HOW TO START A FRANCHISE SYSTEM IN CANADA

John L. Rogers, Likewise Law

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. trademark, 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 trademark 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 "trademark"?

Canada's *Trademarks Act*[1] defines a "trademark" as: a sign or combination of signs that is used or proposed to be used by a person for the purpose of distinguishing or so as to distinguish their goods or services from those of others and "sign" is defined very broadly to include a word, a personal name, a design, a letter, a numeral, a colour, a figurative element, a three-dimensional shape, a hologram, a moving image, a mode of packaging goods, a sound, a scent, a taste, a texture and the positioning of a sign.

A trademark represents the franchisor's brand (identity) to the public and helps ensure a consistent image for the franchisor's goods and services. A franchisor must register its trademark in Canada to ensure it is protected from potential claims by third parties in this country.

(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, trademark(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 trademark 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 based on

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

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 some 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 or renovation 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 *Trademarks 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 is established in one of the following manners:

(a) Unit Franchising

In this most common type, the franchisor grants each franchisee the exclusive right to operate its franchise in a specific location and/or territory. In this way, a franchisor can maintain control over the franchisees and their locations.

(b) Area Development Franchising

Area development franchising is different than unit franchising, as it grants a particular area developer 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 itself to enter into separate franchise agreements with franchisees whom the subfranchisor selects and administers, within a specific territory. Initial fees and ongoing royalties paid by franchisees are split between the franchisor and subfranchisor.

5. What specific laws govern franchise relationships in Canada?

6 of the ten Canadian provinces, namely British Columbia, Alberta, Manitoba, Ontario, Prince Edward Island and New Brunswick have 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, all of them have three key elements:

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

(b) Duties of "fair dealing" and "good faith" in performance and enforcement of a franchise agreement is imposed on both parties; and

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

6. What documents govern the franchise relationship?

A franchise system will be established by a franchise agreement, operations manual and, where required by the 6 provinces noted in 5, a franchise disclosure document. Additional documents may include a guarantee by principals of a corporate franchisee, a collateral security agreement, a software license agreement and a lease or sublease agreement. A brief description of each of these documents follows:

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

A franchise agreement is the contract between the franchisor and the franchisee which 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 trademark(s) and system, on specific conditions. A properly drafted, concise and comprehensive franchise agreement is critical to the success of the franchise system as it is established and it grows.

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

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

The operations manual may also function as a training tool 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 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 trademarks; 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</u>

The disclosure document must include material facts mandated by legislation to permit 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 form of franchise agreement and related documents. If a franchisor fails to disclose in its disclosure document any material facts 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 it receiving the disclosure document. If a franchisor selling in a franchise legislated province fails to provide a disclosure document at all, the franchisee will have 2 years from signing the franchise agreement to cancel and receive its money back. Disclosure documents must be updated regularly by the franchisor to ensure that all "material changes" about its system continue to be disclosed.

(d) Guarantee

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 of the obligations of the corporation be provided. A guarantee is often a contract separate from the franchise agreement.

(e) Software License Agreement

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

(f) Lease or Sublease Agreement

The franchisor may wish to enter in a lease of franchise premises 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 can 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, it is important to keep in mind these key criteria:

(a) experience of the potential advisor in franchising;

(b) recommendations from others who have used the services of a potential advisor; 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. Membership is recommended.

For a free half hour consultation about setting up a franchise system, please feel free to call on me. I have over 30 years experience in franchising (see my website: www.likewise.law).

John L. Rogers 604-209-6451
john@likewise.law