation to be entered into by the franchisees and in which forum should disputes between the parties be settled? Should it choose the franchisor's home jurisdiction in the U.S., the jurisdiction in Canada where each specific franchisee is situated, or one jurisdiction in Canada? Under Ontario, Alberta and PEI franchise disclosure legislation, any attempt to restrict the application of Ontario, Alberta or PEI law, as the case may be, or to restrict venue or jurisdiction to a forum outside the respective jurisdictions, would be void with respect to a claim otherwise enforceable under the legislation in each of Ontario, Alberta or PEI. While such legislation does not prevent the general application of U.S. law in its entirety to the cross-border franchising relationship, it will require special consideration by franchise counsel to ensure compliance with the franchise legislation.

- Does the franchisor wish to force the franchisee to mediate, arbitrate, or litigate any dispute that it may have in the U.S. and by applying U.S. law? It may wish to do so to deliberately increase the franchisees' cost of pursuing an action against the franchisor and to otherwise create a disincentive for the franchisee to do so. A U.S. franchisor may also choose its own jurisdiction as the governing law and forum due to its familiarity with its laws and courts in question and to better control and monitor any mediation, arbitration or litigation.

- Alternatively, a U.S. franchisor may wish to adopt the law of a specific province or the province of the residence of the franchisee in question. Choosing the franchisee's jurisdiction provides the franchisor with the ability to more easily and effectively enforce a court order as against the franchisee.

- If, however, a U.S. franchisor chooses for simplicity sake one jurisdiction in Canada as the choice for law and forum for all of its franchisees across Canada, then the courts of that province may be less willing to enforce such provisions if there is no local presence by the U.S. franchisor or the franchisee in the said jurisdiction.

Below is a chart which summarizes some of the advantages and disadvantages associated with the various options faced by counsel when drafting the forum and governing law provisions of the franchise agreement on behalf of a foreign franchisor. We have assumed for example purposes only that the franchisor's jurisdiction is the United States, while the franchisee is situated in the Province of Ontario:

| **Forum and Governing Law** | **Advantages** | **Disadvantages** |
|---|---|---|
| Franchisor's Jurisdiction (e.g., U.S.) | ✓ Most convenient and familiar forum for Franchisor<br><br>✓ Inconvenient forum for Franchisee (disincentive to litigate) | ❖ If, on the other hand, client anticipates that the more likely need is to sue its franchisees, it would be more difficult to enforce a U.S. judgment in Canada |

| **Forum and Governing Law** | **Advantages** | **Disadvantages** |
|---|---|---|
| | ✓ Greatest advantage where client anticipates that it will be sued by Franchisee | ❖ U.S. courts may be reluctant to issue injunctive relief where it needs to be enforced in Canada. Multiple concurrent proceedings therefore may be required, creating potential duplication and procedural complexity |
| Ontario | ✓ Courts are more sophisticated and franchise savvy in Canada's most populous and affluent Province (which may be an advantage)<br>✓ Most convenient and familiar Canadian forum for franchisors<br>✓ One Province for Canada leads to more consistent enforcement<br>✓ Advantages are similar to U.S. jurisdiction with respect to Franchisees in other provinces<br>✓ Easier to enforce in Canada than U.S. Judgment | ❖ Courts may be reluctant to enforce if no Franchisor presence in Ontario<br>❖ Same disadvantages as U.S. jurisdiction (but less so) with respect to Franchisees in other provinces |

| Forum and Governing Law | Advantages | Disadvantages |
|---|---|---|
| Jurisdiction Where Franchise Situated | ✓ Single proceeding for all relief sought, injunctive relief<br>✓ Easier to enforce judgment in Franchisee's jurisdiction<br>✓ Greatest advantage whose client anticipates it will be suing Franchisee | ❖ Less consistency and less efficient use of counsel than choosing one Canadian jurisdiction<br>❖ Most convenient and familiar forum for Franchisee<br>❖ Inconvenient forum for Franchisor (Incentive for Franchisee to litigate) |

**D. Arbitration**

The arbitration provisions, if present in the U.S. documentation, should be carefully examined to determine whether arbitration is appropriate in the Canadian context in the first place, and if so, whether any amendments are required to make these provisions more suitable for use in Canada. Arbitration is recognized as having a number of advantages over traditional litigation, including the following:

- Limited review or appeal.
- Potentially more control.
- Faster process and limited discovery.
- The arbitrator may be selected by the parties.
- Confidentiality could be maintained.

There are however disadvantages to arbitration as well:

- The rules of procedure and evidence may not be applied by the arbitrator.
- Whereas the costs of having a judge and a courtroom are free, the parties to the arbitration generally assume the arbitrator's fees and expenses, cost of the hearing room and any other costs associated with the arbitration.

- The chosen arbitrator or arbitrators may not have the requisite legal and franchising expertise.

- Franchisors who wish to delay the process or to have their franchisees incur additional costs may be frustrated by the often expedient arbitration process.

- As noted above, arbitrations often restrict the ability of the parties to appeal or to conduct a judicial review of the arbitral award or decision.

A few additional comments regarding arbitration are in order.

First, if the U.S. franchisor decides to include arbitration provisions within its franchise documentation, it is important to carve out from such provisions a number of important matters that should not become the subject of the arbitration. For example, a U.S. franchisor should insist that any dispute regarding its trade-marks should not be settled by way of arbitration, so as to maintain its right to protect its valuable trade-mark assets by pursuing its legal remedies in court. Also, the U.S. franchisor should ensure that it is not precluded from obtaining from any court any interim or interlocutory relief (including mandatory or prohibitive injunctive relief), measures for the interim preservation of property (including the court-ordered appointment of an interim receiver), and/or other relief available to safeguard and protect its interest and rights under the franchise documentation outside of any arbitration proceeding.

Second, it may be preferable for Canadian arbitrators to arbitrate the matter between the U.S. franchisor and the Canadian franchisees as Canadian arbitrators may be better suited to address issues that are uniquely Canadian, particularly if Canadian law is the governing law of the contract. On the other hand, U.S. franchisors might prefer to utilize the resources of a U.S. arbitrator due to the said arbitrator's familiarity with the franchise system, the proximity of such arbitrator (and the place of arbitration) to the franchisor's head office and because of its overall existing relationship with the U.S. franchisor.

### E. Guarantees in the Province of Alberta.

When a foreign franchisor desires that a guarantee be provided by a guarantor of the Canadian entity situated in the Province of Alberta, it is incumbent upon the franchisor to secure the guarantee in accordance with the requirements of the Alberta Guarantees Acknowledgment Act. In particular, no guarantee has any effect unless the person entering into the obligation appears before a notary public, acknowledges to the notary public that the person executed the guarantee, and signs a statement at the foot of the certificate of the notary public in the prescribed form in the presence of the notary public.

**F. General Contractual Issues.**

There are several key issues to be addressed in the franchise documentation to be prepared on behalf of the foreign franchisor. Some of the issues that require attention by the foreign franchisor include whether the foreign franchisor should:

i. Grant exclusive or non-exclusive territories?

ii. Impose performance criteria which if not met by the Canadian entity are grounds for termination or the imposition of other serious penalties (such as the narrowing down of the exclusive territory, if any)? Please note in this regard that imposing certain penalties may not be enforceable if they are deemed to be a penalty, as opposed to a genuine pre-estimate of liquidated damages.

iii. Reduce the initial franchise fees, royalties or other payments (as an inducement to purchase the first franchise or number of franchises in Canada, for example)?

iv. Provide other incentives or penalties depending upon the performance of the Canadian franchisee, area representative, area developer or master franchisee?

v. Offer the Canadian entity the right of first refusal to purchase the rights to any adjoining territory, and if so, at what price and upon which terms?

vi. Attempt to restrict the Canadian entity from competing with the franchise system of the franchisor post termination or expiration of the franchise agreement?

**G. Canadian Legislation.**

Canadian Counsel should alert foreign franchisors of all particular legislation which may impact upon the franchisor's specific business and industry. Some Ontario legislation, for example, with far-reaching impact may include the Liquor Licence Act, the Consumer Protection Act, the Employment Standards Act, and the Human Rights Code.

## 8. CONCLUSION

Bringing a foreign franchisor into Canada is often a very exciting project for all concerned. Yet, it is rife with a series of often intricate business and legal issues which require special attention and consideration by the foreign franchisors and their professional advisors. A panoply of business and legal issues from product sourcing, advertising, training, intellectual property protection and enforcement to tax issues and document preparation arise and must be dealt with professionally and with the recognition that Canada is in fact a society distinct in many respects from foreign jurisdictions, even when speaking of the United States. The risks are too great to simply assume otherwise. As when one makes any substantial investment, caution is the order of the day.

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