A Guide for U.S. Franchisors Entering the Canadian Market

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Franchisors from the U.S. are increasingly entering the Canadian market. Although some view Canada as a mere extension of the U.S. domestic market, there are some notable differences in Canadian business practises, and the Canadian legal framework for franchising. As such, it is imperative that franchisors understand the similarities and differences of the Canadian legal and business framework before entering the market.

Why Choose Canada?

Canada presents a stable, promising area of opportunity for American franchisors hoping to expand their operations. Among other attractive features, Canada has a well educated, highly-skilled workforce, with workers who have disposable income and spending patterns similar to Americans. Canada has undeveloped land, natural resources, extensive infrastructure of highways, railways, shipping lines, and telecommunications, all features that support and enable successful business operations. Canada is also generally receptive to foreign investment, with business practices and legislative trends that tend to follow those in the U.S. In short, while Canada is technically an "international market" for U.S. franchisors, it is also close enough to the U.S. market in so many ways that it would often make sense to choose Canada as the first foray into international franchising.

Jurisdiction over Franchising

Federal Legislation

Like the United States, governmental power in Canada is rooted in a system of federalism where powers are divided between federal and provincial levels of government. Even though the federal government has expressed no interest in regulating franchising, there is federal legislation related to franchising about which franchisors should be mindful. For instance, franchisors should be aware of federal legislation regarding intellectual property, such as trademarks, since a franchise relationship is essentially one where the franchisee licenses its trademarks from the franchisor. Further, federal regulation of competition, the equivalent to American antitrust law, is relevant to various activities in franchising, including price fixing, mergers, abuse of dominant position, tied selling, refusal to deal, exclusive dealing, market restriction, delivered pricing, and advertising practices.

Provincial Legislation

Given that contracts fall within provincial jurisdiction, as of the date of writing, five provinces, Alberta, Ontario, New Brunswick, Prince Edward Island, and Manitoba have enacted franchise legislation. All have come into force with the exception of Manitoba, which is expected to do so within the next year. The Ontario, Manitoba, Prince Edward Island, and New Brunswick statutes are wide-reaching in that they apply to any franchise to be operated in whole or in part in their respective provinces, whereas a franchisee must have some connection to Alberta, such as residency, in order to fall within the purview of the Alberta legislation. As of the date of writing, the five provinces without a franchise law are British Columbia, Saskatchewan, Quebec, Nova Scotia, and Newfoundland. So, unlike most countries in the world with franchise laws, there is franchise law in only some parts of Canada, and not other parts.

Common Law and the Civil Code

It is important for franchisors to note that the legal systems of all provinces in Canada, with the exception of Quebec, are based largely on a common law system. The common law is a system based on precedents created by historical and ongoing judgments of the courts. Both the United States and most of Canada have common law legal systems that emanate from Britain. Quebec has maintained a civil law tradition, using the *Civil Code of Quebec* ("Civil Code") to apply broad codified principles to particular situations. There is no specific franchise statute in Quebec, but the Civil Code does apply to franchising in general.

Protecting Intellectual Property in Canada

Trademarks

A trademark can be used in connection with logos, wares, trade dress, and trade name, among others. Registration is the best way to protect trademarks, and franchisors should file an application in Canada as early as possible to preclude another party from registering or using those marks. An application may be filed on the basis of intent to use, or if the trademark is used and registered in a country that is a treaty partner with Canada. Canada is a relatively inexpensive country when it comes to protection of trademarks, and that cost is certainly minimal compared to the costs of recovering a trademark that has fallen into the wrong hands.

Passing Off

A common law cause of action for passing off may be available to protect a trade name, trade dress, or other trademark-like rights even where the trademark owner has not registered the mark, or to protect an overall look that may not be readily protected through a trademark registration.

Copyright

Copyright can subsist in works such as advertising materials, operating manuals, computer software, graphics and design marks. Under the Canadian *Copyright Act*, the owner of an original literary, dramatic, musical or artistic work is given exclusive rights of production, reproduction, performance, and transmission, among others of that work. Registration is not necessarily required in Canada, and this protection extends to unregistered works created in the U.S.

Patents

Although not a common issue in franchising, registration of inventions can provide a statutory monopoly over any new and useful inventions. Franchisors should be mindful of the fact that these protections vary across countries, and that something subject to a patent in the United States may not be subject to the same protection elsewhere.

Trade Secrets: Confidential Information

Franchisors should ensure that techniques, formulas, recipes, processes and compilations of technical information are not revealed to competitors. The common law protects trade secrets if the information disclosed has the necessary quality of confidence, was disclosed in circumstances where the recipient knew or ought to have known that the information was disclosed for a limited purpose, and was used for a purpose other than that for which it was disclosed. Generally, confidentiality provisions are essential terms for any franchise agreement.

Registering Domain Names

Aside from ".com", Canada has the ".ca" top-level domain name in extensive use. These domain names must be registered with the Canadian Internet Registration Authority and are handled on a first-come, first-served basis. It is advisable for American franchisors to protect their principal names through early registration of Canadian domain names.

Choosing a Structure

Direct Franchising from the U.S. into Canada

Direct franchising from an American resident franchisor to Canadian single-unit franchisees is still a very common method of cross border franchise expansion, but likely becoming less common. This structure is more costly, and might subject the U.S. resident to a non-resident withholding tax, where the franchisee will have to remit to the Canadian income tax authorities a prescribed percentage of the amounts paid or credited to a non-resident franchisor as rent, royalty or a similar payment, including the initial franchise fee. Applicable tax treaties might reduce tax payments to 10% of the amount to be paid. Some franchisors lessen this tax burden by "grossing up" the amount otherwise payable by the Canadian franchisee, however this strategy is not well received by franchisees, since they bear the cost of lowering the franchisor's tax obligations.

Master Franchising, Area Development, and Area Representatives

Master franchising, area development, area representatives and hybrid arrangements are all becoming more common as multi-unit vehicles for international expansion of a franchise system. And, it is no different when the expansion being contemplated is to Canada.

Under a master franchise agreement, a franchisor grants a "master franchisee" a territory within which to sub-franchise to third parties. This structure might result in a certain loss of control for a franchisor and an additional party with whom profits and royalties must be shared. However, it is beneficial to a franchisor because the master franchisee can act as a local, self-sufficient party who organizes franchise recruitment, site selection, construction and operational support.

Under an area development agreement, a franchisor grants a franchisee the right to open franchises within a defined territory over a fixed period of time. Generally, these agreements do not allow for the franchisee to sub-franchise to third parties. However, they allow the area developer to operate units and fulfill some franchisor functions. Franchisors should carefully select this franchisee to ensure successful completion of these important functions.

Although less common at present, area representative arrangements are increasingly being used. In these arrangements, the franchisor will still enter into franchise agreements directly with the franchisee, but enlist more involvement and assistance from local area representatives. This method is beneficial to the franchisor because it can retain control while shifting responsibility (for example, in marketing efforts) to the area representative in exchange for a percentage of royalties payable by the unit franchisees.

Joint Venture Franchising

A joint venture franchise is a contractual structure where each venturer, usually the franchisor and the local partner, makes a contribution for a single common purpose, usually a local entity. Any of the multi-unit structures described above might have joint venture ownership. That being said, it is not a commonly used approach.

Canadian-Based Subsidiary of Affiliate

Using a Canadian subsidiary or affiliate corporation as the franchisor is sometimes a tax-efficient way to enter Canada. Incorporation can be done in any province or at the federal level. Some provinces may be chosen because they do not require Canadian residents as directors, while most provincial corporations do require at least one Canadian resident director. Franchisors may also want to consider incorporating a special purpose unlimited liability corporation ("ULC"), which can only be done in Alberta, British Columbia and Nova Scotia. ULCs can desirable for several reasons. ULCs allow American investors to claim Canadian-based loss against U.S. taxable income or claim a foreign tax credit for Canadian taxes paid by the ULC in the investor's U.S. tax return. However, ULCs are costly and their tax benefits depend on tax treaty obligations. They may also not be most desirable if the US franchisor wants to keep its profits in Canada and have them taxed at Canada's current corporate tax rates, which are lower than those in the U.S.

The key is for any U.S. franchisor to get competent tax and other corporate before starting the expansion, so that the structure chosen and built is as tax efficient as is possible.

Franchisor/Franchisee Relationships in Canada

Qualification as a Franchise Relationship: Contracts and Statutes

In all of Canada, as in the U.S., the franchise relationship is a contractual one where the agreement between the parties determines their rights and obligations. In those provinces with a franchise law, the legislation dictates what is considered to qualify as a franchise relationship. Based on the expansive definition of a "franchise" under the provincial statutes, there are likely many existing relationships that, unbeknownst to the parties, fall within the definition of a franchise. So while "dealers", "distributors", and various "licensees" may not consider themselves franchises, under the Canadian provincial franchise laws, they may very well be. This is in addition to the very typical "business format" franchise that is commonly understood to qualify as a franchise.

Good Faith Requirement

All provincial franchise statutes provide for a statutory duty of good faith and fair dealing by both the franchisor and the franchisee, and, except for Alberta, explicitly state that the duty includes a duty to act in good faith and in accordance with reasonable commercial standards. The common law has confirmed these good faith obligations but clarified that a franchise relationship is not a fiduciary one, and therefore franchisors are not required to act selflessly and with undivided loyalty on the interest of their franchisees. Overall, franchisors must act promptly, honestly, fairly and reasonably. As long as they have regard for the legitimate interests of their franchisees, franchisors can act in their own self-interest.

Employment Relationship

Canadian law is more generous in terms of severance and notice requirements, and franchisors should enlist legal advice on whether their franchise relationships could be considered an employment relationship (as opposed to independent contractor), thereby placing severance and notice requirements on the franchisor at contract termination. In some cases that are now well over 20 years old, franchisors were found to be employers because they exerted such total control over their franchisees that the relationship was seen as one of employment and not as a contract between independent contractors.

Quebec

Special consideration must be given to franchising in Quebec, in part because of the Civil Code. First, the Civil Code includes the duty of good faith between parties to all contracts. Franchisors should therefore exercise a degree of restraint in competing with their franchisees, so that the benefits and advantages of the franchisee are not denied. Second, a franchise agreement might be classified under the Civil Code as an “adhesion contract”, where essential, non-negotiable provisions are imposed by one of the parties. If any provisions of this type of agreement are incomprehensible or unreadable for a reasonable person, abusive, or considered to be “external clauses”, they may be nullified or changed by a court. Lastly, business dealings in Quebec are mainly in French, and customers and employees may insist (and have a right to insist) that they be permitted to conduct their daily business in French. If this is problematic, franchisors could make use of master franchising or area developers to expand to Quebec.

Disclosure Requirements

All regulated provinces require franchisors to provide the prospective franchisee with a franchise disclosure document before granting the franchise. The disclosure document must be delivered at least fourteen days prior to the earlier of the parties' entry into any agreement relating to the franchise or the prospective franchisee's payment of any consideration.

The provincial franchise laws require that franchise disclosure documents contain all “material facts”, which casts a net beyond the U.S. disclosure requirements. There is little judicial guidance, but the Ontario *Act* defines material facts as "any information about the business, operations, capital or control of the franchisor or franchisor's associate, or about the franchise system, that would reasonably be expected to have a significant impact on the value or price of the franchise to be granted or the decision to acquire the franchise.” Franchisors should obtain local Canadian legal advice on the issue of material facts, and what is required to be included in a Canadian disclosure document.

It is not advisable to use a U.S. disclosure document in Canada, since the Canadian requirements are different enough that courts in Canada have already stated that a U.S. disclosure document is not adequate. It is also not advisable to put a wraparound document containing jurisdiction specific information on a U.S. disclosure document since the costs and benefits of doing so are not significant when compared to the legal risks.

All of the franchise statutes provide for limited exemptions where disclosure documents are not required. But they are limited in availability, and must be used only with caution.

One important difference between Canadian and U.S. franchise laws is that none of the provincial franchise statutes require “registration” of the franchisor or the franchise disclosure document. On the other hand, each franchise law in Canada provides to franchisees various rights to rescind the franchise agreement, and/or sue for statutory damages, if the disclosure requirements are not met. Again, because of the remedies available to franchisees in the disclosure law provinces, knowledgeable Canadian franchise counsel is key.

Leasing of Premises

Historically, it was a very common practice in Canada is for the franchisor to first lease the business or retail premises, and then to sublease them to the franchisee. The benefit is that, under this structure, the sublease and royalty payments are deemed to be rent, permitting franchisors to exercise remedies usually available to landlords, such as the right of physical re-entry and termination without court sanction, in the event of non-payment of rent. However, this also results in contingent liability attached to holding leases. So, it is becoming a less common approach.

So, Canadians are beginning to follow the U.S. example in allowing franchisees to directly lease the premises from the landlord. In that case, a franchisor will want to obtain some right to enter the premises and assume the lease in the case of a default by the franchisee as tenant.

Equipment and Supply Issues

Franchisors should be aware that depending on the nature of the items, franchisees may face challenges in importing proprietary equipment, inventory or supplies into Canada. It all depends on what is being imported. So investigation is critical. Further, franchisors should draft their franchise agreement and disclosure documents to account for volume purchases, rebates, and discounts, and to account for whether the franchisor will make a profit on the sale of these items to franchisees.

Taking Security

Franchisors can take a security interest in the franchisee's assets to protect themselves in the event of default on payment. Canadian provincial security interest legislation has mandated that security interests are given priority based on registration and perfection. Franchisors should consider the probability that their interests will be subordinated to those of the franchisee's primary lender.

Moving Forward

Overall, franchisors should keep all of the above considerations in mind when entering Canada. Wherever possible, franchisors should "push" into the market" by first developing a detailed, strategic entrance plan. That being said, many U.S. franchisors first have and continue to decide to enter Canada because of interest expressed in their brand by an entrepreneurial Canadian, resulting in the American franchisor being "pulled" into the market. In either situation though, the franchisor needs to understand that Canada is sufficiently similar to make it an easy entrée to international expansion, but sufficiently different to require proper legal, consulting and accounting advice before embarking on such a plan.

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