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Franchise Agreements[1]

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A. Introduction

The relationship between franchisor and franchisee is largely a matter of contract. The franchise agreement is the principal contract that defines this relationship and sets out the rights and obligations of the parties for the duration of that relationship. In Canada, several provinces have enacted specific franchise legislation. While existing franchise legislation sets the basic rules within which the parties must operate, it is the franchise agreement that fundamentally defines the particular obligations of the franchisee and the franchisor.[2] It is therefore essential that franchisee agreements be clear, precise and comprehensive. Although franchise agreements vary depending on the nature of the particular business under consideration, there are many aspects that are shared by most, if not all, such agreements. This chapter will discuss in general the contractual provisions that are commonly found in franchise agreements and which set out the basic parameters for the establishment, operation, renewal and termination of a franchise.

B. The Granting Clause

The granting clause is one of the most important provisions in the franchise agreement. It defines the nature and extent of the rights granted by the franchisor to the franchisee. Particular attention should therefore be paid by both parties to the question of what bundle of rights is being granted. Is it simply the right to use the trade name or trademark or the right to operate a business in accordance with the franchisor's system of operations in conjunction with the trade name or trademark? A clear understanding of what is being granted is essential. Another important question is whether the rights being granted are exclusive or non-exclusive. In most cases, the franchisor grants a combination of the two. Even where there is an exclusive grant to operate a franchised business, the granting clause must address the area over which exclusivity has been granted, be that simply a certain specified location, a particular radius around a location, or a broader geographical area. A franchisor should consider whether, and under what circumstances, the grant of exclusivity may be altered or revoked. For example, a franchisor might retain the right to grant additional franchises after a certain threshold has been reached, which can be defined according to a number of criteria, such as population density or when a certain sales level has been achieved. A franchisor might also retain the right to reduce the size of an exclusive territory in the event of default by the franchisee. Furthermore, the franchisor might reserve the right to offer its products or services through other distribution mechanisms even where certain exclusive rights to operate a franchise within a territory have been granted, such as through sales via the internet.

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[1] Adapted from a paper co-authored and co-presented at the OBA 8th Annual Franchise Law Conference, by Peter Viitre, of Blake Cassels & Graydon, LLP and David Kornhauser of Macdonald Sager Manis, LLP, "Franchising 101 —Understanding the Fundamental Aspects of the Franchise Relationship."

[2] Often there are a multitude of other agreements between the parties, in addition to the franchise agreement, that define specific aspects of each party's rights and obligations (i.e. sub-lease agreements, software license agreements, etc.).

Often a franchisor will also “reserve” certain rights notwithstanding the grant to the franchisee. The reservation of rights usually provides that a franchisor can, even within an exclusive territory:

- use the trademarks to market the goods or services through other channels of trade or distribution or in a business which involves only aspects of the franchised business;

- use other trademarks to market the same or similar goods or services; and

- use the trademarks to market the goods or services to a systems customer (which is usually defined to mean a customer which has some ongoing relationship with the franchisor that extends over more than one franchised territory).

As well, the reservation of rights clause also makes it clear that the franchisor can market the goods or services using the same trademarks outside of the exclusive territory.

Clearly, it is essential that the granting clause be carefully drafted. Both parties must have a firm understanding of the nature and extent of the business relationship they are entering.

C. The Term

The “term” is the length of time during which the franchisee has the right to operate the franchised business under the franchisor’s trademarks and system. There are a number of important and competing factors involved in determining the appropriate term. Generally speaking, a franchisee will want a term that is long enough for it to realize a return on its capital investment and ideally, to earn a reasonable profit. The length of time that a franchisee is allowed to operate can be thought of as akin to an annuity. That is, a franchisee makes a capital investment at the start of the contract, being comprised of the franchise fee, construction costs, furniture, fixture, equipment and other related expenditures, in exchange for the right to generate revenues for a certain period of time. The longer the period that a franchisee has to operate the franchised business, the more time a franchisee has to recoup its initial investment, thus increasing the value of the business to the franchisee.

Conversely, once the term has expired, a franchisor is in a position to obtain an additional fee from the franchisee for the right to continue to operate the franchised business. Most franchise agreements are structured so that a franchisee may renew for an additional term or terms provided that the franchisee meets certain conditions, including the payment of renewal fees. Where leased premises are involved, the term will be limited by the franchisee’s ability to remain at the location or find other, mutually satisfactory premises.

D. The Initial Franchise Fee and Continuing Royalty Fees

The payment of money by the franchisee represents the most important element of the consideration received by the franchisor for the licenses granted to the franchisee. Most franchise agreements provide that the franchise fee has been fully earned and is non-refundable upon payment, which is usually concurrent with the execution of the franchise agreement. Problems can arise if the franchise agreement is terminated prior to the commencement of operations, for example, upon failure of the franchisee to satisfactorily complete training or if satisfactory premises are not found within a specified time frame. Notwithstanding that a franchise agreement might state that the franchise fee has been fully earned, the fair dealing duty contained in existing franchise legislation, as well as the common law duty of good faith, may require the franchisor to return a portion of the franchise fee. Thus, franchise agreements normally

state that the franchise fee is allocated among the various services that the franchisor provides to the franchisee and that the related portion of the franchise fee is fully earned at the commencement of those services. That is, certain percentages can be allocated to the provision of plans or designs for the premises, or for initial training. If the franchisee terminates the agreement subsequent to the commencement of a specific item, the franchisor would be entitled to retain the portion of the franchise fee that had been allocated to the item since the parties agreed in advance as to its cost.

In most cases, the franchisee will be required to pay to the franchisor royalties for the ongoing right to use the franchisor's system and trademarks. Franchise agreements generally set out in clear terms that the franchisee is obligated to pay continuing royalties to the franchisor, the basis upon which those continuing royalties are calculated (i.e., a flat monthly fee or on a percentage basis), when the royalties are due, the method of payment and the interest payable on late remittances. Any taxes exigible on the initial franchise fee and continuing royalties are normally stated to be the responsibility of the franchisee.

E. Rights of Renewal

As discussed above, most franchise agreements are structured so that a franchisee is allowed to renew for an additional term or terms so long as certain conditions are met. Providing a franchisee with the right to continue to operate the franchised business beyond the original term is generally beneficial to both the franchisor and the franchisee. From the franchisor's perspective, having an experienced individual with whom it is already familiar continue to operate the franchised business makes it easier to manage and administer the system as a whole. From the franchisee's point of view, he or she will be able to generate additional revenue on the initial investment and avoid having to "start over again."

Franchise agreements explicitly set out whether or not the franchisee has the right to renew and if so, for how many renewal terms. They should also state clearly the conditions the franchisee must meet in order to exercise any right of renewal. Typical conditions include:

- The franchisee's continuous and substantial compliance with the terms and conditions of the franchise agreement, including the franchisor's operating standards;
- Timely payment of all amounts due and owing to the franchisor under the initial term;
- A continuing right on the part of the franchisee to occupy its premises, whether by direct ownership or through the continuation of a lease or sub-lease;
- A requirement to provide advance notice of the franchisee's intention to renew;
- Depending on the amount of the renewal fee, a requirement that the franchisee pay a deposit upon providing notice of an intention to renew;
- The payment of the renewal fee;
- A requirement to make reasonable capital expenditures to renovate or modernize the premises to meet the franchisor's then current standards;
- A requirement to complete any retraining;
- The execution of the franchisor's then current form of franchise agreement, which may contain, among other things, different royalty rates and advertising contributions; and

- The execution of a release by the franchisee in favour of the franchisor.[3]

The amount of the renewal fee is essentially a business decision for the franchisor. However, renewal fees generally range from a percentage of the original franchise fee to the then current initial franchise fee that new franchisees would be required to pay. A franchisor should consider whether it is appropriate to charge a renewing franchisee the then current initial franchise fee since the franchisor will not incur the same costs as it would for new franchisees. That is, the franchisor will not be faced with the costs associated with finding, designing and opening a new location, training a new franchisee, printing new manuals, and the myriad other expenses associated with getting a business off the ground. Thus, the renewal fee could simply be as little as reimbursement of the franchisor's legal and administrative costs incurred in connection with the renewal.

Franchisors might also avoid granting franchisees a right of renewal, preferring instead to allow them to request a renewal and applying some or all of the conditions set out above as qualifying criteria. The exercise by the franchisor or its discretion in evaluating these criteria, whether in connection with a right to renew or a renewal request, may be circumscribed by the statutory duty of fair dealing in those jurisdictions in which franchise legislation exists or the common law duty of good faith in those provinces without franchise legislation.

F. Business Premises and Relocation

Typically, franchisees operate out of leased premises as tenants of a third party landlord. The leased premises should be described with some particularity in a schedule to the agreement. Where the leased premises have not been ascertained at the time the franchise agreement is entered into, the agreement should provide that the premises are to be subsequently acknowledged by the parties.

In certain circumstances, the franchisor is required or chooses to enter into a direct contractual relationship with the landlord in order to retain control over the leased premises. If a franchisor enters into the head lease with the landlord, then in order for the franchisor to legally allow the franchisee to operate the franchised business from the premises the franchisor must enter into a sub-lease agreement with the franchisee. Theoretically, the rent is payable by the franchisee as sub-tenant to the franchisor as sub-landlord and then from the franchisor as tenant to the landlord. However, sub-lease agreements often provide that the franchisee must pay rent directly to the landlord. Additionally, the sub-lease agreement usually also contains "cross-default" provisions in the event that the franchise agreement is terminated, which provides the franchisor with the benefit of landlord-like remedies in the event of default by the franchisee. The advantage of using a sub-lease agreement from a franchisor's perspective is that it

[3] Following the decision of the Ontario Court of Appeal in *405341 Ontario Limited v. Midas Canada Inc.*, 2010 ONCA 478, 2010 Carswell Ont. 4714, 70 B.L.R. (4th) 1 (Ont. C.A.). It is no longer appropriate for a franchisor to insist on the execution of a release as a condition to the renewal or assignment of a franchise agreement. In *Midas*, the Court of Appeal stated that the requirement that a franchise execute a release as a pre-condition to a renewal of a franchise is *prima facie* unenforceable and contrary to the Act. Even in those provinces without franchise legislation, a franchisor should consider whether it is appropriate to insist on the execution of a release as a condition of the renewal or assignment in circumstances where the parties have divergent views about their respective rights and obligations or are already in the midst of litigation. It may be that the common law duty of good faith requires the franchisor to effect the renewal or assignment notwithstanding that no release is forthcoming.

provides the franchisor with the same rights and remedies as a landlord in the event that a franchisee fails to pay rent or if the "cross default" provision becomes applicable. The disadvantage of the sub-lease agreement is that the franchisor becomes legally responsible to the landlord for all of the obligations under the head lease.

In addition, the franchisor will generally have the right to sublet the leased premises to a *bona fide* franchisee without having to obtain the landlord's consent. If the landlord's consent is required, the terms and conditions of obtaining that consent should be clearly defined. In such circumstances, the franchisor must ensure that the landlord has not retained the right to terminate the lease should the franchisor wish to assign the lease to a subsequent franchisee. Conversely, if the franchisee enters into the head lease with the landlord, then for the franchisor to retain control of the premises it will require that all three parties enter into a lease option agreement (or equivalent). The lease option agreement usually provides the franchisor with two fundamental rights:

> 1) that the landlord provide the franchisor with notice of any defaults by the franchisee and that the franchisor has the right to cure those defaults; and
>
> 2) that the franchisor is entitled to take over the lease upon notice to the landlord that the franchise agreement, or one of the other ancillary agreements between the franchisor and the franchisee, is terminated.

The advantage of the lease option agreement is that the franchisor is not directly responsible for the obligations under the lease agreement unless the franchisor wishes to become so responsible. The disadvantages are that it usually takes longer for the franchisor to acquire control of the premises from the franchisee in the event of default and is a little more cumbersome to negotiate.

A relocation provision permits a franchisee to change the location at which the franchisee operates the franchised business, and is generally used in two circumstances. First, a relocation provision allows a franchisee to relocate in the event it is required to vacate the leased premises prior to the end of the term of the franchise agreement. Secondly, the original location might become unsuitable for a variety of reasons. Such a provision would permit the franchisee to relocate in order to ensure the continued viability of the franchised business. In either case, the consent of the franchisor is usually required.

G. Construction and Upgrade of Premises

Franchise agreements typically establish whether the franchisor or the franchisee will be responsible for preparing the plans for the premises. The agreement will also determine who is responsible for construction. In most cases, a franchisor will be in a better position to prepare the plans since it has greater experience in adapting different premises for the operation of the franchised business and in achieving consistency of look and feel across the system. A franchisor will also usually be better positioned to tackle construction and development since its contractors often have experience with the particular work required. A franchisor might also be able to take advantage of economies of scale.

In cases where the franchisee is responsible for construction and development, the franchisor will, as a general rule, reserve the right to approve the plans prior to the commencement of work. The franchisee will normally be required to obtain all necessary permits and ensure that all furniture, fixtures and equipment conform to the franchisor's specifications. Finally, the franchisee will have to finish all construction and development work within a within a specified time frame following the execution of the franchise agreement.

H. Franchisor Obligations Regarding Training and Continuing Assistance

Most franchise agreements provide for the training of the franchisee and its key employees at or before the opening of the franchised business and on an ongoing basis, either through refresher courses or upon the introduction of new products or services. In addition, franchisors will commonly offer advice and assistance to the franchisee on an "as needed" basis throughout the term of the franchise agreement.

With respect to initial training, the agreement should set out how much and what types of training the franchisee is to receive, the number of people who are required or eligible for initial training and where the training is to take place. The agreement should also establish which party is to absorb the related costs. Generally speaking, most franchise agreements provide that the franchisor is responsible for the cost of instruction and materials with the franchisee bearing the associated travel and living expenses. Typically, the franchisee receives no compensation during the training period. In addition, the franchise agreement should detail the particular aspects of the initial training program including the use of the computer system, the hiring and training of employees, purchasing, and the formulation of marketing strategies and programs. The agreement should also state that it is the responsibility of the franchisee to hire and train its own employees.

As noted, franchise agreements normally contain provisions allowing the franchisor to require the franchisee to attend and successfully complete additional or supplementary training programs and other refresher courses. In addition to requiring such courses as a result of new products or services, franchisors typically reserve the right to require further training in the event of poor performance by the franchisee. Most franchise agreements also include provisions allowing the franchisee to request additional or supplementary training. Franchisees are usually required to pay for all aspects of additional training.

I. Franchisee Obligations Regarding Standards of Operation

In addition to the franchisee's payment obligations, provisions in the franchise agreement regarding the franchisee's ongoing obligations with respect to the operation of the franchised business are extremely important. They serve as a standard against which the franchisee's conduct will be measured in determining whether the franchisee is operating its business in a manner consistent with the franchisor's system. They are also the means by which the franchisor is able to ensure a consistent quality of products or services and a uniform look and feel throughout the system. Aside from non-payment, failure of the franchisee to comply with its continuing obligations regarding quality and consistency of operations is the most common basis for terminating the franchise agreement.

In this regard, franchise agreements normally contain provisions requiring that:

- a specific individual devote his or her full time and attention to the business;
- the franchisee comply with all continuing mandatory specifications, standards and operating procedures prescribed by the franchisor from time to time;
- the franchisee secure and maintain all licenses and permits needed to operate the franchised business and that the franchised business be operated in compliance with all applicable legislation;
- the franchisee provide prompt, courteous and efficient service;
- the franchisee maintain adequate and properly trained staff;

- the franchisee obtain and maintain an adequate supply of marketing and promotional materials;
- the franchisee participate in the franchisor's advertising programs;
- the franchisee participate in the franchisor's training programs;
- the franchisee maintain sufficient working capital to operate the business;
- the franchisee install and maintain any required point of sale system or other connectivity to the franchisor;
- the franchisee purchase and source product inventory and supplies from particular suppliers, as well as providing for the treatment of discounts and rebates;
- the franchisee allow the franchisor to enter and inspect the premises for the purpose of ensuring that the franchisee is operating the business in accordance with the franchise system;
- the franchisee maintain the physical condition of the premises and prescribing the furniture, fixtures and equipment to be used in the operation of the business;
- the franchisee maintain certain types and minimum amounts of insurance;
- the franchisee obtain and maintain certain credit arrangements;
- the franchisee make prompt payment to suppliers and other creditors of the business; and
- the franchisee not subcontract its obligations to operate the business.

J. System Modifications

In order to ensure that the franchisor can maintain consistency in the system and adapt to changing market conditions, franchise agreements normally impose on the franchisee the obligation to adopt new products, equipment, services and trademarks as they are developed by the franchisor and implemented over time. This would include, for instance, the franchisor's right to update the system's primary trademark, or even to rebrand the system under a different primary mark, in order to revitalize the system as the brand matures. The expense of compliance with modifications to the system is usually borne by the franchisee.

K. Protection of Trademarks

At the heart of any franchise agreement is the grant to the franchisee of a non-exclusive, non-transferable licence to use the franchisor's trademarks at the premises or in a defined territory during the term of the franchise agreement, for the sole purpose of operating the franchised business. In addition to this limited licence, franchise agreements usually contain a detailed array of obligations and restrictions requiring the franchisee to protect the franchisor's trademarks from misuse and infringement. These provisions typically state that:

- the use of the trademarks does not confer on the franchisee any ownership rights;
- all goodwill associated with the trademarks vests with the franchisor;
- the franchisee must display a notice indicating that the franchisee is a franchisee of the franchisor and a licensee of the trademarks;
- the parties must co-operate in the event of an action for infringement by a third party;
- the franchisee must conform exactly to the franchisor's instructions when reproducing the trademarks; and
- the franchisee may not use or register the trademarks in its own name or in the name of any other person.

Protecting the franchisor's trademarks clearly benefits the system as a whole, as well as individual franchisees within the system.

L. Advertising and Promotion

One of the benefits of a franchise system is the ability of the franchisor to achieve economies of scale and purchasing power in the development and implementation of marketing and promotional campaigns. Relatively small and regular contributions by franchisees towards an overall advertising effort can create a market presence beyond what an individual franchisee could achieve with the same expenditure of funds.

The franchise agreement normally provides that the franchisee is obligated to pay an advertising contribution to the franchisor's national or regional advertising fund. Additionally, provisions dealing with advertising and promotion should state:

- the basis on which the advertising contribution is calculated (i.e., a flat monthly fee or as a percentage of gross sales);
- when the advertising contribution is due (normally, payment is required at the same time as the payment of the continuing royalties); and
- that the franchisee acknowledges that the franchisor's advertising programs are to benefit the system as a whole and not a particular franchisee.

The provisions of the agreement dealing with advertising and promotion should also detail how the franchisor will use the contribution. Most often, the franchisor is given the discretion to determine whether or not to expend the funds and to select the types of media and the specific advertising content. Franchise agreements usually state that the franchisor is under no obligation to ensure that individual franchisees benefit directly or in proportion to the amount paid.

In addition, franchise agreements normally impose upon franchisees an obligation to spend certain amounts, either on a flat fee basis or as a percentage of gross sales, in order to promote the franchised business within their own local marketing area and may require them to co-operate with other franchisees within a certain geographic area for joint advertising campaigns.

Finally, franchise agreements generally require franchisees to acknowledge that the franchisor has the right to delegate its marketing and promotion responsibilities, that the designees might not be "at arm's length" from the franchisor, that the amounts paid to such designees are within the franchisor's discretion, provided that the fees are in accordance with those charged in the market place for goods and services of comparable quality and that the franchisor is entitled to charge an administrative fee for managing the advertising fund.

M. Business Records and Reporting Requirements

The obligation to maintain business records and to report details of the operations of the franchised business is obviously critical, especially where the franchisee is paying continuing royalties and advertising contributions as a percentage of gross sales. However, the purpose of this obligation is greater than merely to ensure that the franchisee is submitting the proper amounts; it is considered to be a central part of the franchisor's ongoing effort to supervise the operations of each franchisee and thereby to maintain consistency across its system.

Franchise agreements generally address a number of issues relating to business records and reporting requirements, including the obligation to:

- Maintain proper records. Most of the information that a franchisee is required to record and maintain is the same as that used in any business (i.e., invoices, payroll records, sales tax records, etc.), while other types of information may be specific to the nature of the franchise system in question;

- Use an approved bookkeeping or accounting system. In many instances a franchisor will only require the franchisee to purchase an "off-the shelf" accounting system. In other circumstances, the franchisor will have developed its own accounting software that the franchisee will be required to use;

- Provide certain reports and financial information to the franchisor. This obligation is usually not just limited to providing reports of gross sales, but may include quarterly and annual financial statements, with different levels of comfort (i.e., internally prepared as opposed to externally prepared) and to varying standards ("notice to reader", "review engagement" or "audited"). The obligation to maintain and report records is an important tool in ascertaining whether or not a franchisee is complying with its obligations to report gross sales;

- Allow the franchisor to inspect the franchisee's records during normal business hours. Provision might also be made for periodic inspections;

- Allow the franchisor to inquire into the franchisee's third party relationships, for example, with suppliers or bankers, in order to provide the franchisor with further information regarding a franchisee's compliance with the franchise agreement; and

- Purchase or maintain certain point of sale and other computer equipment that is compatible with the equipment used by the franchisor.

With the continuing march of technology and the use of the internet, franchisors are likely to require franchisees to use certain point of sale equipment as well as all of the necessary supporting hardware and software (i.e., dedicated computers, phone lines, modems, printers and other related accessories).

Franchise agreements regularly provide franchisors with the right to electronically retrieve data and information from the franchisees' equipment.

Many franchise agreements also require the franchisee to maintain the confidentiality of information provided by the franchisor. Usually, the franchisor will not be under any obligation to review or provide the franchisee with any advice with respect to any of the information provided.

N. Guarantees and Security

Most franchise agreements grant the franchisor a security interest in all of the franchisee's assets and undertaking as security for the performance of the franchisee's obligations. The franchisee usually must execute a general security agreement in favour of the franchisor, which, in Ontario, must be registered in accordance with the provisions of the *Personal Property Security Act*[4] in order for the security interest to be perfected. Franchisors will generally subordinate this security interest to security interests granted by the franchisee for funds it has borrowed in order to establish the franchised business. In addition, where the franchise is a corporation or other non-natural person, the individual principals of the franchisee will normally be required to give the franchisor their personal guarantees of the franchisee's obligations.

O. Assignments and Transfers

Franchise agreements typically allow the franchisor, or the franchisee on consent by the franchisor, to assign the agreement to third parties. Provisions dealing with the right of the franchisor to assign tend to be quite simple. The franchisor usually has an absolute power to assign all of its rights and obligations to a third party. Once the third party has agreed to assume those rights and responsibilities, the franchisor is released from further obligation.

Assignments by franchisees are usually much more restrictive and the relevant provisions are accordingly much more detailed. First, a franchise agreement will typically set out all of the conditions or criteria for determining whether or not an assignment has been affected by the franchisee.

That is, a franchise agreement will generally deem certain occurrences to amount to an assignment, such as the sale by the franchisee of assets, shares or partnership interests in the franchised business, the grant of security to third party lenders or the realization against the assets of the franchised business by a receiver or a trustee. The franchisor will normally be given the authority to control or direct the actions of the franchisee when such an assignment has, or is deemed to have taken place.

Secondly, franchise agreements typically provide that no part of the franchise agreement may be assigned without the prior consent of the franchisor and set out the criteria that the franchisor will apply to determine whether or not to allow any proposed assignment. Further, detailed conditions for the completion of the assignment are usually spelled out, including requirements that:

- there be no existing default on the part of the franchisee;
- all accounts be settled, both with the franchisor and third parties;
- the proposed assignee demonstrate to the franchisor's satisfaction that it meets the franchisor's business, ethical, reputational, and financial standards;

- the proposed assignee enter into a written agreement with the franchisor agreeing to assume all of the franchisee's obligations or alternatively, the execution of the franchisor's then current form of franchise agreement, which may contain, among other things, different royalty rates and advertising contributions;

- the assignee and its key employees successfully complete the franchisor's training program;

- the franchisee pay certain fees to the franchisor, which can be a flat fee or a percentage of the amount paid to the franchisee by the assignee;

- the franchisee pay all of the franchisor's out-of-pocket costs of administering the assignment; and

- the franchisee deliver a complete release in favour of the franchisor.[4]

The conditions of assignment can be somewhat modified to permit transfers to family members upon death or disability. Finally, many franchise agreements will allow the franchisor to acquire the franchise on the same terms and conditions contemplated by the assignment by way of a right of first refusal.

P. Default Provisions and Termination Rights

Integral to the viability and success of the franchise system is the ability of the franchisor to terminate a franchisee if the franchisee fails to comply with the terms and provisions of the franchise agreement. Franchisors generally have termination rights in the period prior to the commencement of the franchisee's operations (i.e., prior to the signing of a lease for the premises or as a result of the franchisee's failure to successfully complete the franchisor's training program). However, in most circumstances, the termination of a franchisee will occur as a result of a breach (or a series of breaches) of the franchise agreement subsequent to the commencement of the operation of the franchised business.

In cases where the franchise agreement provides the franchisee with the opportunity or right to seek alternative dispute resolution in the event of a dispute between the parties (i.e. mediation or arbitration), the agreement will generally exclude this right in the event that the franchisor wishes to terminate. That is, the franchisee cannot "arbitrate" or "mediate" the franchisor's ability to terminate.

Termination rights typically arise "automatically" in the following circumstances:

- where the franchisee commits an act of bankruptcy, becomes insolvent or a petition for bankruptcy is filed and not discharged within a certain time;

- where a receiver is appointed over the franchised business or distress proceedings are commenced;

- where the franchisee ceases or takes steps to cease operations, or surrenders or otherwise loses its right to occupy the premises; or

- where the franchisor withdraws the right to use its trademarks.

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[4] Please refer to footnote 3, infra.

By providing that the franchise agreement is "automatically" terminated, the franchisor maintains control over the system and the trademarks effective to the date of the defaulting event. Most franchise agreements also provide that the franchisor can terminate, typically on a stated notice period and, in many cases, with an opportunity to cure, if the franchisee fails to comply with its obligations, such as:

- failing to pay amounts owing to the franchisor or to suppliers;
- failing to submit reports;
- attempting to assign the franchise agreement or any of its rights under the agreement without complying with the assignment provisions of the franchise agreement;
- allowing someone other than a designated manager to manage or control the franchised business;
- failing to maintain insurance or if existing insurance is cancelled or threatened to be cancelled;
- engaging in conduct harmful to the trademarks or the goodwill of the system;
- defaulting in any of the other terms or conditions in the franchise agreement or in any other agreement between the franchisee and the franchisor or its affiliates;
- receiving more than a stipulated number of default notices; or
- willfully or fraudulently misrepresenting any fact, condition or report.

As an alternative to termination, franchise agreements often provide the franchisor with the right to appoint a manager to oversee and manage the franchisee's business. Whatever, the termination rights are, they should be clearly set out given the impact that termination has on both the franchisee and the franchisor.

The rights and obligations of the parties in the event that the franchisor makes the decision to terminate should also be set out in the agreement. In such case, the franchisee is often obliged to:

- cease operations and all use of the trademarks;
- remove from the premises or otherwise discontinue the use and display of all distinctive equipment, signs, invoices and other items that display the trademarks or are associated with the system;
- return the franchise manual and other confidential information to the franchisor;
- notify phone companies of the termination of the franchisee's rights to the business phone number and listings;
- pay all amounts owing to the franchisor; and
- vacate the premises and transfer all related rights to the franchisor.

In most cases, franchise agreements spell out the rights of the parties consequent on the franchisee's failure to perform these obligations, including a right on the part of the franchisee to cure the default, a right on the part of the franchisor to seek injunctive relief to prevent the franchisee from continuing to use the trademarks and a genuine pre-estimate of the damages that will accrue to the franchisor in the event of default.

Franchisors are normally given certain other rights upon termination, including the right to purchase the assets of the franchisee's business, the right to enter the premises, the right to operate the franchised business and to retain all profits generated and the right to claim damages. Such rights, and the franchisee's obligations set out above, are usually stated to survive beyond the termination of the franchise agreement.

Q. Restrictive Covenants

Generally speaking, there are three elements to restrictive covenants in franchise agreements: one for the treatment of confidential information, another restricting the franchisee from competing during the term and for a certain period of time subsequent to the term, and a third restricting the franchisee from interfering with the operation of the businesses of other franchisees or the franchisor.

Part of the value of any system is the knowledge base that the franchisor has developed for various aspects of the franchised business. The disclosure of this knowledge base to parties outside of the system could obviously cause harm to the franchisor and to its other franchisees. In light of these concerns, franchise agreements often state that the franchisee:

- acknowledges that all matters relating to the operation of the franchised business are confidential and are trade secrets of the franchisor;
- agrees to maintain the information as confidential during and subsequent to the term of the franchise agreement;
- agrees to not use the information in any other business; and
- agrees to not copy or reproduce the information.

Covenants not to compete during the term and for a certain period of time subsequent to the term are also critical to the integrity of the system and thus are normally included in franchise agreements. In order to be enforceable, these kinds of clauses are carefully worded to ensure that they limit the franchisee's rights only to the extent necessary to re-establish the franchisor's presence in the market previously occupied by the franchisee.

Factors that the courts will take into account in determining the enforceability of a non-competition covenant include the geographical area to which the franchise is restricted, the duration of the covenant and whether a non-solicitation covenant would suffice in the circumstances.

As noted earlier, the franchise agreement and the provisions it contains are the primary source of the rights and obligations of the parties over the term of the relationship. However, franchise legislation has been enacted in certain provinces. These statutes impact both the rights of, and obligations imposed upon, both franchisees and franchisors.

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