

# Franchises

Intellectual Property & Technology

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## The Franchise Business by George Wowk

Franchise businesses are everywhere and their numbers continue to grow. It is difficult to drive down a street in a commercial part of a city without seeing a number of franchise businesses. For many individuals, franchises provide an enticing opportunity to own and operate one's own business. For the franchisor, selling a franchise provides an opportunity to expand the reach of the franchise system without being concerned with the day-to-day operations of the individual franchised business.

The purchase and sale of a franchise business can be a wonderful opportunity for both parties and at the same time can represent risks for both parties. Therefore, it is important for the parties to make an informed decision before entering into a franchise relationship and to ensure that an appropriate franchise agreement is in place.

## Nature of the Franchise Relationship

Very generally, a franchise is a business where one party, the franchisor, establishes the branding and the manner by which the franchised business is to operate and the other party, the franchisee, becomes responsible for the day-to-day operations of the franchised business. In exchange for being permitted to own and operate the franchised business, the franchisee will make periodic payments to the franchisor and comply with the franchisor's specific operating requirements. Usually, for any given franchise system, there will be one franchisor and many franchisees. As well, there is no reason a franchisor cannot own and operate one or more franchises.

It is through the consistent use of the franchise branding and the consistency in the offering of the products and services by all franchisees that significant goodwill in the marketplace is developed. This goodwill increases the value for both the franchisor and the franchisees.

## Types of Franchise Businesses

- **Fast food restaurants**
- **Full service sit-down restaurants**
- **Automotive services**
- **Automotive dealerships**
- **Employment and staffing**
- **Cleaning**
- **Coffee vendors**
- **Moving and storage**
- **Real estate brokerages**
- **Retail sales**
- **Fitness**
- **Health and beauty**
- **Security services**
- **Hotels**
- **Financial services**
- **Pest control**
- **Printing**
- **Education**
- **Dry cleaning**
- **Lawn care**
- **Weight control**
- **Dating and introductions**

## Benefits of the Franchise Relationship

A franchise system enables the franchisor to concentrate on developing and expanding the franchise system while not having the responsibility for the day-to-day operations of the franchise outlets. Each franchise outlet is typically owned and operated independently by a third party, the franchisee. This structure permits the system to grow significantly faster than it could otherwise.

From the franchisee's point-of-view, the franchisee is able to own and operate a business that may already have significant goodwill in the marketplace. As well, the franchisee is able to participate in a system that has already been proven to be successful. This removes a significant amount of the risk associated with starting up a business. Another benefit to the franchisee is the fact that the franchisor typically provides a significant amount of guidance to the franchisee in the day-to-day operations of the franchised business. Since the franchisor has already figured out what works and what does not work for the particular business, the franchisee will have the benefit of that information.

From the consumer's standpoint, a franchise system represents a known offering of goods and services, reducing the risk to the consumer of an unsatisfactory experience. As an example, consumers know exactly what they will be getting when they order a Big Mac at a McDonalds even though the customer may never have been at that particular McDonalds location. Consumers will also have comfort in other matters such as the standards of cleanliness and safety that are maintained by McDonalds.

## **Risks of the Franchise Relationship**

Of course, franchises have their risks. From the franchisor's point-of-view, one of the most significant risks arises from the loss of direct control over the manner in which the franchised business is operated. A single bad experience at a franchise outlet may result in a consumer refusing to visit every other franchise outlet in the future.

For the franchisee, there are also a number of risks and obligations. The most notable obligation is the ongoing payment requirement to the franchisor just for the right to operate the franchised business. These payments would not have to be paid if the franchisee started a business independently of the franchise system. However, these fees often represent the additional value to the franchisee due to brand recognition and the existing goodwill in the marketplace as well as the reduced risk through being able to own and operate a proven business model.

Another risk or limitation to the franchisee is that the franchised business must be operated within the strict requirements set by the franchisor. This may limit the modifications the franchisee may make to the product and service offering. This lack of control over the business may be a source of frustration for the franchisee as he or she may not be able to pursue available opportunities. However, most franchisors do provide for some flexibility, recognising that market conditions may differ from location to location. For example, McDonalds offers the McLobster in the Maritimes and the Ebi Filet-O in Japan, which is basically a burger made from shrimp.

Financial risk is certainly a potential for any franchisee. By signing a franchise agreement, the franchisee is making a long-term commitment to operate the franchised business. If the franchised business is not profitable for any number of reasons, the franchisee could suffer substantial losses over an extended period of time.

## **Franchise Legislation**

Currently only Alberta, Ontario and Prince Edward Island have franchise legislation, all of which is fairly similar and which simplifies compliance across Canadian jurisdictions. New Brunswick may soon adopt its own franchise legislation. Because there are some notable differences in the legislation, it is important to ensure that proper expertise is engaged.

Franchise legislation contains a number of specific obligations. Most notable among the obligations is the franchise disclosure document and the requirement that the franchisor deliver a franchise disclosure document to the potential franchisee. This is discussed in more detail further on in this publication.

Franchise legislation also contains a number of remedies for the franchisee in the event the legislation has not been complied with. Most notable is the right of the franchisee to cancel the franchise agreement and to be compensated for any damages the franchisee has suffered if the franchisor fails to deliver the franchise disclosure document within the prescribed time limits. As well, in the event the franchise disclosure document contains a misrepresentation, the franchisee will be entitled to compensation for any loss suffered as a result of the misrepresentation.



## When a Franchise Exists at Law

Given the requirements of franchise legislation and the consequences of failing to comply, it is important to know when franchise legislation applies to the relationship. Not all relationships will give rise to a franchise relationship. That said, the legislation is drafted fairly broadly, so it captures many types of relationships, even those that have not historically been considered to be a franchise relationship.

Under Alberta law, a “franchise” is defined to include a right to engage in a business (i) where goods or services are offered for sale in association with a trademark owned by the franchisor (ii) under a marketing or business plan prescribed by the franchisor and (iii) which involves ongoing financial obligations to the franchisor. If these elements are present then the parties are in a franchise relationship—it does not matter what the parties call the relationship or what the agreement states about the nature of the relationship. Once a franchise exists, the requirements of the legislation come into play.



## Franchise Disclosure Documents

As discussed above, one of the key requirements of franchise legislation is the requirement of the franchisor to deliver a franchise disclosure document to the potential franchisee. The franchise legislation sets out the information that is required to be included in the franchise disclosure document. This information includes: information about the franchisor, information about the franchised business, information about the products and services and information about the fees. There are some exemptions to the requirements of a franchise disclosure document.

A franchise disclosure document is also required to contain all material facts. A material fact includes any fact about the business, operations, capital requirements or control by the franchisor in relation to the franchised business where the fact, if known by the franchisee, would be expected to have a significant effect on the value of the franchised business being purchased or would have a significant effect on the decision by the franchisee to purchase the franchised business.

There are consequences for the failure to deliver a franchise disclosure document within the time limits prescribed and, in particular, the franchisee will have the right to cancel the franchise agreement and sue for any damages suffered. As well, in the event the franchise disclosure document contains a misrepresentation, the franchisee will be entitled to compensation for any loss suffered due to the misrepresentation.

## Franchise Agreements

The primary means of binding the franchisee and the franchisor in the franchise relationship is the franchise agreement. The franchise agreement contains the rights and obligations of the parties. Some of these agreements can be quite extensive.

Most franchisors will insist that the parties use the franchisor's form of franchise agreement. Not surprisingly, the provisions in a franchise agreement typically favour the franchisor. However, as with most agreements, they are open to some negotiation despite the franchisors' resistance to having their forms of agreements changed.

Often, the franchisee will be investing considerable time, effort and money in developing and running their franchised business. As well, the franchisee will likely be exposed to significant risk in the event the business does not work out. Therefore, it is important that an appropriate franchise agreement be in place from the franchisee's perspective.

From the franchisor's perspective, the franchise agreement needs to contain provisions that will protect the franchisor in the event the franchisee is not complying with all of the requirements of the franchise system. These requirements are there to ensure that the standards for services and products are maintained and that there is consistency between franchise outlets. Many franchise systems are extremely valuable and a single franchisee can create a significant amount of damage in a short period of time. Therefore, it is important that the franchise agreement properly protects the franchisor's interests.

While the terms of the franchise agreement generally favour the franchisor, a franchisee should take comfort that those terms will also apply to all other franchisees. Therefore, in the event another franchisee fails to operate in accordance with the requirements of the franchise system, the franchisor would have the ability to keep the franchisee in line. That, in turn, will serve to protect the value of the businesses of all franchisees. Think of the damage to the franchise system of a fast food restaurant if it become widely publicised that a single franchise outlet had a number of rats living within the premises.

## **Common Provisions of Franchise Agreements**

### **(i) Fees**

One of the more apparent obligations of a franchisee is the obligation to make ongoing payments to the franchisor. These payments come in a number of different forms. Usually, there will be a franchise fee paid at the time the franchise agreement is signed by the parties. As well, there will usually be an ongoing royalty fee which is usually calculated based on some percent of the gross revenue of the franchised business. As well, there may be a marketing fee, calculated in the same manner as the royalty.

The franchisor is generally entitled to keep the franchisee fee and royalty and use them in any manner it so desires. The marketing fee is generally treated differently and the franchisor is typically required to use the marketing fee, albeit with wide discretion, for marketing activities for the benefit of the franchise system. From the franchisee's perspective, the franchisee may want some assurances that some of the marketing fee it pays will benefit its own franchised business. This may not occur if, for example, the entire marketing fee is spent in some other territory.

### **(ii) Term and Renewal**

Many franchise agreements run from between 5 to 10 years before termination. As well, most franchise agreements will contain an option giving the franchisee the right to renew the franchise agreement for one or more additional terms. Some franchise agreements may be renewed indefinitely.

Obviously, at the end of the original term and all of the renewal terms, the franchisee must stop operating the franchised business. Therefore, it is important for the franchisee to negotiate the initial term and the renewals so that the franchisee will have sufficient time to operate the business to generate an adequate return to compensate for the risk assumed and for the investment of time, effort and money.

With the right of renewal, the franchise agreement usually sets out certain requirements that must be fulfilled prior to the renewal. These requirements may include, the payment of a renewal fee and carrying out repairs and updates to the premises of the franchised business. Sometimes, on renewal, the franchisor will be entitled to change the royalty amounts as well as other fees payable by the franchisee.

Often, in order to renew, the franchisee is required to give notice of renewal during a limited timeframe. If the franchisee fails to give notice during this timeframe, the franchise agreement will then terminate. Therefore, it is important for the franchisee to diarize these important dates.

### **(iii) Location and Relocation**

One of the prime considerations for a franchised business is site selection. The right location can make all the difference. Ideally, the franchisor should have some expertise in site selection and should provide assistance to the franchisee in this regard.

Once a site has been selected, the franchisee will have to negotiate a lease for the premises. The length of the lease should coincide with the length of the franchise agreement. This will ensure that the franchisee does not have to make ongoing lease payments when it does not have a business to operate or conversely, be without premises for the franchised business if the lease terminates before the franchise agreement.

Due to unforeseen circumstances it may be necessary to relocate the franchised business. For example, the existing premises may be damaged by fire or, the demographics of the location may change over time and the location may no longer be suitable for the franchised business. Therefore, it is important that the franchise agreement includes a means for relocation of the franchised business.

### **(iv) Territory**

One of the items often negotiated in a franchise agreement is the territory of operations of the franchised business. This may include an exclusive territory for the franchisee as well as restrictions on where the franchisee may offer its products and services.

An exclusive territory gives the franchisee the exclusive right to operate within a given area. The last thing a franchisee would want is for the exact same business to open up next door. The size of the exclusive territory will depend on a number of factors, including population density, traffic patterns, demographics and the type of business. While two Starbucks may be able to exist peacefully kitty-corner from one another, other franchised businesses may need the exclusive rights to an entire city. An example of such a franchise is a sports team.

On the other hand, the franchise agreement may confine a franchised business to a particular area. This may be done to prevent the franchisee from providing products and services in territories that have been or will be allocated to other franchisees.

### **(v) Inputs to the Franchised Business**

Most franchised businesses will need to purchase products and services as inputs. As an example, the ingredients used for menu items. In many cases, the franchisor will determine who is entitled to supply those products and services. The franchisor does this to ensure that the inputs to the franchised business meet required standards. In many circumstances, the franchisor may identify itself as the only supplier of certain products and services. Again, the franchisor does this to ensure quality. The risk to the franchisee is that the prices for these products and services may not be competitive.

**(vi) Operating Standards and Operating Manuals**

One of the recurring themes in this publication is the need of the franchisor to ensure consistency among franchise outlets. For this, the franchisor typically develops an operating manual. The operating manual will set out the details of the operating requirements of the franchised business, including, as appropriate, hours of operations, manner in which products and services are provided, processes to be followed, health and safety requirements and the like. If the franchisee fails to follow the operating manual, the franchisor may then have the right to terminate the franchise agreement.

**(vii) Construction and Updates**

Many franchise agreements contain provisions relating to the initial construction and development of the franchise outlet. These provisions will ensure that the premises of the franchised business comply with the design and layout requirements of the franchise system. This, in turn, ensures consistency among franchise outlets.

As well, over time, it may be necessary for the franchise system to evolve to keep the franchise system contemporary and in keeping with changes in consumer tastes. In order to do this, the franchisor needs to have the ability, from time to time, to force franchisees to update their premises and to purchase new equipment. As this may require significant additional investment by the franchisee, the franchisee should ensure that the additional investment required is reasonable and that the franchisee will see a return from this investment.

**(viii) Training**

Often the franchisor will provide training for new franchisees. Some of this may be provided in a traditional classroom environment and some may be provided at an existing franchise outlet. The training serves two purposes. Obviously, it will assist the franchisee in learning how to run the franchised business and it will also serve to promote consistency across all franchise outlets. Often there is a fee payable for training.

**(ix) Default and Termination**

One of the more contentious issues the parties may face in negotiating a franchise agreement are the particular circumstances in which the franchisor is entitled to terminate the franchise agreement. The obvious issue for the franchisee is that all of their investment in time, effort and money will be lost in the event the franchise agreement is terminated. As well, all future profit potential will be lost. From the franchisor's point-of-view, the franchisor needs to have the ability to terminate a franchise in the event the franchisee is not complying with operating and other requirements.

Clearly, the franchisor should not be able to terminate for a single trivial transgression. The particular circumstances which would entitle a franchisor to terminate is a matter for negotiation between the parties and is one of the more important matters to be addressed in the franchise agreement.

**(x) Obligations of Confidence and Non-Competition**

In many franchise systems, the franchisor will be providing the franchisees with a significant amount of valuable confidential information. This may include, for example, recipes for menu items and methods of doing business.



As such, most franchise agreements will contain provisions that prevent the franchisee from using or disclosing this confidential information except as necessary for the operation of the franchised business.

As well, during the course of operating the franchised business, the franchisee will likely have created a great deal of goodwill with customers. Therefore, most franchise agreements will contain non-competition provisions to prevent the franchisee from opening and operating a competing business after the franchise agreement terminates. This prevents the franchisee from redirecting customers to the competing business. Similarly, most franchise agreements restrict the franchisee from operating a competing business at the same time they are running the franchised business.

#### **(xi) Sale of the Franchised Business**

As with any business, the franchisee will likely want the ability to sell the franchised business at some point. Most franchise agreements contain restrictions on the ability of the franchisee to sell the franchised business. Of particular concern to the franchisor, is that it will want to make sure that the purchaser of the franchised business meets its criteria for a franchisee.

### **(xii) Personal Guarantees**

One of the more effective means that a franchisor has to ensure compliance with the franchise agreement is to require the owners of the franchised business to personally guarantee all of the obligations and liabilities of the franchised business. When the owner is personally liable, he or she is less likely to walk away from the franchised business and more likely to be attentive to the ongoing operations of the franchised business.

The obvious risk to the franchisee is that despite his or her diligent and best efforts the franchised business may still fail. When this occurs, not only will he or she lose all of the investment, but may also become personally liable for the debts of the franchised business. In a worse case scenario, the owner of the franchisee may lose his or her home, savings and other assets.

As a compromise, the parties will often agree on a limited guarantee, where the owner's personal liability is limited to some specific monetary amount. Often this will be enough to ensure that the franchisee operates in a diligent manner but, at the same time, will not be financially ruined if the franchised business does not work out. In many respects, it makes sense that the success of the franchised business be a shared risk rather than just the sole risk of the franchisee and the owner of the franchisee.

## **Summary**

Franchise legislation has been put in place in some provinces to protect the interests of franchisees. Primary among the protection provided is the requirement of the franchisor to deliver a franchise disclosure document to the potential franchisee. The intention of this requirement is that the franchise disclosure document will help the potential franchisee make an informed decision before purchasing the franchised business and investing a significance amount of time, effort and money.

The franchise relationship can be a fairly complex relationship due to the amount of control that a franchisor needs over the franchisee. This complexity is then reflected in the franchise agreement, making these agreements long and complex. The franchise agreement will typically address the various rights and obligation of the parties and allocate the various risks between the parties. The parties need to spend adequate time considering these risks and weighing the appropriateness of the various provisions contained in the franchise agreement.

A franchise can be rewarding for both the franchisee and the franchisor. The franchisor gains the opportunity to expand the franchise system while at the same time acquiring someone who is passionate about the business to look after the day-to-day operations. The franchisee gains the opportunity to own and operate a proven business and to participate in the related financial rewards.

# BD&P Intellectual Property & Technology Team

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