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INFORMATION FOR PROSPECTIVE FRANCHISORS

Business is thriving and you are thinking of expanding your operations. You are wondering if franchising is the way to go. You encounter franchised businesses every day of your life and most likely patronize more than a few. You are impressed with the apparent seamlessness of those businesses and perhaps have heard that that franchising is a simple and effective way to make a lot more money out of what you've already built.

The truth however, is not so simple or straightforward. Franchising is a complicated undertaking involving many significant business and legal considerations. Our team has the knowledge and insight to guide you through the process of transforming your business into a franchise system. We will apply our cumulative experience to your particular business reality to help you make sound decisions throughout that process and to provide you with the tools you will need to meet each challenge along the way.

In order to assess whether franchising is your best option, several key issues must first be addressed:

✓ Is franchising an appropriate model for expanding my business?

Franchising is one of several means through which a business can expand. What most people have in mind when thinking of franchises are entities known as "business format" franchises. Fast food restaurants are prime examples of business format franchise systems. The goal there is consistency is quality and presentation throughout the franchise system. The key to this model is that the goods or services offered to the consumer, as well as the means in which they are offered, are highly systematized. However, not all businesses are suitable for franchising. Depending on the nature of the goods or services the business produces, the complexity of the processes that are involved and a host of other factors, expansion might best be accomplished through other means.

Common alternatives include the establishment additional corporate stores owned and operated by same entity that owns and operates the original business, product distribution arrangements, sales agency relationships and simple licensing schemes. Each of these formats has its own advantages and disadvantages depending on the characteristics of the original, prototype business. In order to determine which

method of expansion is the best fit, a thorough analysis of all aspects of the prototype must be carried out. That exercise will highlight the pluses and minuses of your operation and will clarify which model will most effectively build on the core strengths of your business.

The choice of the appropriate mode of expansion is not solely a business decision. There are significant legal implications to becoming a franchisor. In jurisdictions that have specific franchise legislation, such as Ontario, the requirements of that legislation must be met. Competent legal advice is necessary to assist you in navigating through these issues.

✓ **How do I determine if my business is ready to expand through franchising?**

To answer that question, a feasibility study should be carried out. The feasibility study will not only help determine that issue – it will also provide valuable insight in to how the transformation can be best accomplished.

The first step is to break down the prototype into its individual components and characteristics. While there is no precise number of criteria that must be assessed, concrete issues that should be analyzed and quantified include the following:

- What is the essential nature of the product or service the business offers, and what is its appeal to the consuming public?
- What is the market for the product or service? Does the product or service fill a niche that is not currently occupied or are there competitors offering the same or similar products or services? How do their products and services compare to yours? How direct is the competition? What is it about yours that differentiate them from those offered by others? Can those differences be exploited further and if so, how? What is their price point and how does it match up to yours?
- Do your products or services have limited geographical appeal or can they be successfully marketed and sold in other regional, provincial or national markets?
- Do you currently have adequate legal protections in place to preserve the intellectual property rights in your goods or services?
- How easy or difficult is it to replicate your products or services? Does it require expertise or can the business be “reproduced” in a straightforward, standardized format? Will a simple training program be sufficient to enable individuals from a broad range of backgrounds operate a franchise?
- Have you identified the ideal franchisee? Who might fit that description depends in large part on the nature of the goods or services your business

provides. The more complicated the product, or the means of delivering that product is, the more sophisticated the franchisee will have to be.

- Have you developed, or are you in the process of developing a training program for your franchisees? Have you prepared an operational manual that deals with each and every component of the system? Ideally, your franchisees will acquire a turnkey operation in which most of the questions they will face at start-up have been answered during the training process or can be resolved by reference to the manual. Putting the necessary effort into training and the manual at the outset will reduce the time and energy you will have to devote to the nuts and bolts of individual franchisee operations in the future.
- Does the current, prototype business have the capacity to manage the development of a franchise system? This is a crucial question and must be looked at from a number of perspectives. Does your business have sufficient retained earnings to fund the rollout of the system? While capital will be generated through the payment of franchise fees, those funds will not be available to pay for the groundwork that will have to be done in the lead up to the sale of the initial franchises. If those funds do not exist within the business, is it in a position to raise the necessary capital? Have potential sources been identified and what are the prospects of actually securing necessary financing?
- A second, related question relates to franchise fees. That is, what level of revenue will you need to generate through franchise fees in order to fund the system and provide you with a healthy return? After all, you are embarking on this path with a view to profit. However, a balance must be struck between the income you would like to see from the payment of franchisee fees and the need to attract individuals willing and able to make the investment. They too need to see a profit from their labours. Simply put, you don't want to price yourself out of the market.
- Does your business have the logistical wherewithal to manage the rollout? Do you have the management and administrative staff in place to handle the myriad tasks involved in establishing a franchise system? It must be remembered that the business of being a franchisor is not the same business carried on by the prototype. That business was about delivering your particular goods or services to the consuming public. A franchisor is no longer in the business of delivering product to the consumer. In a franchise system, this task falls on the franchisees. Rather, the franchisor is in the business of managing the development of the system, establishing and refining protocols to improve the quality of the goods and services that are now being provided by others, and protecting and promoting the brand in the marketplace. The skills sets needed by the people responsible for overseeing the system through rollout and beyond will in all likelihood be quite different than those who currently staff the prototype. While this is not necessarily so in all cases, a careful assessment must be made to determine whether or not existing personnel are up to the job.

These are some of the key issues you will need to assess through the feasibility study. As with any worthwhile undertaking, the more prepared you are, the more likely you are to achieve success.

✓ **How is the franchise relationship governed?**

The relationship between franchisor and franchisee is primarily contractual. The central document is the franchise agreement, which sets out in great detail the rights and obligations of the parties over the duration of their relationship. The franchise agreement is prepared by or on behalf of the franchisor and as such is generally protective of the franchisor's interests. Several of the key provisions of franchise agreements are discussed below.

- The granting clause establishes the bundle of rights granted to the franchisee and determines whether they are exclusive or non-exclusive in a particular geographical territory. Importantly, the granting clause normally reserves certain rights to the franchisor to, for example, offer the system's goods or services through other channels or under different trademarks within that territory.
- The franchise agreement defines the initial term of the relationship as well as any renewal terms that the franchisee will have the option, if certain criteria are met, to exercise. The length of the initial term should be long enough to allow the franchisee to recoup its investment and generate a profit and to establish the brand's presence in the territory but must be balanced against the franchisor's interest in generating renewal fees. Both the initial franchise fee and the amount to be paid upon renewal, or a mechanism for calculating that amount, will also be set out in the agreement. In addition, the agreement will determine the continuing royalties that the franchisee will have to remit to the franchisor, which entitle the franchisee to continue to use the franchisor's system and trademarks.
- Franchise agreements normally establish the parameters for the franchise's business premises. Responsibility for the various tasks associated with leasehold improvements and construction will be assigned to either the franchisor or the franchisee. In most cases, franchisor will want to retain the right to operate a franchise out of a given location if a particular franchisee proves to be unsuccessful. If the property is owned by a third party, the franchisor will often enter a head lease with the landlord and sublet the premises to the franchisee. This allows the franchisor to maintain the right to use the premises in the event the relationship with the franchisee is terminated for whatever reason.
- Performance standards are also set out in the franchise agreement, as well as the consequences for failing to meet those standards. These provisions are crucial to business format franchising. Consumer loyalty to a particular franchise lies in the consistent quality of the goods or services offered at every

outlet in the system. Franchisors therefore have a vital interest in maintaining that consistency.

- Training is an essential aspect of quality control. Thus, franchise agreements outline the training to be provided by the franchisor to new franchisees and any supplemental training that might be available. Franchisors normally offer initial training to franchisees free of charge. Franchisees are generally responsible for training their own employees.
- Advertising is an essential tool for the promotion of the brand. Most franchise agreements require the franchisee to contribute fees to the franchisor's advertising programs on an ongoing basis. The agreement usually spells out how the franchisor will use those contributions. The overall advertising burden is often allocated between the franchisor and the franchisee, with the franchisor being responsible for national or regional campaigns and the franchisee for local marketing efforts.
- To ensure the integrity of the brand, a franchise agreement will contain specific protections for the system's trademarks and commercial symbols. Franchisees are normally granted a non-exclusive, non-transferable licence to use those marks during the term of the agreement but only for the purpose of operating the franchise and only in accordance with the strict requirements of the franchisor.
- The franchise agreement also defines the franchisee's business record keeping and reporting requirements. Strict compliance with these obligations is crucial for a number of reasons. Accurate accounting and reporting provides the information the franchisor needs to calculate the royalties and advertising contributions that each franchisee must pay. It also allows the franchisor to monitor the health of all of the franchisees in the system.
- The consequences of default on the part of the franchisee of its obligations are specified with particularity in the franchise agreement. The right of the franchisor to terminate the agreement is perhaps the most important tool the franchisor possesses to maintain control over the system and its members. Not all defaults are equal and franchisees are normally given the opportunity to cure those that do not go to the heart of the relationship. The obligations of the parties after termination will also be spelled out, including the obligations of the franchisee to vacate the premises, to return all intellectual property to the franchisor and to not interfere or compete with the franchisor or other franchisees for a specified period of time.

These are just a few of the more important provisions contained in a typical franchise agreement. Other matters, such as those relating to system modifications, assignments and transfers, security over the franchisee's business assets and personal guaranties are dealt with either in the franchise agreement or other subsidiary agreements.

Franchise agreements are complex and comprehensive documents that are central to a franchisor's undertaking. We have the insight the legal expertise to craft a comprehensive franchise agreement suited to your particular needs.

✓ **What regulatory issues are involved in franchising my business?**

In addition to the laws of general application that pertain to all commercial activities, several provinces, namely Ontario, Alberta, Manitoba, New Brunswick and Prince Edward Island, have enacted specific legislation governing franchises. The legislation is not restricted to any particular sector or industry. Rather, it applies to all businesses that meet the statutory definition of franchise. The Ontario statute, the *Arthur Wishart Act (Franchise Disclosure), 2000* (the "Wishart Act") and the regulation made under it, set out the basic rights and obligations of franchisors and franchisees. Of primary concern to businesses considering expansion through franchising are the extensive disclosure obligations imposed by the legislation.

- Under the Wishart Act, a franchisor is obliged to deliver to a prospective franchisee a disclosure document at least 14 days before the franchise agreement or any other agreement relating to the franchise is signed by the prospective franchisee or any payment is made by the franchisee. This cooling off period allows a prospective franchisee to study the document in order to make an informed decision whether to purchase the franchise. The disclosure must be contained in a single document. Ontario courts have held that the failure to do so amounts to no disclosure at all.
- A franchisor must also deliver a statement of "material change" regarding any change that falls within the definition of that term and which occurs after the disclosure document is delivered but before any agreement is signed or money paid by the franchisee.
- The required content of the disclosure document is described in detail in the Wishart Act and the regulation. The disclosure obligations are extensive. Importantly, the disclosure document must include all "material facts", which the Act defines expansively to include any information regarding the business, operations, capital or control of the franchisor and its associates "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".
- In particular, the disclosure document must contain the following information:
 - the business background of the franchisor, including information about the length of time franchisor has been engaged in the line of business associated with the franchise and the length of time the franchisor has been involved with its current or any other franchise system;
 - the business background of the directors, general partners and the officers of the franchisor;

- a statement, including details, as to whether the franchisor, its associates or a director, general partner or officer of the franchisor has been convicted of fraud, unfair or deceptive business practices or the violation of a law that regulates franchises or business within the last ten years, has been subject to an administrative order or penalty imposed under a law of any jurisdiction regulating franchises or business or has been found civilly liable for misrepresentation, unfair or deceptive business practices or for violating a law that regulates franchises or business, including failure to provide proper disclosure to a franchisee, or if there are any pending proceedings involving those issues;
 - details of any bankruptcy or insolvency proceedings involving those and other enumerated persons in the last six years;
 - the franchisor's financial statements;
 - a list of all of the franchisee's costs associated with the establishment of the franchise, including the amount of any franchise fees and whether or not they are refundable, as well as estimates of any inventory, leaseing, leasehold improvement, rental and other costs necessary for the establishment of the franchise;
 - the terms and conditions of any financing that the franchisor might offer;
 - a description of the training that is offered or required by the franchisor;
 - a description of any advertising contributions the franchisee is required to pay;
 - a description of any exclusive territory granted to the franchisee;
 - the contact information for each existing franchisee in Ontario and certain information regarding those that have been cancelled, not renewed, reacquired by the franchisor or otherwise closed; and
 - a description of any restriction or condition relating to the termination or renewal of the agreement or transfer of the franchise.
- The disclosure document must also contain a signed and dated certificate certifying that it is complete and contains no untrue information, representations or statements. The courts have held that the failure to include a properly signed and dated certificate amounts to a failure to make the required disclosure.

The consequences of failing to comply with these disclosure obligations are significant. Under the Wishart Act, a franchisee can rescind the franchise agreement, in other words walk away from the deal, without penalty or obligation within the sixty day period following the receipt of a disclosure document if the disclosure document or statement of material change was not provided within the stipulated time frame or the disclosure document does not contain all of the required information. Further, a franchisee can rescind the agreement within two years after entering the franchise agreement if the franchisor never provided the disclosure document. If a franchisee validly rescinds a franchise agreement, the franchisor must, within 60 days, refund the franchise fee, purchase the franchisee's inventory and supplies if the franchisee was required to purchase them under the franchise agreement and compensate the franchisee for any losses incurred in acquiring, setting up or operating the franchise.

In addition, a franchisee that suffers a loss due to a misrepresentation contained in a disclosure document or a statement of material change or because of a failure to disclose the required information, the franchisee can sue the franchisor, its associates and other listed persons for any damages that flow from the misrepresentation. The Wishart Act deems a franchisee to have relied on such a misrepresentation.

In light of the interpretation Ontario courts have given the franchisor's disclosure obligations, the importance of complying with them cannot be overstated. Clearly, any plans for expansion through franchising could be thwarted at the outset by a poorly drafted or incomplete disclosure document.

✓ **Does existing franchise legislation impose other obligations on franchisors?**

Yes. The Wishart Acts establishes other rights and obligations for both franchisors and franchisees.

- The Act imposes on each party to a franchise agreement a duty of fair dealing in its performance and enforcement. The duty of fair dealing is defined to include the duty to act in good faith and in accordance with reasonable commercial standards.
- The duty of fair dealing has been variously interpreted to include an obligation on the part of the franchisor to exercise its powers under the franchise agreement in good faith and with due regard to the interests of its franchisees and, where the franchisor is given a discretion under the agreement, to exercise that discretion with proper motive and not arbitrarily, capriciously or in a manner that defeats the reasonable expectation of the parties.
- The statute also gives each party to a franchise agreement the right to sue for damages any other party that breaches the duty of fair dealing in the performance or enforcement of the agreement. This means that a franchisor

must be mindful of the interests of its franchisees when carrying out the terms of or when taking steps to enforce its rights under the franchise agreement. Any failure to comply with this duty could expose a franchisor to a lawsuit by affected franchisees. In such an action, the franchisee would not have to show any monetary loss flowing from the breach of the duty to be successful. That is, it would be sufficient to simply establish that the breach occurred to justify an award of damages.

- Although not an obligation imposed on franchisors, the Wishart Act does provide franchisees with a significant right that impacts a franchisor's ability to exercise control over the system. The statute specifically affords franchisees the right to associate and prohibits franchisors and their associates from interfering with, prohibiting or restricting with that right, by contract or otherwise. Any provision in a franchise agreement that purports to abridge the right is void. Further, franchisees have a right of action for damages against a franchisor or its associate for the breach of this right.
- This right allows franchisees to associate with each other to pursue whatever agenda they choose so long as the terms of their respective franchise agreements are honoured. Independent franchisee associations are becoming more prevalent in Canada and franchisors should expect them to become more active going forward. However, franchisors have been creative in meeting this challenge and have created other types of franchisor controlled organizations such as the franchisor advisory council that provide franchisees a voice in system affairs.

The practical scope of the duty of fair dealing has yet to be fully fleshed out by the courts. Similarly, the extent to which the right to associate will affect franchise systems remains unclear. However, it is safe to say that both have a significant effect on a franchisor's ability to conduct its affairs solely in accordance with what it considers to be in its best interests. Franchise agreements and disclosure documents must be crafted in ways that recognize these legislative requirements. Businesses that intend to pursue the franchise option must understand clearly that their desire to shape the system is, at least to some extent, constrained by these realities.