HOW TO START A FRANCHISE SYSTEM IN CANADA

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This paper answers commonly asked questions about setting up a franchise system in Canada.

1. What requirements should be considered before starting a franchise system?

There are a few basic requirements to starting a franchise system in Canada. It is important to start with a business that has: (a) an existing, proven and profitable operation, ideally at several locations; (b) distinctive branding (e.g. trade-mark, store design, standard products or services, etc.); and (c) standard methods of operation. The business should be organized to support its expansion and growth from financial and operational perspectives. In addition, a business owner should assess his or her capabilities to train, supervise and manage a group of franchisees.

2. What is a franchise?

A "franchise" is often defined as a business format method of distributing goods or services (or both) using an established trade-mark and a proven system of doing business. There are many different kinds of franchises, for example, restaurants, dating services, home inspection, home restoration, security systems, DVD sales and rentals, maid services, lawn care services, real estate brokerage, hotels, motels, travel agencies and pubs, just to name a few.

(a) What is a "trade-mark"?

Canada's *Trade-marks Act*[1] defines a "trade-mark" as: (a) a mark that is used by a person for the purpose of distinguishing or so as to distinguish wares [goods] or services manufactured, sold, leased, hired or performed by him from those manufactured, sold, leased, hired or performed by others; (b) a certification mark; (c) a distinguishing guise; or (d) a proposed trade- mark. A "proposed trade-mark" is a mark that is proposed to be used by a person for the purpose of distinguishing or so as to distinguish wares or services manufactured, sold, leased, hired or performed by him from those manufactured, sold, leased, hired or performed by others.

A trade-mark represents the franchisor's brand (identity) to the public and helps ensure a consistent image regarding the franchisor's goods and services. A franchisor must register its trade-mark(s) in Canada to ensure they are protected from potential claims by third parties.

(b) What is a "franchise system"?

The manner in which an owner operates his or her business is referred to as a "system". The system includes the owner's business format, marketing plan, trade-mark(s), methods, standards and operating procedures. When an owner decides to franchise his or her business, he or she becomes a "franchisor" and his or her business becomes a "franchise system".

Within a franchise system, a franchisor licenses use of its trade-mark and system to a franchisee who pays an initial fee for the right to join the system for a significant term, as well as an ongoing royalty usually

[1] R.S.C., 1985, c. T-13.

based on a percentage of revenue derived from operating the franchise, with the franchisee in return receiving training and ongoing support from the franchisor.

3. What are the advantages and disadvantages of franchising?

The following chart lists some of the advantages and disadvantages of franchising to a new franchisor:

Advantages	Disadvantages
– rapid expansion of the system with lower financial risk as franchisees are required to pay for initial construction and start-up costs of franchise locations	– the franchisor is obligated to comply with statutory requirements under franchise legislation in several provinces (see item 5 below) and the federal *Trade-marks Act*
– the franchisor generally requires fewer employees, resulting in reduced overhead costs and expenses per count, particularly for wages	– the franchisor has less control over the franchisees than it has had over its employees, as the franchisees are independent business owners
– franchisees are generally motivated to run a profitable business because of their personal investment in the franchise	– potential for lower profits if some franchisees are inefficient
– while the franchisees manage day-today operations, the franchisor can focus on strategic development of the system (e.g. new products and services, marketing, etc.)	– the franchisor must comply with its contractual obligations to the franchisees, which may result in restrictions to rapidly updating or changing the system to adapt to changes in the marketplace

4. What are the different types of franchising?

A franchise system may be established in one of the following ways:

(a) Unit Franchising

In the most common unit franchise system, the franchisor grants each franchisee the right to operate its franchise in a specific location and/or territory. This type of franchise allows a franchisor to maintain control over the franchisees and their locations.

(b) Area Development Franchising

Area development franchising is different than unit franchising, as a particular area developer is granted the right to establish several franchises within a defined area.

(c) Master Franchising and Subfranchising

In a master franchise situation, a franchisor grants a ‘subfranchisor’ the right to enter into separate franchise agreements with franchisees it selects and administers, within a specific territory. Initial fees and royalties paid by franchisees are split between the franchisor and subfranchisor.

5. What laws govern franchise relationships in Canada?

Five of the ten Canadian provinces, namely Ontario, Alberta, Prince Edward Island, New Brunswick and Manitoba, have passed franchise legislation. The legislation requires each franchisor to disclose to potential franchisees by "disclosure document" the information they need to make an informed decision on whether to purchase a franchise. While each province's franchise legislation differs somewhat, they all have three key elements:

(a) A franchisor is required to provide written disclosure of important facts to potential franchisees within a "franchise disclosure document";

(b) A duty of "fair dealing" in performance is imposed on both parties to a franchise agreement; and

(c) Franchisees have the right to associate with each other without interference from the franchisor.

British Columbia does not have franchise legislation at present, but is expected to have similar legislation sometime in 2016.

6. What documents govern the franchise relationship?

A franchise system will be established by a franchise agreement, operations manual and, where required by law, a franchise disclosure document. Additional documents may include a guarantee (maybe with collateral security), a software license agreement and a lease or sublease agreement. A brief description of each of these documents is as follows:

(a) <u>Franchise Agreement</u>

The franchise agreement is the contract between the franchisor and the franchisee that governs their franchise relationship, and outlines the rights and obligations of each of them. The franchise agreement grants the franchisee the right to operate a franchise using the franchisor's trade-mark(s) on specific conditions. A properly drafted, concise and comprehensive franchise agreement is critical to the success of the franchise system as it grows.

(b) <u>Operations Manual</u>

The operations manual contains the franchisor's standards for operating the franchise and the sale of goods and services.

It may also function as a training manual for new franchisees. For example, an operations manual may include: (i) a list of standard equipment and inventory; (ii) procedures for opening and operating the franchise; (iii) standards for cleaning and maintaining the interior and exterior of the franchised location; (iv) standard forms for processing orders and record keeping; (v) procedures for reporting sales and paying royalties and advertising fees to the franchisor; (vi) restrictions on the use of trade-marks; and (vii) guidelines for advertising and promotion of the franchise. The operations manual must be updated over time as the franchise grows and develops new products, services and methods of operating to ensure consistency of the franchise system.

(c) <u>Disclosure Document (not required in BC at present)</u>

The disclosure document must include information mandated by legislation which is needed by a prospective franchisee to make an informed decision about whether to purchase a franchise, as well as copies of the franchisor's latest audited or review engagement financial statements, its franchise agreement and related documents. If a franchisor fails to disclose any material information or documentation required by applicable franchise legislation, any franchise agreement that is signed between the franchisee and franchisor may be cancelled by the franchisee within 60 days of receiving the disclosure document, with all costs incurred and fees paid by the franchisee in establishing and operating the franchise to be reimbursed by the franchisor. (If a franchisor selling in a franchise legislated province failed to provide a disclosure document at all, the franchisee will have 2 years to cancel.) Disclosure documents must be updated regularly by the franchisor to ensure that all "material changes" about its system continue to be disclosed.

(d) <u>Guarantee</u>

If the franchisee is a corporation, a franchisor may require (as a condition of entering into the franchise agreement) that an individual or third party guarantee the obligations of the corporation. A guarantee is usually a separate contract.

(e) <u>Software License Agreement</u>

A software license agreement sets out the franchisee's rights and obligations regarding its use of the franchisor's software in an intranet and/or internet setting.

(f) <u>Lease or Sublease Agreement</u>

The franchisor may wish to enter in a lease of premises to be franchised directly with the landlord. If the franchisor does so, the franchise agreement will impose an obligation on the franchisee to sign the franchisor's form of sublease agreement. The sublease agreement passes on rights (in particular, the right of possession) and obligations of the franchisor under the lease to the franchisee, while allowing the franchisor to maintain a direct contractual relationship with the landlord.

7. What professional advisors are available to assist?

There are many professional advisors who may be qualified to assist a business owner who wishes to start a franchise system in Canada. Franchise consultants can provide advice from a business perspective, while lawyers specializing in franchise law can assist with understanding the legal requirements of starting a franchise system, as well as preparing a franchise agreement, disclosure document and related documents. When choosing a professional advisor, keep in mind these key criteria:

(a) experience of the potential advisor in franchising;

(b) recommendations from others who have used the services of potential advisors; and

(c) membership of the potential advisor in the Canadian Franchise Association.

The Canadian Franchise Association is a good source of information regarding franchising and professional advisors and may be accessed at www.cfa.ca.

For a free one-half hour consultation about setting up a franchise system legally, please feel free to call on me:

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